

Shareholder Suit as the Corporate Control Strategy of Investment

The author analyses one of the major dilemmas of corporate law, which relates to corporate mechanisms for controlling and safeguarding investment. Corporate law creates a systemic matrix, which facilitates the organizational management of the business entity and the activism of the investor. Separating ownership and control by the management of the JSC creates the presumptive risk of unfair action. The managing person is more oriented toward increasing personal profit rather than maximizing the value of the company. Therefore, along with the general mechanisms of internal corporate management of the risk, beyond the competence of the general meeting, it is necessary to equip shareholders with the corporate control mechanism having precise aim. Shareholder suit is one of the mechanisms of controlling and safeguarding the investment, which may be of the following types: direct (individual) suit, indirect (derivative) suit, and class action. A suit is a methodological tool used for initiating liability and restoring infringed rights of shareholders. Classes of the suit are the corporate strategy of investment, which is related to the control function of the shareholder.

Giorgi Makharoblishvili

*associate professor in law
Tbilisi State University*

ORCID – 0000-0002-3426-566X

e-mail: giorgi.makharoblishvili@tsu.ge

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1. Introduction

The main line of the content of modern capitalism is realized in the form of investment. Large-scale industrial activity, which requires the accumulation of considerable pecuniary wealth, is „revived” in such legal form as Joint Stock Company (hereinafter – JSC). JSC stands out for the diversity of financial mechanisms for attracting investments and legal functionality, the corporate basis of which is making a dissociation between ownership and control¹. The excessive danger of reducing, misappropriating, or wasting invested capital by the opportunist

1 William M. Fletcher, *Fletcher Cyclopedia of the Law of Corporations*, vol. V (Eagan: Thomson/West, 2011), 481.

behavior of so-called centralized management is within the legal form of JSC, dissociating ownership and control. Hence, JSC has a qualitatively central place in the context of investment platform and research object.

The investment risk factor is balanced in three general directions: based on portfolio theory², by providing a diversified investment portfolio, using internal and external corporate control mechanisms. The investment portfolio is diversified if the investment is proportionally implemented in different business entities³, the entrepreneurial line and, in most occasions, geographical area, is divergent. The diversified management of the investment, primarily, is done on the market for corporate control⁴. The internal corporate control mechanism is of many types and forms⁵, the unity of which systemically creates a strategy of organized control and protection of invested capital. As for external corporate control, it is shown based on the market for corporate control. The market for it is the tool developed at the capital market for resolving problems resulting from unfair actions of the JSC management. For instance, in case of a hostile takeover, management is dismissed from duty⁶. The market for corporate control is one of the substantive strategies for protecting investment along with such internal corporate protection mechanisms as shareholder suits.

On the internal organizational level, the person managing fiduciary duty in the JSC has the inherent competence to represent a business entity, as a separate subject, in relations with third persons⁷. Partners of the corporation need to have such competence⁸. The principle that a corporation is entitled to the claim of compensating damages for incurred harm, is called proper plaintiff rule⁹. But during the functioning of JSC, the situation may emerge when inherent representative of JSC does not exercise its title. The judicial or

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- 2 James D. Cox, Thomas Lee Hazen, *The Law of Corporations*, vol. II, 3rd ed. (St. Paul: Thomson/West, 2010), 91.
 - 3 Cox and Hazen, *The Law of Corporations*, vol. II, 3rd ed., 92-93.
 - 4 Arthur R. Pinto, Douglas M. Branson, *Understanding Corporate Law*, 3rd ed. (New York: LexisNexis, 2009), 108-109.
 - 5 Giorgi Makharoblishvili, *General Analysis of Corporate Governance* (Tbilisi: World of Lawyers, 2015), 225-325. (In Georgian).
 - 6 Cox, Hazen, *The Law of Corporations*, vol. II, 3rd ed., 95-97.
 - 7 Alan Dignam, John Lowry, *Company Law*, 8th ed. (Oxford: Oxford University Press, 2014), 185.
 - 8 Breckland Group Holdings Ltd v. London and Suffolk Properties Ltd [1989] BCLC 100. Compare: Foss v. Harbottle, 67 Eng. Re. 189, 203 [Ch. 1843].
 - 9 Derek French, Stephen Mayson, Christopher Ryan, *Company Law*, 26th ed. (Oxford: Oxford University Press, 2009-2010), 548.

