Conclusion and Future Directions

9.1 The Approach of the Book

The primary aim of this book was to advance and extend the scope of current discussions on the law relating to derivative actions. The book attempted a fundamental rethink of the content of the derivative action and its objectives. It expressed a view of the derivative action’s grand mission in order for it to meet corporate governance realities and address the concerns of a swiftly changing corporate world. It clarified the nature of the action and the circumstances where its application might be deemed propitious, and identified problems that might arise in the pursuit of the derivative action. It explained why the derivative action retain an important role in policing management in closely held corporations and argued that the action has a role to fill in the context of both private and public companies.¹ The book also examined closely the scope of the new statutory derivative action and the procedural framework for the application to leave as introduced by Pt 11 of CA 2006. It critically assessed the reform plans, looking in particular at major possible obstacles. The discussion was geared toward providing the reader with critical tools to assess the likely impact of these reforms. Most regrettably, it was shown that these reforms do not advance a new policy for when and, more important, for what purposes, the action should be utilized, nor will these reforms be likely to provide the derivative action with a more adequate role than previously held. The book then focused on and examined the conditions that might produce positive inducements to litigate. It expressed a view on what might be the optimal level of such litigation with a view to enhancing the potential effectiveness of the action as a controlling mechanism, and proposed means to assist in achieving that level. Crucially, the book strongly linked the actual viability of derivative actions to funding mechanisms, namely developing adequate means to fund derivative actions so as to make them worthwhile financially. Otherwise, it is submitted, the entire discussion on derivative actions will remain academic. Finally, the book showed that the derivative action has sufficient relevance to merit independent existence, as the benefits of retaining

¹ As discussed above in Introduction under 4, Ch 5 under 5.3.2, 5.4.4.1(a) and (c), and Ch 8 under 8.2 and 8.3.7.
the derivative action would clearly outweigh the gains from dispensing with the derivative action in favour of a single form of action under the unfair prejudice remedy.²

9.2 The Proposed New Framework

The book calls for action on three complementary levels, namely, conceptual—the adoption of a new framework in the guise of the Functional and Focused Model (FFM) to govern derivative action litigation; strategic—the employment of appropriate incentives and fee rules which advance the premises behind the FFM; and maintaining doctrinal consistency—by clarifying the interaction between the derivative action and the unfair prejudice remedy.

At the conceptual level, the book advocates the introduction of the FFM. Its core idea can be best expressed in the negative. Some may argue that litigation is just another corporate asset—no more, no less. It is not. At least when serious breaches of duty involving directors are at stake, the derivative action is a mechanism of corporate accountability. Admittedly, it is an imperfect and flawed mechanism, but so are most others. The FFM is an attempt to preserve this mechanism of accountability and to address its major flaws in the context of both private and public companies. The FFM likewise acknowledges the unique structure and features of the derivative action, for example, the fact that it is only through satisfying the court’s requirements that the claimant earns the right to bring the action. This is a unique procedure which otherwise does not, normally, exist in civil cases. The FFM does not place its primary reliance on courts or litigation. Instead, its starting premise is that litigation is a fail-safe remedy, a safety net for instances when other mechanisms of accountability fail. Under the FFM, the derivative action is essentially confined to those instances which can be best described as ‘functional’ and ‘focused’. It is functional, for the derivative action should be used only if it serves one of its prime functions, namely deterrence and compensation. This means that the model highlights the functional logic behind the derivative action. This ‘functional’ aspect of the inquiry also involves closely harnessing the derivative action to the corporate interest it represents by inviting the court to consider the public character of the norms raised by the derivative action as set out above, so that the action is more likely to be viewed as an instrument that affirms desirable norms in the corporate setting. The framework that the model developed is also ‘focused’ in the sense that the litigation should be focused on: (1) those areas or instances in which other mechanisms of accountability fail; and (2) the nature of the inquiry conducted in court as set out above by the FFM. In essence, this defines when the safety net is needed. The case for shareholder intervention is based on the value to shareholders of having

² CA 2006, s 994 (formerly CA 1985, s 459).
this ‘weapon of last resort’ which could benefit them both in the rare instances in which it would be actually used and, more importantly, in the instances in which its mere existence would induce management to act in shareholders’ interests. Given that shareholders will not constantly use the power to intervene even if it is available, they should not be practically deprived of the power ever to intervene.

