Margit Vutt

Magister iuris,
Analyst of Legal Department, Supreme Court

Shareholder's Derivative Claim — Does Estonian Company Law Require Modernisation?[*1]

1. Shareholder of a public limited company — merely an investor or also a vigilant guard?

Whether and to what extent a member or shareholder should be able to influence the organisation as a whole is one of the most general conceptual issues in the development of company law provisions.[*2] The nature and protection of shareholders' rights are closely related to the question of whether and to what extent shareholders as the providers of certain resources to the company should have the right to check the use of these resources.[*3] One of the ways to answer this question is that a shareholder's rights with respect to the company should indeed be limited, because a public limited company is led by the directing bodies (directly or indirectly) elected by the shareholders and the company should be protected from shareholders' excessive interference. This approach is based on the premise that a shareholder is, first and foremost, an investor — they deliver funds to the company, expecting to gain profit over time. On the one hand, the directors of a company are relatively independent agents acting in the interests of the shareholders; on the other hand, the shareholders should have some kind of control over the directors.[*4] To counterbalance the agency theory, it is stressed that a shareholder should be interested in the functioning of the company as a whole and this interest should not be limited to financial aspects, as the company's assets belong to an independent person — the public limited company.[*5] However, it is a common view these days that in well-organised corporate governance, the shareholders, as the company's residual claimants[*6] should have at their disposal an effective means of influencing the company's

1 The article was published with support from ESF grant No ETF7297 "Theoretical Bases of the Harmonisation of Main Institutes of Civil Law in Europe and Its Impact on Civil Law and Lagislation in Estonia".

2 M. Habersack. Die Aktionärklage – Grundlagen, Grenzen und Anwendungsfälle. – Deutsches Steuerrecht 1998/14, p. 533.

3 T. Laurer. US – Corporate Governance während einer feindlichen Übernahme – oder "der Revlon Auslöser". – Zeitschrift für Vergleichende Rechtswissenschaft. Archiv für Internationales Wirtschaftsrecht. 103. Band. August 2004, p. 317.

4 K. M. Eisenhardt. Agency Theory: An Assessment and Review. – Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance. T. Clarke (ed.). Oxon 2004, p. 79.

5 E. Ferran. Company Law and Corporate Finance. New York 1999, p. 315.

6 A residual claimant is a person whose right to receive back the sum invested in the company is granted in the last order, after the claims of all (other) creditors have been met.

activities when necessary.[*7] For example, it is noted in Winter's report[*8] that as shareholders focus on wealth creation, they are very suited to act as "watchdogs" who act not only on their own behalf, but also on behalf of other stakeholders. It has been noted in legal literature that in response to the rather extensive powers of the directing bodies, restoring the role of the shareholders has recently come to light again in Europe, amongst other things in legal regulation.[*9] Protection of shareholder rights has also been stressed in various European Union documents as a priority area.[*10]

Where a majority shareholder finds that a member of a directing body of the company has infringed or is infringing his or her obligations, the shareholder can usually respond to the situation, at a minimum, by replacing the member of the directing body and thus ensuring the possibility of claiming damages on behalf of the company. A minority shareholder's possibilities to influence the directing bodies are minimal. In most Member States of the European Union (including Estonia), the law vests special protective rights in shareholders representing a certain amount of share capital; such rights include the right to call the general meeting, to request a special audit, and other minority rights.[*11] These are some of the most common ways for minority shareholders to intervene. The shareholders' right to claim damages on behalf of the company from a member of a directing body is a much less common legal remedy, which is not available under the company law of all countries. Usually it is the Anglo-American legal system that affirms the possibility of the shareholders' derivative claim, while in continental Europe the attitude to the permissibility of such intervention has been rather reserved.

The extent of harmonisation of company law has varied greatly in different areas; the main priorities in the protection of shareholders' rights have concerned the holding of general meetings and voting issues (such as the extension of possibilities of distance voting), also the right to receive information.[*12] Even so, shareholders' intervention is now more regulated in many European countries than in Estonia. Major changes have also lately taken place in the regulation of derivative claims in the UK law, which is part of the Anglo-American legal system.[*13] Thus, convergence is noticeable when it comes to the protection of shareholders' rights in the European Union, while the nature of the convergence is horizontal rather than vertical.

The objective of this article is to analyse the nature of derivative claims of shareholders' of a public limited company and the provisions and judicial practice concerning this legal remedy in various legal systems, particularly as exemplified by the USA, UK, and Germany. The subject is topical, amongst other reasons, because Germany has also gradually transposed and improved the regulation of derivative claims, while Estonia used the German example when devising the two-step management structure of public limited companies. The article seeks an answer to the question of whether Estonian company law would require modernisation, as the rights of shareholders, including minority shareholders, are being enhanced in Europe.

2. Concept and meaning of derivative claim

There is a contract-like relationship under the law of obligations between a member of a directing body and the company; of all the existing types of contracts, this relationship stands closest to an authorisation relationship.[*14] Therefore, a member of a directing body will primarily have obligations to the company as the quasi-mandator. The legal remedies arising from an obligation (including rights of claim) are, however, rela-

7 P. Ireland. Company Law and the Myth of Shareholder Ownership. – International Themes in Business Law. S. Hardy, M. Butler (ed.). Vol. 2. Part III: Shares and Ownership, Shareholders. London 2007, p. 43.

8 Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company law in Europe. Brussels, 4.11.2002. Available at http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf (21.11.2008).

9 L. Timmerman, A. Doorman. Rights of Minority Shareholder in the Netherlands. – Electronic Journal of Comparative Law, December 2002/6.4. Available at http://www.ejcl.org/64/art64-12.pdf (21.11.2008).