normative preventive strategy for such circumstance is prescribed in laws of various countries, from where we can select so-called exceptional representation¹⁰, which dogmatically may be mentioned as protective mechanisms of investment. The mentioned mechanism of investment control and protection is the shareholder suit¹¹, which may be of the following type: direct suit, indirect (derivative) suit, and class action¹². The kinds of shareholder suits are mainly prescribed by legislation. The elements of legal regulations from Georgia, the US, and the UK, along with judicial practice were taken as a basis and, using the comparative legal method, preferably analyzed through the prism of Georgian reality.

2. Corporate grounds for filing shareholder suit

Separation of ownership and control evokes a presumptive risk of unfair action from the JSC management. The manager is more oriented toward increasing personal gain rather than maximizing the value of the firm¹³. Therefore, along with the general mechanisms of internal corporate management, it became necessary to equip minority shareholders with the corporate control mechanism having a clear purpose beyond the competence of the general meeting¹⁴.

In the 19th century, the derivative suit developed as a mechanism in USA judicial law¹⁵, which was directed against abuse of power by the managing person and solving dilemma¹⁶ created because of the separation of ownership and control in the corporate law¹⁷. However, the grounds of the derivative suit are related to the Court Decision¹⁸ of England¹⁹. In the case of the specific precondition, the shareholder can put on the corporate „shoe”

10 Cox, Hazen, *The Law of Corporations*, vol. II, 3rd ed., 196-201.

11 Franklin A. Gevurtz, *Corporation Law* (ST. Paul: West Group, 2000), 397.

12 Alan R. Palmiter, *Corporations, Examples and Explanations*, 5th ed. (New York: Aspen Publishers, 2006), 313-319.

13 Cox, Hazen, *The Law of Corporations*, vol. 2, 3rd ed., 89.

14 Cahn, Donald, *Comparative Company Law*, 607.

15 Hawes v. Oakland, 104 U.S. 450, 453-461 [1882].

16 Palmiter, *Corporations*, 5th ed., 309.

17 Lado Chanturia, *Corporate Governance and Liability of Directors in Corporation Law* (Tbilisi: Samartali, 2006), 415. (In Georgian).

18 Foss v. Harbottle, 67 Eng. Re. 189, 203 [Ch. 1843].

19 William T. Allen, Reinier Kraakman and Guhan Subramanian, *Commentaries and Cases on the Law of Business Organization*, 4th ed. (New York: Wolters Kluwer, 2012), 367.

and request restoration of the illegal action taken about the corporation in case managers are not doing so²⁰. The establishment of the derivative suit as a mechanism of corporate control resulted in the activation of so-called stealing minority shareholders and advocates, whose motive became to gain money and decrease expenses. The creation of such a practical reality gave impetus to legislative regulation of derivative suits in the USA, which subjected its filing to preconditions and made it quite tricky. After the reform, procedural and formal difficulties of derivative lawsuit proceedings resulted in moving emphasis on the application of direct suit²¹. However, a derivative suit's purpose differs from a direct suit's application area. The direct suit may be directed to the realization of the right such as the right to receive information²², call a general meeting, challenge the decision of the general meeting, etc.²³. The right to challenge the decision of general meeting is the individual right of a shareholder, which bears a controlling function over the legality of the decision made at the general meeting²⁴.

Compared to the USA, a shareholder's suit was implemented into the Law of Georgia „on Entrepreneurs” in 1999²⁵, after making amendments to the mentioned law²⁶. The current regulation of derivative suit of shareholder was defined after the renewal of the law of Georgia „on Entrepreneurs” in 2021²⁷. Hence, such a suit as a derivative suit has been prescribed by the normative act in the Georgian Corporate Law field compared to the USA and the UK.

3. The corporate control function of a shareholder suit

The corporate purpose of JSC is to attract investment and such management of the attracted capital with legal and financial mechanisms, which is

20 Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 548 [1949].

21 Pinto and Branson, *Understanding Corporate Law*, 3rd ed., 453-455.

22 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 202.5.

