Japan

Shareholder derivative action: safeguards against abuse

by Koji Takahashi

The shareholders of a company entrust the daily management of the company to a group of experts, namely directors. But as the owners of a company, shareholders maintain certain means of influence over the management of the company in order to protect the value of their shares and their right to receive dividends. Normally their influence is exercised through the expression of opinions and the casting of votes at shareholders' general meetings. However, there are other means of influence and one of them is the derivative action. It is an action against directors brought by a shareholder on behalf of the company. Where a company has incurred damage due to a breach of duty by a director, the company is entitled to take an action against the director, but is usually reluctant to do so. The derivative action enables shareholders to enforce directors' liability on behalf of the company. This article examines some aspects of its recent operation in Japan.

REFORM OF THE DERIVATIVE ACTION

In Japan the derivative action was relatively unused until recently.

The obvious disincentive for shareholders to bring a derivative action is meagre personal reward for winning the action, since any recovery awarded accrues to the company, not to the plaintiff-shareholder. The shareholder benefits only indirectly through the increase in dividend or in the value of his shares, which can be negligible.

One of the other disincentives, until recently, was expensive filing fees that a plaintiff might have to pay to initiate a derivative action. Until recently the filing fees were a certain proportion of the amount claimed from the directors. In derivative actions this amount can be enormous.

However, in the aftermath of a series of corporate scandals that came to light with the collapse of the bubble economy, steps were taken in 1993 to strengthen the shareholders' grip on management by making the derivative action more available. As one of the main features of the reform, the filing fees were set at 8,200 yen (approximately £40), regardless of the contested amount (art. 267(4) of the Commercial Code; art. 4(2) of the Civil Procedure Expenses Act).

EFFECT OF THE REFORM

The 1993 reform resulted in a dramatic increase in the number of derivative actions. The size of actions has also grown since the amount of filing fees no longer goes up with the amount claimed. Consequently, the derivative action has now become a potent deterrent to managerial misconduct.

On the flip side, concern is growing over abusive derivative actions. Corporate racketeers called *sokaiya* and other unscrupulous shareholders may use the derivative action to put pressure on directors with a view to extorting money or to resolving a personal dispute with the company in their favour. Regardless of the strength of their claim, the directors may find it cheaper to yield to their demand than to fight through the action (see *Amicus Curiae*, Issue 6, p. 7).

SAFEGUARDS AGAINST ABUSE

A shareholder wishing to bring a derivative action must first demand that the company initiates an action against the directors and must allow the company 30 days to decide whether to accede to or reject the demand (art. 267(2) of the Commercial Code. art. 267(3) provides an exception where there is a risk that the company may suffer irrecoverable loss by the lapse of 30 days). Only a shareholder who owns a share continuously for the past six months may make this demand (art. 267(1) of the Commercial Code).

These requirements may be effective in curbing frivolous actions. However, they will have a limited effect in deterring those shareholders who are determined to abuse the derivative action. A shareholder can bring a derivative action even if they bought a share after discovering an assailable director's conduct. All they have to do is wait six months after buying a share, make a demand and wait a further 30 days. The decision of the company not to bring an action, however well-reasoned, cannot stop the shareholder starting an action. (To avoid bias in favour of the targeted directors, it is not directors but auditors who are given power to decide whether the company should accede to the shareholder's demand: art. 275–4 of the Commercial Code.)

FAME

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DISMISSAL OF THE CASE AS AN ABUSE OF RIGHT

The intended purpose of conferring on shareholders the right to pursue a derivative action is to obtain recovery of damages for the company. If a shareholder brings a derivative action for other purposes, e.g. to cause harm to the directors, it may be dismissed as an abuse of right (e.g. Nagasaki District Court, 19 February 1991).

However, since a plaintiff-shareholder's personal gain from winning a derivative action can be minimal, it is not always possible to expect shareholders to bring a derivative action genuinely for the purpose of obtaining recovery for the company. If the claim is well founded, the action should not be dismissed too easily just because the plaintiff has an unintended purpose. Thus in one case, the plaintiff brought the derivative action in order to become famous, so that he would be able to claim higher fees as an attorney. The court denied the motion to dismiss the action on the ground of abuse of right. Instead, it proceeded to try the merits of his claim and eventually held in his favour (Tokyo High Court, 3 July 1989; affirmed by Supreme Court, 9 September 1993. See also Tokyo District Court, 18

April 1991; Tokyo District Court, 26 October 1995).