10 E.g., Commission of the European Communities. Communication from the Commission to the Council and the European Parliament. Modernising Company Law and Enhancing Corporate Governance in the European Union — A Plan to Move Forward. Brussels, 21.05.2003. COM(2003) 284 final. Available at http://www.ecgi.org/commission/documents/com2003_0284en01.pdf (21.11.2008); Directorate General for Internal Market and Services. Consultation on Future Priorities for the Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union. Available at http://ec.europa.eu/internal_market/company/docs/consultation/consultation_en.pdf (21.11.2008), etc.

11 About the different types and threshold of minority rights, see L. Timmerman, A. Doorman (Note 9).

12 M. Kotkke. Harmonisierung der internen Struktur von Aktiengesellschaften – die europäische Empfehlung zur Unabhängigkeit der Direktoren und zu den Ausschüssen. Dissertation zur Erlangung der Doktorwürde. Augsburg, 2007, pp. 54–55. Available at http://deposit.d-nb.de/cgi-bin/dokserv?idn=987381342&dok_var=d1&dok_ext=pdf&filename=987381342.pdf (21.11.2008).

13 Canada, Australia, New Zealand, and the UK have now regulated the issue by law instead of the former common law regulation. See, e.g., A. Steinfeld, M. Mann, R. Ritchie *et al*. Blacktsones Guide to The Companies Act 2006. Oxford 2007, p. 103.

14 The Supreme Court has understood the relationship between a management board member and the company in the same way. See CCSCd 26 April 2005, 3-2-1-39-05. – RT III 2005, 15, 155 (in Estonian).

tive — they pertain not to everyone, but to a specific person — the other party to the obligation.[*15] In the same way, this right can usually be exercised only by the other party to the obligation (the entitled person), which is why in a situation where a member of a directing body infringes his or her obligation and causes damage to the company, it is the company that is entitled to assert a claim. However, a legal person is an artificial subject of law created by law,[*16] which acts via its directing bodies, and this principle may preclude the assertion of a claim against a member of a directing body, if there is no mechanism to eliminate the infringer's possibility to influence the assertion of the claim. This problem arises especially sharply in the conflict between minority and majority,[*17] because a majority shareholder can influence the violator (at least theoretically) via control of directing bodies. In addition, positive law usually creates a mechanism that takes the decision over the assertion of a claim "one step higher" (in the event of a two-step management structure, to the competence of the supervisory board or general meeting).

Due to the above, the company laws of many countries have extended the shareholders' right of interference and, in certain circumstances, allowed shareholders representing a certain proportion of share capital to file a claim for compensation in the courts against a member of a directing body who has infringed his or her rights. Such a legal remedy has been also called *actio pro socio* in legal literature. In the event of *actio pro socio,* a claim is not filed directly to protect the claimant's own right, but also the right of others (who are connected to him or her under company law or otherwise).[*18] Therefore, the nature of the rights being protected differs from the rights protected by one's own claim: a derivative claim is mainly aimed at protecting the company's interests, while a shareholder's personal claim is only aimed at protecting the shareholder's own financial interests.[*19] There is also a distinction based on whether the shareholders can only decide over the assertion of a claim or can actually file the claim independently. The latter case is the classic derivative claim: the claim is brought by a shareholder or shareholders, not by the company (via a representative elected by the shareholders), although it is the company which is sought to be compensated.[*20]

Although the guarantee of shareholders' rights should be considered important, it has been mentioned in legal literature that giving shareholders an easy possibility of claim could lead to a situation where groups of displeased shareholders would disturb the company's operations with their constant claims and thus reduce shareholder value.[*21] This is why the possibilities for such claims are limited even in those legal orders that allow for derivative claims.

3. Legal regulation of derivative claims in the company law of various countries

As mentioned above, different legal orders have different approaches to the position of shareholders in a company and hence the legal remedies afforded to them. It has even been argued in literature that the degree of protection of shareholders' rights varies a great deal depending on the legal system or family of law. A group of economists led by Rafael La Porta, Florencio Lopez-de-Silanes, and other authors have noted in their series of articles titled "Law and Finance",[*22] which evoked responses from many legal scientists, that common law countries offer better shareholder protection than continental Europe.[*23] It is, of course, true that in German company law, the structure of directing bodies is mainly based on the theory of independent

15 H. Köhler. Tsiviilseadustik. Üldosa (Civil Code. General Part). Tallinn 1998, pp. 30–31, marginal 11 (in Estonian).

16 For more details about the content of the legal subjectivity of a legal person in private law see K. Saare. Eraõigusliku juriidilise isiku õigussubjektsuse piiritlemine. Doktoritöö (Delimitation of the Legal Subjectivity of a Legal Person in Private Law. Doctoral Thesis). Tartu 2004 (in Estonian).

17 A limited liability company inevitably entails sources of conflict between different types of interest groups, and the second most common conflict besides that between the owner and the manager is the conflict of interests between majority and minority shareholders. For detailed discussion, see H. Hansmann, R. Kraakman. Agency Problems and Legal Strategies. – The Anatomy of Corporate Law. A Comparative and Functional Approach. R. Kraakman *et al*. (ed.). Oxford 2004, p. 21.

18 C. Griebler. Die zivilrechtliche und strafrechtliche Haftung eines geschäftsführenden Organs einer Tochtergesellschaft bei „upstream securities" im Konzern nach schwedischem und nach deutschem Recht. Dissertation zur Erlangung der Doktorwürde. Bremen 2006, p. 52.

19 M. Habersack (Note 2), pp. 533–535.

20 *Ibid.*, p. 533.

21 See D. Bradford. Shareholder Derivative Suits: A Growing Concern for Corporate Directors and Officers. – Advisen. Insight for Insurance Professionals, July 2005. Available at http://www.cnapro.com/pdf/ShareholderDeriviativeSuits_Advisen.pdf (21.11.2008).

22 R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R. Vishny. Law and Finance. – Journal of Political Economy, December 1998 (106) 6. Available at http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/publications/LaPorta%20PDF%20Papers-ALL/Law%20and%20Finance-All/Law%20and%20Finance.pdf (21.11.2008).