23 Chanturia, *Corporate Governance and Liability of Directors in Corporation Law*, 416.

24 Irakli Burduli, *Foundation of Corporate Law*, Vol. II (Tbilisi: Meridiani, 2013), 74-75. (In Georgian).

25 Chanturia, *Corporate Governance and Liability of Directors in Corporation Law*, 434-435.

26 Law of Georgia on Entrepreneurs, Legislative Herald, I, 1999, №24, Article 110,

27 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 222.

addressed towards maximization of economic output²⁸. The functioning process of JSC directed to gain profit is accompanied by representation expenses, which is related to the asymmetry of information in public JSC – the manager of JSC possesses such information on everyday work of JSC, legal and economic condition, including damage caused by abusive action, which is not available to shareholder, as well as investor²⁹. Informational asymmetry may become the trigger for opportunistic behavior of management. One of the aims of corporate law is to prevent using asymmetric information for private purposes, which is attainable by putting management behavior into the area of various corporate strategies.

Corporate law creates a systemic matrix, which facilitates organizational management of business entities and investors' activism. Investing capital into JSC means transferring direct control (with disposition) right over property to the business entity. „Dispositional” control is the competence of JSC management, which requires balancing by corporate control mechanisms³⁰. Internal corporate control mechanisms derive from the shared participation of shareholders in JSC and are attached to the member status.

The competence of management to administer invested assets is one of the categories of risk, which on the internal corporate control level mostly is balanced by the standard of fiduciary duty of manager and authority of shareholders' general meeting, as of “supervisory”³¹ body. The part expressed in shares ensures managerial and property rights for shareholder, which are essentially realized at the shareholders' general meeting; however, the suit is internal corporate control mechanism of such category, that must be considered within the rights independent from shareholders' general meeting³².

There are *ex ante* and *ex post* mechanisms for investment protection. The shareholder suit entails preventive and *post factum* aspects of investment protection³³. The preventive essence of corporate suit is the expectation of its practical application towards the targeted subject³⁴, and this creates ground for correcting potential behavior³⁵.

28 Makharoblishvili, *General Analysis of Corporate Governance*, 60-61.

29 Cox and Hazen, *The Law of Corporations*, vol. II, 3rd ed., 89-90.

30 Allen, Kraakman, Subramanian, *Commentaries and Cases on the Law of Business Organization*, 4th ed., 379-392.

31 Burduli, *Foundation of Corporate Law*, vol. II, 195-211.

32 Burduli, *Foundation of Corporate Law*, vol. II, 73-87.

33 Compare: Cox, Hazen, *The Law of Corporations*, vol. 2, 3rd ed., 121-136.

34 Allen, Kraakman and Subramanian, *Commentaries and Cases on the Law of Business Organization*, 4th ed., 414.

35 Compare: Georgian Supreme Court Decision №-687-658-2016, 06/11/2018, field 74.

The suit is the methodological lever and is used for the purpose of initiating liability³⁶ and restoring infringed rights of shareholders. Restoring infringed right and protecting the interest of shareholders is possible on two occasions. In particular, the shareholder can protect his/her individual interest through so-called direct suit, the outcomes of which are considered towards himself/herself on the other hand, shareholder can protect the interests of JSC, where the feedback is portrayed only with indirect form (so-called derivative suit)³⁷. Classes of the suit are the corporate strategy of protecting the investment, which comes from the controlling function of shareholders.

4. Classification of suit types

The modern civil procedure law doctrine determines suit as the application of an interested person to the court with the request to protect infringed or disputable right through dispute resolution regarding it³⁸.

The suits are distinguished based on analyzing procedural legislation and material legislation³⁹. According to procedural legislation and doctrine, the main types of suit are action for awarding, action for transforming, and action for acknowledgment⁴⁰.

„Classification of suit is possible in accordance to plaintiff requests. Based on the opinion developed in doctrine, in the substantial law main types of suits are property lawsuits, such as vindication and negatorial claim. A vindication claim is a suit filed by the nonpossessory proprietor or other legal owners against an illegal owner about the return of a natural object defined by individual character. Negatorial claim is directed against such infringement of a right, which is not related to losing ownership over the object but is obstructing the usage and disposition of the object, that means a person does not have the possibility to exercise mentioned powers because another person obstructs their realization by his/her action. There are also suits deriving from the law of obligations and contract law, as well as non-contractual relations (delicts, unjust enrichment). Each of them aims to return the property to an authorized person and restore conditions existing before the

36 Chanturia, *Corporate Governance and Liability of Directors in Corporation Law*, 411.

37 Palmiter, *Corporations*, 5th ed., 309. Compare: Allen, Kraakman, Subramanian, *Commentaries and Cases on the Law of Business Organization*, 4th ed., 367-368.

