Explaining the UK Shareholder Derivative Suits Puzzle

DAVID GINDIS
University of Hertfordshire, UK

DAVID GIBBS-KNELLER
University of East Anglia, UK

WINIR Symposium on Global Capitalism & Its National Varieties
Loughborough University London, UK
16 December 2019
Lawsuit against Boeing seeks to hold board liable for 737 MAX problems

Two Shareholder Climate Suits Against Exxon in Texas Get Consolidated

Oracle directors: Shareholders can go ahead with billion-dollar derivative suit

Yahoo Data Breach-Related Derivative Suit Settled for $29 Million

Alphabet gets two-month delay to reply to shareholder lawsuit over executive misconduct

Wells Fargo officials enter $240 million settlement over bogus accounts

(Reuters) - Wells Fargo & Co executives and directors have reached a $240 million settlement with shareholders over the creation by bank employees of millions of consumer accounts.
Private enforcement of directors’ duties

**Shareholder derivative suits** (SDS): shareholders suing directors/officers for breach of fiduciary duties on behalf of company (≠ creditor derivative litigation, shareholder class actions)

**In a nutshell**: (a) SDS tell directors that shareholders think some action/inaction has harmed the company; (b) directors have opportunity to respond/take corrective action; (c) otherwise remedies pursued in court

**Aims**: improve board integrity and accountability, reduce managerial entrenchment, mitigate agency costs, good governance

These benefits need to be weighed against the costs
**COSTS**

Key trade-off

**Legitimate claims vs frivolous suits**, enforcement vs abuse (Geltner 2012)

**Collective action and free-rider problems** limit legitimate claims (Cox 1984; Cox & Thomas 2009)

**Rent-seeking** by investors and lawyers increases chances of frivolous suits (Fischel & Bradley 1986; Romano 1991; Winter 1993)

**Derivative suits are high-cost solution to agency problem**: elusive definition of director duties, information asymmetries, threat to otherwise valuable shareholder-director relationship, alternative disciplining mechanisms (Gibbs-Kneller & Ogbonnaya 2019)

**Nonetheless, convergence to US-style SDS statutes around the world** (Siems 2012)
Convergence in name of good governance: protects investors, facilitates external finance, favors financial development, improves capital market liquidity, attracts incoming FDIs

De jure convergence, de facto divergence

**Companies Act 2006 Pt 11**: restrictions pursuant to rule in Foss v Harbottle removed, SDS now available to any individual shareholder, no minimum stake

**Very few claims in UK** (Gibbs-Kneller & Ogbonnaya 2019)

Divergence within Anglo-American common law system, outsider model

Similar bundles of governance practices, similar alternative disciplining mechanisms
GAPS IN LITERATURE

Existing literatures

**Comparative corporate law literature**: divergence addressed, but no social-scientific framework other than agency theory (Geltner 2017)

**Comparative corporate governance literature**: frameworks exist, but divergence not addressed (although mentioned in Filatotchev, Jackson & Najagima 2013)

Analytical importance of meso level

Acknowledged (Deeg & Jackson 2007) but relatively neglected

Focus on **bundles of firm-level governance choices** and complementarities with **national-level legal/political environments** (Ward et al 2009; Aguilera et al 2012)

**Meso level**: locus of court enforcement (Ménard 2014)
MESO-LEVEL DETERMINANTS

Allocation of cost liability (Hertig 2004; Ferran 2009; Armour et al 2009)

American rule (parties pay own fees) vs English rule (loser pays all fees)

Gatekeepers (Erickson 2017)

Board (special litigation committee) in US vs court in UK

Factual implementation (Gibbs-Kneller & Gindis 2019)

Court rules of SLC procedure in US vs court rules on substance of claim in UK

Basis for discussion of interactions between incentives, costs, contingencies and complementarities (Aguilera et al 2008) between corporate, legislative, judicial domains
POSSIBLE COMPLEMENTARITIES

Contrasting bundles

UK case: director duties explicit, claim assessed by outsider, courts as gatekeepers, no reputational effects, courts rule on substance of claim, business judgment rule, courts committed to limiting litigation, English rule, higher litigation risk

US case: director duties implicit, claim assessed by insider, boards as gatekeepers, reputational effects, courts rule on SLC procedure, business judgment rule, courts relatively willing to allow litigation, American rule, lower litigation risk

Result: far greater number and value of claims in US

English rule vs American rule amplifies combined effect of other factors

There would likely still be far less derivative litigation in UK if the American rule were adopted
UK SDS puzzle is puzzling if one believes in universal (US-style) solutions to agency problem, or that convergence in substantive law correlates or ought to correlate with convergence in enforcement.

Changes in company law without accompanying changes in court practices are unlikely to yield the expected results.

Courts are actors with their own path-dependent procedures and imperatives which are holistic (i.e. apply to all types of claims, not just derivative claims), hence unlikely to change.

Difference between changes in formal law and changes in court practices reflects distinction between fast-moving and slow-moving institutions (Roland 2004).