23 U. C. Brändle. Shareholder Protection in the USA and Germany — "Law and Finance" Revisited. – German Law Journal 2006 (7) 03, pp. 257–278.

supervision, according to which an independent supervisory body is considered to be the best protector of the company's interests.[*24] Udo Brändle has criticised the position of La Porta *et al*. and noted that although German company law has been somewhat more modest in allowing shareholders to intervene, one should not forget that shareholders representing 10% of the share capital were able to decide on the assertion of a claim on behalf of the company already before the aforementioned study was published.[*25]

The main source of company law in the United Kingdom is the Companies Act 2006[*26] (CA 2006), Part 11 of which governs derivative claims. These provisions were recently modernised: according to the amendments that entered into force on 1 October 2007, the former principle of admissibility of proceedings, which originated from the *Foss v. Harbottle* case, was replaced by a more flexible approach that allows for more rational and clearer identification of a shareholder's right to file a derivative claim.[*27] The pre-reform check of admissibility of proceedings was based on two premises: firstly, the underlying violation had to be not approvable by a majority decision, and secondly, the violator's control of the company had to prevent the assertion of the claim.[*28] The latter principle meant that where a majority of shareholders, independent of the violator, accepted the situation, a derivative claim was not admissible.[*29] This is why *Foss v. Harbottle* did not allow for the actual protection of minority shareholders' interests.[*30] As a result of the reform, CA 2006 provides that any shareholder may file a derivative claim regardless of the number of shares held by him or her, regardless of the nominal value of the shares and of when he or she acquired the shareholding. A claim can be filed against any current or former member of a directing body, as well as against a shadow director[*31]. The spectrum of violations in which case a derivative claim can be filed is also quite wide — both intentional and negligent breaches, and breaches of both duty and trust.[*32] At the same time, doubts have been expressed in connection with the reform about whether such extension of shareholder rights together with the newly introduced express obligation of the directors to act in the best interests of the company would not lead to an excessive activism of shareholders and jeopardise the business judgement rule as the main guarantor of the directors' independence.[*33]

In German company law, it is, as a rule, up to the supervisory board to decide on a claim against members of the management board (§ 111 of the *Aktiengesetz*[*34] (AktG)); filing a claim for compensation for damage resulting from a breach of the duties of supervisory board members is within the competence of the management board (AktG § 78).[*35] In addition, AktG § 147 allows the general meeting to decide on the filing of a claim against members of a directing body: according to subsection 1 of the aforementioned section, the general meeting usually decides on the filing of such a claim by simple majority.[*36] A claim has to be filed with a court within six months of the general meeting's decision. According to AktG § 147 (2), the general meeting may appoint a special representative of the company, if necessary, for the assertion of the claim. Such regulation has been in force in Germany for a long time, while German company law has lately also taken a considerable step toward extending the rights of shareholders.[*37] After intensive discussions[*38], the *Bundestag* adopted on

---

[24] A. F. Conard. The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law. – Michigan Law Review 1984 (82), pp. 1464–1467.

[25] U. C. Brändle (Note 23), pp. 272–273.

[26] Available at http://www.opsi.gov.uk/ACTS/acts2006/ukpga_20060046_en.pdf (21.11.2008).

[27] B. Hannigan. The Derivative Claim — an Invitation to Litigate? – Hannigan and Prentice: The Companies Act 2006 — A Commentary. B. Hannigan, D. Prentice (ed.). Butterworths, London: LexisNexis 2007, p. 65.

[28] It should be noted that common law also considers the company itself the first most appropriate plaintiff in the event of a claim for damages against a director.

[29] There were a few exceptions to this general rule, for example the majority's protection was precluded in the event of a fraud against the minority.

[30] G. Morse. Charlesworth's Company Law. G. Morse, S. Girvin *et al.* (ed.). 17th edition. London 2005, pp. 337–338.

[31] The Estonian law is not familiar with the concept of a shadow director; the closest institute, with certain reservations, is constituted by the persons influencing the activities of a public limited company as specified in § 289^2 of the Commercial Code, whose liability was set out by an amendment to the Commercial Code that entered into force on 1 January 2006. It is planned to extend this regulation to the provisions governing private limited companies. In English law, the legal status of a shadow director has quite specific content. See, e.g., G. Morse (Note 30), pp. 269–270.

[32] B. Hannigan (Note 27), p. 76.

[33] *Ibid*., p. 68.

[34] Aktiengesetz vom 6. September 1965 (BGBl. I S. 1089), zuletzt geändert durch Artikel 11 des Gesetzes vom 16. Juli 2007 (BGBl. I S. 1330). Available at http://bundesrecht.juris.de/bundesrecht/aktg (21.11.2008).

[35] W. Bayer. Aktionärsklagen *de lege lata* und de *lege ferenda*. – Neue juristische Wochenschrift 2000/36, p. 2613.

[36] This provision governs not only claims for compensation for damage against members of a directing body, but also against founders and other persons, e.g., persons who have contributed to damaging the company intentionally or by gross negligence upon transfer of assets to the company upon the company's foundation (AktG §§ 46 and 47). The regulation also governs ex-post incorporation (AktG § 53).

[37] M. M. Siems. Welche Auswirkung hat das neue Verfolgungsrecht der Aktionärminderheit. – Zeitschrift für Vergleichende Rechtwissenschaft. Archiv für Internationales Wirtschaftsrecht. 104. Band. August 2005, p. 376.

[38] G. Spindler. Haftung und Aktionärsklage nach dem neuen UMAG. – Neue Zeitschrift für Gesellschaftsrecht 2005/21, p. 865.

15 June 2005, an act regulating the integrity of companies and the modernisation of the right of contestation (*Gesetz zur Unternehmensintegrität und Modenisierung des Anfechtungsrechts*[*39]), which entered into force on 1 November 2005, and has been called the most important reform of the German company law since 1965.[*40] Among other things, the act supplemented *Aktiengesetz* with § 148, under which shareholders representing the certain amount of share capital are entitled under certain conditions and in lieu of the company to assert claims for compensation for damage against members of directing bodies.