38 The Civil Code of Georgia, Parliament's Gazette, 31, 24/07/1997, first and second articles, also see: Georgian Supreme Court Decision №-687-658-2016, 06/11/2018.

39 Georgian Supreme Court Decision №-687-658-2016, 06/11/2018.

40 Georgian Supreme Court Decision №-302-285-2017, 16/06/2017.

infringement of the right. For instance, a delict claim is addressed toward restitution of non-contractual damage. Such damage results from infringement when parties are not in a contractual relationship. Comparing to vindication, where the subject is only a natural thing, in case of a delict claim the damage may be restituted in natural form, as well as in monetary form when it is not possible to restitute in natural form. Claims on unjust enrichment⁴¹ have a place when there is an occasion of returning assets received (acquired or reserved) without legal grounds, at the expense of others' goods, because of a person's illegal or legal action, or force majeure, by which the restoration of the balance of asset circulation is reached by restoring the economic condition of damaged person⁴².

In corporate law, shareholder suit is classified into three types. The suit, as a rule, protects the personal legal interest of shareholders. According to the material and procedural legislation, the abovementioned classification of the suit is a form of operating claim.

4.1. Individual suit

The subject of study of corporate law is the internal organizational relations of a business entity, among which the relations of the business entity and partner are considered, where the partner and entrepreneur are independent subjects. Showing JSC as an independent subject is strengthened with fiction theory and emphasizes its separated personality⁴³. In the relationship between JSC and the shareholder, the shareholder is not protected by the principle of limited liability⁴⁴ and he/she (shareholder) acts as an individual subject. Deriving from the theory of separated personality⁴⁵, JSC partner does not have a direct interest in the assets of JSC. However, the partner and the business entity may conclude an agreement⁴⁶. Generally, the relationship

41 With regard to unjust enrichment, see Giorgi Rusiashvili, *Unjust Enrichment Law I: Conditiones of Fulfillment* (Tbilisi: Lawyers' world, 2017), 16-94. (In Georgian).

42 Georgian Supreme Court Decision №-687-658-2016, 06/11/2018. Compare: Konrad Zweigert, Hein Kötz, *Introduction to Comparative Legal Studies in the Civil Law Sphere*, Book II (Tbilisi: Jisia, 2001), 228-256.

43 French, Mayson, Ryan, *Company Law*, 26th ed., 122-125.

44 John Armour, Henry Hansmann, Reinier Kraakman, „What is Corporate Law?“, [in:] *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 2nd ed., Reiner Kraakman, John Armour et al., (Oxford: Oxford University Press, 2009), 5-17.

45 *Salomon v. A Salomon and Co Ltd*, AC 22 [1897].

46 French, Mayson, Ryan, *Company Law*, 26th ed., 126.

between partner and business entity is contractual, and the first agreement is concluded in the form of a charter of JSC⁴⁷. Nevertheless, the content of the agreement is more comprehensive and covers numerous directions⁴⁸. Considering the legal dilemma deriving from the individual contract or delict⁴⁹ or JSC functioning, a legal dispute between shareholder and business entity is qualified as a conflict between two independent subjects.

Application of individual suit is the constitutional right of a person, by which he/she may apply to the court to restore the infringed right.

In corporate law individual suit of a shareholder is directed towards protecting rights deriving from the shared property of JSC. In the Civil Code of Georgia (hereinafter referred to as CCG), four grounds for claim are prescribed: contract, causing damage (delict), unjust enrichment, and other grounds stipulated by law⁵⁰. Occasions of shareholder suit mentioned below fall within the grounds listed in article 317 of CCG.