ORDER FOR THE PROVISION OF SECURITY

When a derivative action is initiated, on the fulfilment of certain requirements the court may order the plaintiff to provide security (art. 267(5) of the Commercial Code).

Dual purpose of the order

The primary purpose of orders for the provision of security is to secure the recovery of damages for a wrongful action. If a plaintiff loses a derivative action, he or she may have to pay damages to the defendant if the court determines that he or she knew or did not know in negligence that the claim lacked legal or factual grounds or the institution of the action was otherwise considerably improper. (For the requirements of a wrongful action in general, see Supreme Court, 26 January 1988; in the context of the derivative action, see Tokyo District Court, 25 May 1990.)

The secondary purpose of orders for the provision of security is to deter abusive actions. Orders are often made to attain both purposes. The primary purpose alone cannot explain why the courts have often ordered a prohibitive amount of security, leaving the plaintiff with no choice but to give up the action. Since the courts have been displaying a strong tendency to grant motion for security, some commentators are warning that the availability of the derivative action may be unduly restricted by the increase in the costs of litigation, a result contrary to the intention of the 1993 reform to lower the filing fees.

Requirements for issuing the order

The court may order the provision of security upon prima facie showing by the defendant that the derivative action has been brought in 'bad faith' (art. 267(6) and 106(2) of the Commercial Code). The Japanese word for 'bad faith', *akui*, appears in various contexts of different statutes and assumes different meanings – from mere knowledge to malicious intent – depending on the context. In the context of ordering the provision of security in derivative actions, the previous cases, although not invariably, have found 'bad faith':

- where the plaintiff knows or does not know in negligence that the claim lacks legal or factual grounds;
- where the plaintiff brings an action for a wrongful purpose. (The leading case is Tokyo District Court, 22 July 1994.)

It is to be noted that the first of these two tests mirrors the requirements for obtaining damages for a wrongful action. A shareholder, in initiating a derivative action, is sometimes not totally sure that the defendant-directors are liable, especially where the determination of their liability is subject to the business judgment rule. In such cases the plaintiff does not know that the claim lacks legal grounds. But the defendant may still be able to show by prima facie evidence that the plaintiff is negligent in not knowing that the claim lacks legal grounds.

Turning to the second test, this test suggests that even if the plaintiff's claim is legally and factually well founded, an order for the provision of security may be made if the action is brought for a wrongful purpose. If the plaintiff's claim is well founded, the plaintiff will win the action and the question of damages for wrongful action will not arise. Justification for making an order in such cases would have to be sought from the secondary purpose of the order, i.e. curbing abusive actions. However, instances where an order was made solely on the basis of the second test are in fact rare. Typically, the second test has been employed to confirm the plaintiff's bad faith ascertained by the first test. Thus where a plaintiff brings a derivative action solely for the purpose of avenging on directors, often the claim is groundless and the plaintiff is aware of that (e.g. Nagoya High Court, 8 March 1995; Nagoya District Court, 22 September 1995).

So far a clear definition of wrongful purpose has not emerged. It must be remembered that shareholders cannot always be expected to bring a derivative action genuinely for the purpose of obtaining recovery for the company. The courts in some cases suggested that ill-feeling towards directors alone did not constitute a wrongful purpose (e.g. Tokyo District Court, 22 July 1994; Tokyo District Court, 21 February 1995).

A particular question arises where a shareholder brings a derivative action in pursuit of what they see as social or political justice. A claim may be framed in terms of accusing directors of causing loss to the company by allowing excessive expenditure to pursue their plan to build a nuclear power plant, a golf course or the like. The courts have not yet reached a consensus as to whether such motives constitute a wrongful purpose. While some courts held that pursuit of perceived social or political justice indicated a wrongful purpose (Nagoya District Court, 28 February 1995; Gifu District Court, 16 January 1997; Osaka District Court, 28 August 1996 – the case turned on different issues), one appeal court reversed such ruling but added that, if the plaintiff prosecuted their action in a manner driven solely by their social or political goal, the provision of security might be ordered in the course of proceedings (Nagoya High Court, 15 November 1995; appeal from Nagoya District Court, 28 February 1995). The answer to this question would depend on the extent to which companies are to be expected to assume social responsibilities.

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