In order to file a claim, the shareholder or shareholders are required to represent 1/100 of the share capital or hold shares corresponding to € 100,000 of capital. After a claim is filed, its admissibility is first assessed. As the first prerequisite of admissibility, the shareholders must have acquired the qualifying shareholding before they learned about the underlying circumstances of the claim. This is to prevent later acquisition of shares for the purpose of asserting a claim. Secondly, it has to be proved that the shareholders have, during a reasonable time, unsuccessfully requested the company itself to file a claim for damages. Thirdly, there have to be circumstances justifying the suspicion that the company has been damaged by gross violation of law or the articles of association or by unfair play, and fourthly, the claim must not be contrary to the company's interests or constitute an excessive burden on the company. According to AktG § 148 (4), if the court has found the claim to be admissible, the claim has to be filed within three months after the entry into force of the court's decision. Further simultaneous disputes by other shareholders or the company itself are precluded. Also important are the rules, according to which a decision made in such a proceeding is binding on both the company and all of its shareholders, and a listed company has to disclose the admissibility of the claim and the result of the proceedings.

This indicates a trend toward enhanced shareholder protection in the two influential European countries that offer principally different legal solutions in company law as well as several other fields of private law. When assessing the importance of the German reform, we should take into account, among other things, the special structure of German public limited companies: the formation of a supervisory board is a rather indirect way for even majority shareholders to exercise influence.[*41]

Of the non-European countries representing the Anglo-American legal system, the Delaware General Corporation Law[*42] is an example of minimal legal regulation of shareholders' derivative claims; § 327 of the Law only provides for the basic rule: in any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law. The conditions and procedure for derivative suits is addressed in more depth in the US Model Business Corporation Act, §§ 7.40–7.47 of which stipulate the exact prerequisites and limitations of such actions and the procedure rules.[*43]

The example of French law should be pointed out from continental Europe. Article L225–252 of the *Code Commerce*[*44] provides for the shareholders' right to bring an action for liability on behalf of the company against its directors or managing director; further representation requirements apply to listed companies under article L225–120 (individual shareholders cannot file a claim; the rate of representation varies slightly depending on the size of the company's share capital).

Thus, it may be said that the possibility of filing a derivative claim is nowadays one of the statutory remedies of shareholders in a large number of countries.

---

[39] Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts v 22.09.2005. Bundesgesetzblatt Jahrgang 2005, Teil I, Nr 60. Available at https://www.ebundesanzeiger.de/download/bgbl105s2802.pdf (21.11.2008).

[40] G. Spindler (Note 38), p. 865.

[41] AktG § 96 provides for five different methods of setting up a supervisory board depending on whether and to what extent the rules of employee involvement apply to the company; in many public limited companies, only a minority of supervisory board members are appointed by shareholders. Employee involvement is regulated in Germany mainly (but not only) by the Employee Involvement Act: *Gesetz über die Mitbestimmung der Arbeitnehmer* (Mitbestimmungsgesetz) vom 4. Mai 1976 (BGBl. I S. 1153), zuletzt geändert durch Artikel 18 des Gesetzes vom 14. August 2006 (BGBl. I S. 1911). Available at http://www.gesetze-im-internet.de/mitbestg/index.html (21.11.2008).

[42] Available at http://delcode.delaware.gov/title8/c001/index.shtml (21.11.2008).

[43] Model Business Corporation Act Annotated. 2005. 4th edition. Available at http://www.abanet.org/buslaw/committees/CL270000pub/nosearch/mbca/assembled/20051201000001.pdf (21.11.2008).

[44] *Code de Commerce* (Commercial Code). Last amendment: Act No. 2006-11 of 5 January 2006 Art. Official Journal of 6 January 2006. Available at http://195.83.177.9/code/liste.phtml?lang=uk&c=32 (21.11.2008). The provisions discussed in this paper are from the year 2001, so that the English wording can be used regardless of the older version.

4. Judicial practice in derivative claims and related issues

The main economic problem concerning derivative claims is the reduction in shareholder value as a result of a dispute. From the legal-economic viewpoint, a shareholder would rather be encouraged to sell his or her shares if the shareholder's rights are violated, and not burden himself or herself and the company with a time-consuming lawsuit. The US insurance corporation Advisen Ltd.[*45] has analysed the decisions taken in derivative actions during the period 1993–2005, and found that there is an upward trend in the number of derivative action rulings. About half of derivative actions end with decisions in favour of defendants. Only few cases result in monetary relief, while the values are typically relatively low; however, the company always incurs huge legal costs. Therefore, it has been opined that derivative claims and related lawsuits benefit only the legal advisers involved.[*46]

One of the questions that arises in company law, time and again, is to what extent the values of company law (which are largely material values, though with a much broader meaning) should be protected by private law remedies, and whether the provisions of other branches of law, especially penal law, should be used to solve certain problems.

Franklin Gewurtz has conducted an in-depth analysis of two remarkably similar cases of director's liability from two countries representing different legal systems — the United States and Germany.[*47] In both cases, such large severance payouts were made to directors that it caused doubts as to the legitimacy of the payouts. The US case studied was In *re The Walt Disney Company Derivative Litigation* in the Delaware Chancery Court as the court of first instance and the Delaware Supreme Court as the court of appeal.[*48] The shareholders of Disney brought a derivative action and demanded compensation from directors for the damage done to the company by the payment of an excessive severance payout to one of the directors.[*49] As a result of a lengthy and arduous litigation, the court decided that there was no ground for compensation, because the company did not actually suffer loss.