The direct suit mainly protects shareholders' structural, financial, voting and liquidation rights. Model variations of right protected by direct suit are as follows: refusing division of dividend (right to request dividend) after the decision of issuance of dividend (right to receive dividend); ordering JSC recordings, corporate books; requesting calling shareholders' general meeting, where the infringement of fiduciary duty by the manager will be discussed; issues related to JSC reorganization, where the manager infringed obligation that ensured making informed decision by shareholder⁵¹; limiting free circulation of shares (vinculation); restructuring shares of particular class and changing or revoking rights deriving therefrom⁵²; individual contract between shareholder and corporation; suit against fraud committed by manager while acquiring or selling shareholder's share; suit against damage incurred by shareholder or his/her assets by delict; suit against manager infringing fiduciary duty while selling JSC; suit against action *ultra vires* or without authority; suit against such action, which restricts shareholder or causes direct influence⁵³. In most mentioned model variants, for an individual suit,

47 Dignam, Lowry, *Company Law*, 8th ed., 186.

48 Pinto, Branson, *Understanding Corporate Law*, 3rd ed., 459-460.

49 Cahn, Donald, *Comparative Company Law*, 602.

50 The Civil Code of Georgia, Parliament's Gazette, 31, 24/07/1997, first part of article 317.

51 Stephen A. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors*, 6th ed., vol. II (Boston: Aspen Publishers, 2009), 1712.

52 Palmiter, *Corporations*, 5th ed., 313-314.

53 French, Mayson, Ryan, *Company Law*, 26th ed., 559-561.

the shareholder must prove that the damage he/she suffered is separated and isolated from the damage incurred by other shareholders⁵⁴.

4.2. Derivative suit

The derivative suit has a special place in the classification of suit types, which suggests a distinct systemic vision and creates a quasi-legal dilemma, as far as it is non-traditional type of suit and belongs to the class of exceptional representation.

A derivative suit is a mechanism for protection from the outcomes of JSC manager's abusive action, which competes with such a strategy of problem-solving as the market for corporate control. However, the latter has a significant weak side. In need for corporate governance, the motive of „hostile takeover” is formed by systemic infringement of fiduciary duty by the management of the targeted JSC. The singular breach of fiduciary duty by the management of target JSC does not fall within the scope of JSC having the desire of acquisition. The described legal causa is prevented by the strategy of a derivative suit, as far as its application by the management of JSC is possible in case of misappropriation or embezzlement of assets⁵⁵ without the prerequisite of repeating action recurrently. As a counterweight of the market for corporate control, the weak side of a derivative suit is when the managing body of JSC refuses the claim presented to the court. Rejecting the claim is considered a corporate decision and is protected by the principle of freedom of corporate decision⁵⁶.

The milestone of filing a derivative suit is indirectly causing damage to a shareholder. As a result of damage to JSC, all shareholders' investment value decreased⁵⁷. Compared to an individual suit, the shareholder does not suffer direct damage – the scheme of causing damage requires an intermediate ring – the damage must be made to JSC, and the investment value of the shareholder decreases because the loss is faced by its corporation. With a derivative suit, the shareholder protects the corporation, not their personal right⁵⁸. It is used by the shareholder when JSC has the right to claim, where

54 Cox, Hazen, *The Law of Corporations*, vol. II, 3rd ed., 111-113.

55 Cox, Hazen, *The Law of Corporations*, vol. II, 3rd ed., 96-97.

56 Georgian Supreme Court Decision №-687-658-2016, 06/11/2018, 85-ႃ ႃႃ 86-ႃ fields.

57 The occasion is very interesting when JSC has only one shareholder and it uses strategy of protecting interest of investment through derivative suit. See Cox and Hazen, *The Law of Corporations*, vol. II, 3rd ed., 101.

58 Cox, Hazen, *The Law of Corporations*, vol. II, 3rd ed., 103.

the corporation is *prima facie* plaintiff⁵⁹, but because of specific reasons (for instance, conflict of interests) does not use it⁶⁰.

A derivative suit is a possibility of filing suit in the court in favor of JSC and on behalf of shareholder⁶¹. Minority shareholder uses it. The logic of using a derivative suit by a minority shareholder is simple: shareholder having a controlling package of shares has many corporate mechanisms of appointing special representatives, as well as controlling management through the general meeting, for instance, dismissing the manager from their duty, and no additional tool is needed, such as a derivative suit. As a result, the derivative suit is the corporate control strategy for minority shareholders. It is especially actual in the case of public JSC when a majority shareholder or group of shareholders does not exist, meaning the shareholders' structure is dispersed (dispersed shareholder)⁶². It must be noted that using a derivative suit is possible not only against JSC management but also against third persons and majority shareholders⁶³.