Turning to the strategic level, the book calls for the employment of appropriate fee rules which advance the premises behind the FFM. The book examined and assessed four financial strategies to resolve the funding problem. Although it is still early days, the book concludes that the current introduction of conditional fee agreements backed by insurance is an inadequate response to the need to protect claimants from costs in the context of derivative action litigation. Also, with the two-way fee-shifting system, the allowance of the conditional fee agreement offers only a partial solution to the problem of over-deterrence, as a losing party will remain liable for the opposite party’s costs. Unless some sort of mechanism is to supplement this, conditional fees are not likely to make much of an impact on derivative action litigation. Similarly, making a mandatory requirement for the company to pay the costs of litigation may provide more security to shareholders, but ultimately may not alter the perverse incentives of potential derivative action litigants.

By contrast, rewarding claimants in monetary terms by providing them with part of the proceeds of a successful derivative action may bolster the incentives of potential derivative action litigants. In the short term and until US-style contingency fees are allowed in the UK, this may prove to be the most beneficial way towards resolving the funding problem. It is also straightforward and easy to implement. But, in the long run, unless the American type of contingency fee agreements together with supporting mechanisms are adopted to the English system (accompanied by proper safeguards as proposed above), it is unlikely that any reform will make the remedy more accessible. This will make litigation far more likely because it means that no individual shareholder need invest the emotional resources or time usually needed to pursue litigation, let alone the financial resources. This is clearly also warranted by an understanding that contingency fee agreements are more compatible with derivative actions as well as more advantageous than indemnity costs orders or conditional fees agreements. Instead of reinventing the wheel, the book calls for the UK to adopt a US model for derivative actions and see whether over a 10-year period the benefits are clearly outweighed by any evils that may be perceived in that time. If so, one of the major hurdles to the use of derivative action as highlighted by the FFM, that of financing the litigation, can be lifted.

Finally, at the doctrinal level, the book showed that the benefits of retaining the derivative action would outweigh the gains from dispensing of the derivative action in favour of a single form of action under the unfair prejudice remedy. This could, ultimately, leave a gap in the enforcement apparatus of corporate
governance. Be that as it may, the book calls for the restoration of the necessary doctrinal consistency and clarity with respect to the interaction between the two remedies. The book examined and assessed two strategies that may be employed for that purpose. These strategies not only may help preserve the derivative action and enhance its roles as explained above, but could simultaneously enhance the capabilities of other mechanisms of accountability, not least the unfair prejudice remedy, as members may be encouraged to bring this claim rather than the wide-ranging proceedings under the unfair prejudice remedy, and accordingly this will shift some of the burden from that remedy.

On the whole, the FFM developed in this book offers a methodologically organized and conceptually inclusive approach to thinking about derivative actions in general. It seems to have accomplished a threefold objective. First, it responds to and, indeed, fills the critical shortcoming of the academic literature on derivative actions by providing a theoretical structure of derivative action as a law enforcement mechanism in the corporate governance context. Equally important, the FFM advances a conceptually analytic framework and offers insights that, taken together, provide the requisite underpinnings for policy analyses of the derivative action. Finally, the FFM sets guidelines for designing effective regulatory measures where derivative actions are used to enforce the law.

A final note of caution must be sounded. The author believes that the real novelty in the project of this book is that it shows and deals with the challenges facing the derivative action as a coherent whole. And, more importantly, it argues that these challenges should be tackled simultaneously—by adopting a comprehensive set of strategies, each designed to respond to different sets of problems it presents. Herein lies the key aspect of understanding the aim of this book. The attitude taken in this book is that although there is no doubt that each of the above three components is capable of being introduced independently, one cannot look at individual problems in isolation, but should instead survey the entire landscape, and examine and repair the derivative action in its entirety. If this approach is followed, it is likely that the derivative action will be perceived as a potent threat that may operate on the minds of those involved in corporate governance and, over the long run, may change their values and the ways in which they go about their tasks. This will also mean that it is likely that future discussions on derivative actions will not remain solely academic (at least under English law).

9.3 Beyond This Book: Future Directions

Madison has been cited as saying that ‘some degree of abuse is inseparable from the proper use of everything’.

and corporate malpractice. The law has not eliminated these, nor will derivative actions or any other mechanism of corporate governance. But there will be cases where the derivative action proves to be justified as a mode of redressing serious corporate abuse. Against this backdrop, it is hoped that the theoretical inquiry developed in this book contributes towards the aim of providing a new conceptual framework for subsequent discussions and directions for the future study of derivative actions in English law. This book, though conceived of and executed as a self-standing project, can be regarded thus as the first part of a work in progress. A number of further avenues of research relevant to subject study of this book, both law-in-the-books and law-in-practice, could be envisaged.