The compared German case was the case of *Mannesmann*, in which the members of the supervisory board awarded and paid an excessive bonus to an outgoing director and criminal proceedings were brought against them on the grounds of breach of fiduciary duty (*Untreue*).[*50] It should be noted here that similar grounds were introduced to the Estonian Penal Code[*51] by an amendment that entered into force on 15 March 2007; § 217^2 (1) of the Penal Code now defines abuse of trust as illegal use of the right arising from law or transaction to dispose of assets of another person or assume obligations for another person, or violation of an obligation to comply with the financial interests of another person if such act results in major damage but does not contain the necessary elements of an embezzlement.[*52]

The Düsseldorf County Court, as the court of first instance, found that the directors were indeed in breach of their duty when awarding the bonus, but as according to the law, breach of fiduciary duty means causing significant damage to another person's financial interests, and the company was making a profit at the time of the award and the breach did not damage the company's financial situation, the act of the directors did not contain the necessary elements of *Untreue*. The German Supreme Court (*Bundesgerichtshof*) did not agree with the position of the court of lower instance and found that *Untreue* does not necessarily require significant damage to the company's financial interests.[*53] The case was referred back to the county court, but an agreement was reached before the case was heard again: namely, the directors agreed to pay a sum of € 5.8 million and the case was closed.

---

45 About the background of the New York-based Advisen Ltd., see their Web site https://www.advisen.com/company.html (21.11.2008).

46 D. Bradford (Note 21).

47 F. A. Gewurtz. Disney in a Comparative Light. SSRN Electronic Paper Collection. 26.02.2007, pp. 1–38. Available at http://ssrn.com/abstract=965596 (21.11.2008).

48 Decision of the Delaware Supreme Court of 8 June 2006. In *re The Walt Disney Company Derivative Litigation* No. 411, 2005. Available at http://courts.delaware.gov/opinions/(wqdsib55g41l31ajtaxpls55)/download.aspx?ID=77400 (21.11.2008).

49 If we compare the directing bodies of an American public limited company with a company with a two-step management structure, the board is rather like the supervisory board and the Chief Executive Officer is a director who manages daily operations. About the management structure of US companies in greater detail, see M. Vutt. Aktsiaseltsi juhtimismudeli õiguslik reguleerimine. Magistritöö (Legal Regulation of the Management Model of a Public Limited Company. Master's Thesis). Tartu 2006, pp. 27, 32–33 (in Estonian).

50 Decision of the Federal Supreme Court of 21 December 2005: BGH (*Bundesgerichtshof*), 21.12.2005 – 3 StR 470/04. – Neue Juristische Wochenschrift 2006, p. 522.

51 Karistusseadustik. Adopted on 6.06.2001. – RT I 2001, 61, 364; 2007, 31, 187 (in Estonian).

52 According to § 201 of the Penal Code, embezzlement means illegal conversion by a person into his or her use or the use of a third person movable property which is in the possession of another person or other assets belonging to another person which have been entrusted to the person.

53 § 266 (1) of the German Penal Code (*Strafgesetzbuch*) generally defines breach of fiduciary duty as the abuse of another person's right to dispose of property (regardless of the legal basis of disposal) or the abuse of the duty to consider another person's proprietary interests and thereby causing damage to the other person's proprietary interests.

Gewurtz reached an interesting result when comparing the two cases: although the application of director's liability (especially when initiated by shareholders) seemed, at first glance, to be easier under the law of Delaware, it was the German case that ended with a decision deploring the directors' award of the excessive bonus, while the directors of Disney were fully exonerated regardless of their not exactly best practice of corporate governance, as referred in the court decision.[*54] Gewurtz found that such a result may be partly due to different types of proceedings: on the one hand, government prosecutors may well enjoy greater credibility than plaintiffs' attorneys, who make a business out of bringing derivative suits on behalf of shareholders; on the other hand, the criminal court is less experienced in matters of civil law, especially company law, which is why there is less space for discretion from the viewpoint of the business judgement rule.[*55] In any case, the example described above leaves the impression that the German criminal court disregarded the warning that in the event of directors' decisions, a negative consequence (in this case, reduction of the company's assets, although its financial status did not suffer) does not automatically imply mismanagement.[*56] In legal terms, both the directing body's mistake and the damage have to be proved separately.

Gewurtz correctly notes that the absence of civil law alternatives or major obstacles to the application of such alternatives render criminal prosecution the only realistic alternative of exercising one's rights.[*57] It is questionable whether such one-sidedness of legal remedies is correct and serves the interests of a company's stakeholders. The author of this article believes that penal mechanisms cannot be overestimated and that one remedy cannot fully replace another.

It may be concluded from the above that also in the countries where derivative actions have been regulated for a long time, actual lawsuits and the application of directors' liability are not especially common.[*58] Nevertheless, or perhaps even because of that, the legislatures of various countries have attempted to instead enhance the rights of shareholders. It is therefore justified to ask whether Estonian company law could benefit from new solutions.

5. Would Estonia need modernisation of shareholder rights and the legalisation of derivative claims?

The Estonian Commercial Code (CC) provides for a limited competence of shareholders of public limited companies. CC § 298 (1) lists the competence of the general meeting in nine points and adds, as the tenth point, that the general meeting is competent to decide on other matters placed in the competence of the general meeting by law. A general meeting may adopt resolutions on other matters related to the activities of the public limited company on the demand of the management board or supervisory board (CC § 298 (2)). This is the "non-interference" principle, the aim of which is to ensure that a company as an independent legal person acts independently of its shareholders; among other things, it also means subjection to the "majority decides" rule.[*59] The situation where a company can act without judicial, and also without excessive legislative interference, has been considered to be a guarantee of the company's continuity.[*60] Voting at the general meeting would then remain a shareholder's basic possibility to express his or her wishes and attitudes.[*61]

According to CC § 317 (8), the supervisory board shall decide on the conduct of legal disputes with members of the management board and shall appoint a representative of the company for the conduct of such disputes. In the creation of the Estonian legal framework for companies, it has been considered sufficient that the role of the supervisory board as an autonomous supervisory body ensures (especially if the supervisory board members are independent) an appropriate mechanism for filing a claim against a member of the management board. It is the general meeting of shareholders which is competent to decide on the filing of a claim against

[54] It has been mentioned in literature that the court clearly distinguished between "making a bad decision" and "damaging the company", which indeed is not the same from the company law viewpoint. See: The rights and wrongs Ovitz. – Economist, 13 August 2005 (Vol. 376 Issue 8439), pp. 50–51 (Academic Search Premier).