One major challenge of this type of suit is the conflict of interests between the principle of the separated personality of JSC and the fiduciary duty of management. JSC is the legal entity that is entering into a legally binding relationship by the managing body. In public JSC, differentiation of property and control excludes representation of JSC by shareholders in relations with third persons, without the imposition of additional representation authority. For instance, in Georgia, the appointment of a person as a manager entails three stages: selection/appointment, concluding a working contract with the selected person, and registration in the Public Registry⁶⁴. Consequently, a person becomes a corporate, organic legal representative of JSC. Naturally, the shareholder may also become an organic representative⁶⁵, but a derivative suit equips the plaintiff shareholder with the self-selection and

59 Dignam, Lowry, *Company Law*, 8th ed., 187.

60 Pinto, Branson, *Understanding Corporate Law*, 3rd ed., 456.

61 Revised Model Business Corporation Act, 2021, § 7.40, Official Comment.

62 Dignam, Lowry, *Company Law*, 8th ed., 187.

63 Pinto, Branson, *Understanding Corporate Law*, 3rd ed., 456. Compare: Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 176.

64 Burduli, *Foundation of Corporate Law*, vol. II, 378-386.

65 In case of public JSC, as a rule, majority of managing body shall be independent, so-called invited persons.

self-appointment⁶⁶ authority⁶⁷. The aspect accompanies the essence of special representation by the shareholder in derivative suit is that shareholder is given possibility to represent JSC in court in a way that the standard of fiduciary duty does not apply to him/her, even though they have a duty of loyalty towards other partners, based on the status of member⁶⁸.

The derivative suit may be filed against following actions: in case of decrease of shares of corporation caused by abusive action of management, such as embezzlement of JSC assets or unlawfully acquiring business opportunity; request addressed against purchaser of assets of JSC, the purpose of which is cancellation of transaction; in case restitution of damage invoked by fraudulent action on the assets of JSC or damage caused by third person; request addressed against directors, which forces them to dissolve⁶⁹ JSC in response to abusive action of manager; using request, the legal basis of which is the contract between JSC and third person⁷⁰; request directed against managerial decision, which is caused by intentional obstruction of process of acquisition by management, which resulted in losing possibility for shareholders to sell their shares at premium price; in case of infringing fiduciary duty while reorganization through merger⁷¹; in case of unlawfully acquiring⁷² business opportunity of corporation⁷³; in case of realization of claim against agreement stipulated with the conflict of interests⁷⁴.

66 Gevurtz, *Corporation Law*, 397.

67 Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 549 [1949].

68 Cox, Hazen, *The Law of Corporations*, vol. II, 3rd ed., 100.

69 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 78.1 d), 79. Compare: Dignam and Lowry, *Company Law*, 8th ed., 211-212.

70 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 222.1.

71 Cox, Hazen, *The Law of Corporations*, vol. II, 3rd ed., 114-115.

72 Gevurtz, *Corporation Law*, 397

73 Such provision is directly envisaged in the new edition of the law of Georgia on Entrepreneurs, Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 54.4.

74 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 208.9. In case of conflict of interests, additional difficulty may be related to coexistence of grounds for direct and derivative suits: shareholders argues that not only the agreement including conflict of interests is unfair, but also approval of such transaction at the shareholders' general meeting is null. See. Gevurtz, *Corporation Law*, 391.

There also exists so-called double derivative action. This suit is based on the structural form of shareholder's investment, which, in some occasions, distinguishes it from requirements defined for an ordinary derivative suit. The content of the relationship is the following: parent JSC has subsidiary JSC, which (subsidiary JSC) does not apply its claim towards the addressee of claim⁷⁵. The shareholder of parent JSC⁷⁶ has the possibility to apply the claim of subsidiary entity⁷⁷ if both companies refuse practical realization of claim⁷⁸. Outcomes of „double derivative” action are directly imputed to subsidiary JSC, but indirectly to parent corporation and its shareholders⁷⁹. As far as the „double derivative” action depends on the structure of the investment, it may be not only „double” but also „triple” or „quadruple” if the JSC investment portfolio is divided into shares of several subsidiaries⁸⁰.