A first avenue of research relates to the question whether derivative actions could be the subject of contractual means of resolution such as arbitration. Naturally, shareholder litigation is not intended, and indeed it was argued in this book should not be, the exclusive platform for resolving shareholder disputes. There is certainly room for private contractual ordering in shareholder relations and contractual methods of dispute resolution between shareholders. One such method is through the use of arbitration or alternative dispute resolution to resolve shareholder disputes. In the US, for instance, where the contractarian approach is more widely accepted, modification of the derivative action by allowing derivative grievances to be arbitrated in lieu of a derivative action in court has become acceptable. As was explained in this book, the right for a shareholder to take derivative action performs the purpose of checking majority abuse of the company and is thus a public good provided by regulation which otherwise would not be left to private bargain. The limitations of arbitrability in issues in company law involving public interest or equities would support the thesis that a contractual form of dispute resolution such as arbitration would inherently not be able to deal with matters arising under the mandatory/prohibitory aspects of company law. Like others, therefore, this author believes that this area of law is more mandatory/prohibitory in nature and should not be contractually waived or modified. However, there is room to consider that the form of action in derivative actions need not be proceedings in court, as the underlying contract between the company and the third party may envisage other means of dispute resolution.

The following is by no means an exhaustive list.


See, for example, Modernising Company Law (CM 5553-II) (2002) para.2.36.


IH Chiu, above n 5.

ibid 338.
One major criticism that could be levelled at the book is that the conclusions would have been more persuasive if use had been made of empirical evidence and survey data to indicate current social opinion regarding derivative actions and whether the public is likely to increase its appreciation for this type of litigation, particularly in light of the publicly regarded reasons offered in the text. Indeed, this would have been highly desirable. And, some evidence of this nature has been included in Chapter 2. This chapter draws in parts, for example, on studies in social psychology (mainly conducted by Robert Cialdini) and some empirical evidence (mainly from the US). However, in order to go beyond what this book offered to do, it would have been necessary to have more than what is provided by current studies and data on enforcement and social norms. Robust empirical evidence or experimental data is rare. There is also the problem that empirical litigation studies remain subject to selection bias and other limitations. Overall then, given that legal science is in its infancy when it comes to cultural or psychological elements, a fully fledged discussion would have been both extremely complex and largely speculative. It follows that a second, and possibly most promising avenue of research, would be to look into these intriguing issues. For example, much more knowledge is needed on the effectiveness of compensation rules or liability standards.

A third avenue of research relates to the causes and determinants of regulatory interventionism. For example, as was highlighted elsewhere, it is unclear why the US is litigation-oriented when it comes to shareholder protection, whereas other jurisdictions are interventionists when it comes to board structure or substantive group law, but adopt a laissez-faire approach when it comes to enforcement mechanisms, such as litigation. In this context it would be interesting to know more about the role of litigation in a system where capital markets are much less liquid than in the UK.

A fourth and related avenue of research, which was highlighted in Chapter 1, relates to the fact that different mechanisms for dealing with agency cost problems may be used in different legal systems. For instance, it has been suggested that although the US and the UK have similar legal systems that share a common origin, their common history may be less important than the fact that they have developed quite different mechanisms for dealing with the same ‘agency cost’ problems that in the end achieve functionally similar results. It will be therefore

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12 ibid 222.
13 Under 1.4.
interesting to have a genuinely comparative treatment which explained, for instance, why Delaware law is much more litigation-orientated than English law is, and how important the Takeover Code has been (and likely to be in light of recent reform) in the UK context in providing a substitute for a more litigation-centred company law system. Another alternative to such a law-centred system is to rely on gatekeepers, that is, on professional agents who will monitor management and alert shareholders as to opportunistic behavior by their managers.¹⁶ This system works less based on litigation or even private contracting and more based on bonding and reputational capital, seeking to detect and prevent problems before they become crises.¹⁷

Finally, a more general avenue of research will be to examine how, and to what extent, the effective protection of shareholders is linked with other variables, such as contract law, civil procedure, questions of legal effectiveness, as well as social, economic, and cultural differences. It has been suggested that these aspects will be taken into account in future econometric studies.¹⁸

¹⁶ See the recent contribution of JC Coffee to this ‘blind spot’ in the literature on corporate governance in Gatekeepers: The Professions and Corporate Governance (OUP 2006), where he advances hypotheses as to why gatekeepers have recently failed investors and suggests models for reform.

¹⁷ ibid 9.

¹⁸ As part of a promising project on ‘Law, Finance and Development’ at the Centre for Business Research, University of Cambridge, UK. This project aims to consider the mechanisms by which legal institutions shape national financial systems, so as to identify the implications of legal reform for economic development. It is an interdisciplinary project which combines qualitative and quantitative research methodology to yield a uniquely complete set of empirical results. The first of a series of papers on this subject was published shortly before the final draft of this book has gone into publication. See PP Lele and MM Siems ‘Shareholder Protection: A Leximetric Approach’ (2007) 7 JCLS 17.