[55] F. A. Gewurtz (Note 47), p 37.

[56] F. H. Easterbrook, D. R. Fischel. The Economic Structure of Corporate Law. Cambridge 1998, p. 99.

[57] F. A. Gewurtz (Note 47), p. 36.

[58] Even in the USA it is noted that shareholders' democracy is a myth rather than reality. See, e.g., Keeping shareholders in their place. – Economist 13 October 2007 (Vol. 385 Issue 8550), pp. 69–70. (Academic Search Premier). Available at http://www.economist.com/business/displaystory.cfm?story_id=9961252 (21.11.2008).

[59] R. Redmond-Cooper. Management Deficiencies and Judicial Intervention: A Comparative Analysis. – International Themes in Business Law. S. Hardy, M. Butler (ed.). Volume 2. Part III: Shares and Ownership, Shareholders. London 2007, p. 155.

[60] J. Rickford. Fundamentals, Developments and Trends in British Company Law – Some Wider Reflections. First Part: Overview and the British Approach. – European Company and Financial Law Review, December 2004 (1) 4, p. 402.

[61] G. Morse (Note 30), p. 337.

a supervisory board member, but since the law prescribes a majority requirement, the possibility that a 10% shareholder could assert such a claim is almost zero.

This problem has similarities to German law: Manuel Rene Theisen and Wolfgang Salzberger noted in 2002, that since World War II, not a single civil claim for damages had been asserted against a member of a supervisory board in Germany.[*62] At least one of the reasons for this undoubtedly lies in the supervisory board's specific role in the two-step management structure of a public limited company. As daily operations are managed by the management board, it is the management board's activity that influences the company's status either positively or negatively. It may thus be assumed that shareholders are probably not so much interested in gaining control of the supervisory board as they are interested in asserting claims against members of the management board.

In summary, it may be said about Estonian company law that the Commercial Code protects shareholders mainly by an *ex-ante* strategy[*63]: the few existing remedies are aimed at preventing breaches rather than responding to the consequences of breaches. At the same time, application of the *ex-ante* or preventive strategy requires a majority-based influence on the directing bodies of a company, which is why it is usually not available to minority shareholders.

An analysis of the judicial practice of claims against members of directing bodies of companies in Estonia shows that such claims are filed mainly in bankruptcy proceedings.[*64] It is quite difficult to establish and prove the evidence on which a claim is based (especially the damage and the causation), and proceedings often end in a compromise.[*65] The specific nature of bankruptcy proceedings is inevitably transferred to the litigations held on behalf of a bankrupt company: as such proceedings are held with limited resources, the result may largely depend not only on the legal justification, but on whether the creditors of the bankrupt company have the possibilities and desire to "support" the litigation of a claim. Considering that creditors have already incurred damage due to bankruptcy and are not likely to risk further damage, claims for damages against members of a directing body have little success when the company is bankrupt.

This leads to the hypothesis that if the law provided for an adequate mechanism for earlier intervention, it would be somewhat easier to establish the grounds of the claim, because the difficulties of asserting a claim are certainly influenced by the complicated causal chains, which are created over a longer period and under various economic influences, and the mutual relations of which are much more difficult to establish once the company is insolvent.[*66]

Mentioned above were penal law measures as an alternative to civil liability, which is why this issue should also be discussed in the context of Estonian law. The explanatory memorandum to the draft amendment to the Penal Code[*67], which introduces the necessary elements of abuse of trust, states: "Abuse of trust is an offence against property which consists in the illegal use of the right to dispose of another person's assets or to assume obligations for another person, or violation of the duty to comply with another person's financial interests, if such act results in major damage to such other person. For the purpose of these necessary elements of offence, major damage is to be incurred by the person whose financial interests the offender was to comply with, i.e., by the person whose trust is abused. The necessary elements of the offence are limited to major damage, since, as a rule, disputes arising on the basis of the right of representation could be settled by civil proceedings. […] The wording of the necessary elements of the offence follows, among others, the examples of the German and Swiss civil codes (the German StGB § 266 and the Swiss StGB § 158)".

The necessary elements of abuse of trust in Estonian law are thus limited to the extent of damage — only an act resulting in major damage is regarded as abuse of trust. According to § 8 (1) of the Penal Code Implementation Act[*68], damage exceeding one hundred times the established minimum monthly wage is major damage.

---

62 M. R. Theisen, W. Salzberger. Germany's "Aufsichtsrat" board. Three ideas for the 'two-tier' approach. – Legamedia, February 2002. Available at http://www.legamedia.net/dy/articles/article_15789.php (21.11.2008).

63 H. Hansmann, R. Kraakman. Agency Problems and Legal Strategies. – R. Kraakman *et al*. The Anatomy of Corporate Law. A Comparative and Functional Approach. Oxford 2004, pp. 27–31.

64 In particular, see CCSCd 11 May 2005, 3-2-1-41-05. – RT III 2005, 17, 181; 25 April 2006, 3-2-1-27-06. – RT III 2006, 17, 162; 25 April 2006, 3-2-1-27-06. – RT III 2006, 17, 162; 15 May 2006, 3-2-1-36-06. – RT III 2006, 21, 195; 14 June 2006, 3-2-1-52-06. – RT III 2006, 24, 224 (all in Estonian).

65 M. Vutt. Establishment of breaches of directing bodies' duties, including grave errors in management and criminal conduct in the practice of bankruptcy proceedings: Kohtupraktika analüüs (Analysis of Judicial Practice). Tartu 2008, pp. 3–4. Available at www.riigikohus.ee (21.11.2008) (in Estonian).

66 Insolvency entails a cumulation of negative consequences, which is why the establishment of damages can be problematic, because in a bankruptcy situation, the negative consequence of a director's breach has to be distinguished from the overall body of negative consequences that led to the insolvency.

67 Karistusseadustiku ja selle muutmisega seonduvate seaduste muutmise seaduse eelnõu seletuskiri. (Draft Act amending the Penal Code and related Acts. Explanatory Memorandum), 5.06.2006. Available at http://web.riigikogu.ee/ems/saros-bin/mgetdoc?itemid=061590005&login=proov&password=&system=ems&server=ragne11 (21.11.2008) (in Estonian).

68 Karistusseadustiku rakendamise seadus. Adopted on 12.06.2002 – RT I 2002, 56, 356; 2007, 13, 69 (in Estonian).

According to Government of the Republic Regulation No. 254 of 20 December 2007 "Establishment of the minimum monthly wage"*[69], the minimum monthly wage for full-time work from 1 January 2008 is EEK 4350; the damage constituting a necessary element of abuse of trust is thus at least EEK 435,000.

Considerable problems may arise at the present time from the possible application of the principle of opportunity in criminal proceedings.*[70] One of the expressions of the principle of opportunity is Guidance No. RP-1-4/07/3 of the Chief Public Prosecutor of 12 April 2007, which sets out the principles for following public interest in proceedings in the application of §§ 202, 203 and 203[1] of the Code of Criminal Procedure. According to article 49 of the Guidance, there is, generally, public interest in the case of § 217[2] of the Penal Code, but in the context of the additional criteria listed in article 6, it is not clear whether an initial public interest in the proceedings can disappear, e.g., because the injured party does not wish the proceedings to continue. It should be considered likely, taking into account that even in Germany, in the *Mannesmann* case, it was possible to end the proceedings by an agreement.

It follows from the above that the legal rights protected by penal law do not completely overlap with the rights that should be protected by private law. Therefore, one has to take the view that solely penal law mechanisms in Estonian law cannot be considered sufficient legal remedies to respond to the breaches of directing bodies.

Against the background of general tendencies toward balanced extension of shareholder rights in the European Union and elsewhere, one may ask to what extent the Estonian law is following the same trends. Recent changes in Estonian company law have not been remarkable. The provisions of the Commercial Code that entered into force on 1 January 2006 can be regarded as partly an additional introduction of the changes arising from the Law of Obligations Act, and partly as the codification of judicial practice. Later amendments have largely been "forced moves" caused by the transposition of various European Union rules. The amendments of 15 November 2006 arose directly from amendments to the Estonian Central Register of Securities Act*[71] and the need to provide for a detailed procedure for the exchange of information between the Estonian Central Register of Securities and the Commercial Register*[72]; the amendments of 6 December 2006 were necessitated by the implementation of the European Union guideline, according to which from the end of 2007, the founding of a company should not take more than a week;*[73] the amendments of 15 December 2007 introduced the provisions of cross-border merger*[74] and the amendments of 20 March 2008 transposed the directive amending the Capital Requirements Directive.*[75] The extension of shareholder rights has not been much talked about, because there has been no direct pressure to make legislative changes. Still, there is the question of whether a shareholder of an Estonian public limited company, including a minority shareholder, does not need remedies comparable to those available in other European countries. The question is not only about a narrow legislative choice, but about a more general emphasis based on the shaping of the investment environment.*[76]

Although one should agree with the view that, e.g., the harmonisation of various procedural laws*[77] could be one of the development directions among others, it is only a thought which is so far not expressed by the reality of law. This is why support should be given to legislative drafting that contributes to the development of independent private law remedies. In this light, it should be admitted that the inner structure of an Estonian public limited company is very strongly supportive of the autonomy of directing bodies — while, e.g., AktG § 119 allows for extending the competence of the general meeting at the expense of the competence of the supervisory board (but not the management board) by the articles of association, Estonian law does not allow for such extension. Such a great degree of autonomy should be at least partly balanced by appropriate remedies available to shareholders.

---

[69] Palga alammäära kehtestamine. – RT I 2007, 71, 442 (in Estonian).

[70] For details about the principle of opportunity see, e.g., K. Savtšenkova. Kriminaalmenetluse lõpetamine süü väiksuse ja avaliku huvi puudumise tõttu oportuniteedi põhimõtte väljendusena. Magistritöö (Termination of Criminal Proceedings due to Negligibility of Guilt and Lack of Public Interest as an Expression of the Principle of Opportunity. Master's Thesis). Tartu 2007 (in Estonian).

[71] Eesti väärtpaberite keskregistri seadus. Adopted on 14.06.2000. – RT I 2000, 57, 373; 2007, 12, 66 (in Estonian).

[72] Eesti väärtpaberite keskregistri seaduse ja äriseadustiku muutmise seadus (Estonian Central Register of Securities Act and Commercial Code Amendment Act). Adopted on 15.112006. – RT I 2006, 55, 407 (in Estonian).

[73] Äriseadustiku muutmise ja sellega seonduvalt teiste seaduste muutmise seadus (Commercial Code and Related Acts Amendment Act). Adopted on 6.12.2006. – RT I 2006, 61, 456 (in Estonian).

[74] Äriseadustiku ja sellega seonduvate seaduste muutmise seadus (Commercial Code and Related Acts Amendment Act). Adopted on 15.12.2007. – RT I 2007, 65, 405 (in Estonian).

[75] Äriseadustiku ja Euroopa Liidu Nõukogu määruse (EÜ) nr 2157/2001 „Euroopa äriühingu (SE) põhikirja kohta" rakendamise seaduse muutmise seadus" (Act Amending the Commercial Code and Council Regulation (EC) No. 2157/2001 on the Statute for a European company (SE) Implementation Act). Adopted on 20.03.2008. – RT I 2008 16, 116 (in Estonian).

[76] M. Käerdi, R. Lang, J. Raidla, P. Varul, U. Volens. Ettevõtja õigus. Tegevuskava ettevõtlusealase õiguskeskkonna rahvusvahelise konkurentsivõime parandamiseks (Entrepreneurial Law. Action Plan for Improving the International Competitiveness of the Corporate Legal Environment). – Juridica 2006/4, p. 227 (in Estonian).

[77] S. Leibfried, C. Möllers, C. Schmid *et al*. Redefining the Traditional pillars of German Legal Studies and Setting the Stage for Contemporary Interdisciplinary Research. – German Law Journal. Private Law 2006 (07) 08, pp. 670–671. Available at http://www.germanlawjournal.com/pdf/Vol07No08/PDF_Vol_07_No_08_661-680_Articles_Leibfried.pdf (21.11.2008).

6. Conclusions

Following from the above, the author of this article takes the view that consideration should be given to the supplementation of Estonian law with provisions that would allow shareholders, who represent a certain proportion of share capital, to file a derivative claim on behalf of the company. The creation of such a threshold and procedure for the admissibility of proceedings, which would preclude litigation unreasonably burdening for the company, could be somewhat problematic. The hearing of the merits of the claim should certainly be preceded by a procedure by which the court first ascertains the admissibility of the claim. Although Estonian procedural law is not familiar with such a distinct type of procedure as an admissibility check, it does essentially exist *de lege lata*. For example, § 392 (4) of the Code of Civil Procedure[*78] (CCP) does provide for verification of the correctness of acceptance of a matter and the prerequisites for permissibility of the action as a function of pre-trial proceedings. According to CCP § 371 (2) 1), the court may refuse to accept a statement of claim if, based on the facts presented as the cause of action, violation of the plaintiff's rights is not possible, presuming that the factual allegations of the plaintiff are correct, and also, according to subsection 2, if the action has not been filed for protecting the plaintiff's right or interest protected by law, or with an aim subject to legal protection by the state, or if such objective cannot be achieved by an action. The Explanatory Memorandum to the Code of Civil Procedure[*79] also notes that the proceeding of a claim is essentially divided into verification of the admissibility of the action (decisions on refusal to accept or hear an action) and verification of the reasoning of the action (decision to grant or dismiss the action).[*80]

Consideration should certainly be given to the question whether, if the possibility of derivative claims were introduced, it should necessarily become a minority right, and if so, what level of shareholding would allow for the application of such a remedy. It may be said that in addition to the legal possibilities directly provided by law, minority shareholders can form coalitions and exercise (various types of) activism through them, provided that they have sufficient common interest to do so. For example, in Sweden there have even been cases where the minority of a listed company acquires a majority with respect to the company as a whole via interest groups set up to pursue the common goals.[*81]

In continental European public limited companies the concentration of holdings is considerably higher than in the USA and UK, where shareholdings are extremely fragmented.[*82] The author of this article believes that if additional legal remedies were made available to minority shareholders, the peculiarities of Estonian public limited companies should certainly be taken into account. Entitling every shareholder of a listed company to file an action should not be our objective. The corporate governance of listed companies is generally subjected to more thorough rules, including as regards the legal position of shareholders (general meeting rules, distance voting, right to information, etc.).[*83] The lack of shareholder control may even be a bigger problem in public limited companies that have few shareholders and that essentially stand between a private limited company and a listed company.

As a minimum, shareholders could be given the right to decide on the filing of claims not only against supervisory board, but also management board members, and to appoint representatives for such claims. In addition, shareholders representing 10% of share capital should also be entitled to derivative actions, because 10% is currently the general threshold for minority rights in Estonia.

The topic of developing an adequate company law framework also covers issues such as what position we wish to give shareholders in Estonian law and which legal rights should be protected, to what extent and by what means. It is certainly possible to strike a balance between the protection of minority shareholders' rights and the protection of companies from excessive interference by shareholders, while pursuing the goal of creating a secure investment environment. In any case, the objective of the legal regulation of directors' liability should be the stipulation of provisions that would ensure, under certain circumstances, the maximum possible likelihood of directors' liability.[*84]

---

78 Tsiviilkohtumenetluse seadustik. Adopted on 20.04.2005. – RT I 2005, 39, 308; 2007, 16, 77 (in Estonian).

79 Tsiviilkohtumenetluse seadustiku eelnõu. Seletuskiri (Draft Code of Civil Procedure. Explanatory Memorandum). Adopted on 20.11.2003. Available at http://web.riigikogu.ee/ems/saros-bin/mgetdoc?itemid=033370012&login=proov&password=&system=ems&server=ragne11 (in Estonian).

80 Similarly, § 11 (3^1) 5) of the Code of Administrative Court Procedure (RT I 1999, 31, 425; 2007, 67, 413 (in Estonian)) allows the administrative court to return an action to the person who filed it and not hear the action if the person who filed the action or protest cannot obviously be entitled to refer to the administrative court, presuming that the person's factual allegations have been proved.

81 About shareholder activism, see A. Jansson. Collective Actions among Shareholder Activists. Thesis for the degree of Doctor of Philosophy. Växjö University. Sweden 2007.

82 C. van der Elst. Economic Analysis of Corporate Law in Europe: an Introduction. – Financial Law Institute Working Paper Series. WP 2002-01, p. 13. Available at http://www.law.ugent.be/fli/WP/WP2002-pdf/WP2002-01.pdf (21.11.2008).

83 Certain issues are, e.g., covered by the Hea ühingujuhtimise tava (Good Corporate Governance Practice), 1.01.2006. Available at http://www.ecgi.org/codes/documents/cg_recommendations_2005_ee.pdf (21.11.2008) (in Estonian).

84 F. A. Gewurtz (Note 47), p. 16.