Essentially specific components characterize a derivative suit: the JSC systemically has the right to claim, but it is used by the shareholder in their own name and favor of JSC; procedural aspects of the claim entail specific preconditions; outcomes of the claim are imputed to JSC and not the shareholder; along with the procedural aspects⁸¹, the realization of claim requires material ground – a person should be a shareholder; restitution of expenses spent on the proceeding of claim is imposed on JSC, in case of considering shareholder as proper plaintiff. All corporately important components establish derivative suit as special and, at the same time, exceptional corporate control strategy.

4.3. Class Action

Protection of the right of a shareholder is possible through filing individual suit. Still, if there is an infringement of several shareholders' rights by abusive action of management, in such case the type of claim must be a class action. The class action is result of the consolidation of many individual suits⁸²; one of the identifiable grounds for a class action is sharp decrease in the price of public JSC shares. This circumstance is often used by professional

75 Brown v. Tenney, 532 N.W.2d 230 [1988].

76 Gevurtz, *Corporation Law*, 396.

77 Dignam and Lowry, *Company Law*, 8th ed., 194.

78 Cox and Hazen, *The Law of Corporations*, vol. 2, 3rd ed., 195.

79 Compare: Giorgi Jugheli, *Capital Protection in a Joint Stock Company* (Tbilisi: Bona Causa, 2016), 206. (In Georgian).

80 Pinto and Branson, *Understanding Corporate Law*, 3rd ed., 470.

81 Cahn and Donald, *Comparative Company Law*, 602.

82 Allen, Kraakman and Subramanian, *Commentaries and Cases on the Law of Business Organization*, 4th ed., 367.

plaintiff⁸³ legal companies, which stand out for share participation in several dozen corporations⁸⁴.

Class action implies acting in favor of those shareholders whose individual claims are identical or almost identical⁸⁵, and protecting infringed right separately with individual suits could be more practical, considering the numerosity of shareholders (there may be thousands of shareholders)⁸⁶. Moreover, a class action is more convenient and economical⁸⁷, compared to individual suits filed separately⁸⁸. In case of class action, the plaintiff is the representative of other shareholders. Otherwise, it is referred to as a class, group⁸⁹ action⁹⁰.

5. The corporate dilemma of types of a shareholder suit

Differentiation of individual shareholder suits and derivative suits is relevant in terms of procedural and substantial aspects. In the procedural context, requirements and preconditions for proceeding with a suit are essential, and a considerable part entails corporate grounds determining the type of the suit.

The first ground for differentiation is the addressee of the suit: if a shareholder claims for restitution of damage inflicted on personal interest, an individual suit is in place, but if they want the realization of the corporation's claim – then there is a derivative suit in place. Therefore, when filing lawsuit in the form of a derivative or individual claim, two main questions shall be answered⁹¹: who suffered the damage (JSC or shareholder individually) and who will receive benefit in the form of restitution of damage, in case of the approval of claim (JSC or shareholder individually)⁹².

Categorization of types of suits has significant importance for proceeding: derivative suit requires overcoming stages on internal corporate

83 Cahn, Donald, *Comparative Company Law*, 606.

84 Pinto, Branson, *Understanding Corporate Law*, 3rd ed., 511.

85 Dignam, Lowry, *Company Law*, 8th ed., 193.

86 Cahn, Donald, *Comparative Company Law*, 602.

87 Compare: Allen, Kraakman, Subramanian, *Commentaries and Cases on the Law of Business Organization*, 4th ed., 371.

88 Cox, Hazen, *The Law of Corporations*, vol. II, 3rd ed., 104.

89 Direct class action have been brought in these cases: *Smith v. Van Gorkom*, 488 A.2d 858 [Del. 1985]; *Weinberger v. UOP, Inc.*, 457 A.2d 701 [1983].

90 Palmiter, *Corporations*, 5th ed., 316.

91 Cahn, Donald, *Comparative Company Law*, 610-612.

92 Cox, Hazen, *The Law of Corporations*, vol. II, 3rd ed., 110.

level, such as expiration of 90 days term⁹³ after written notification addressed to JSC and establishment that consideration of shareholder's claim does not contradict with JSC interest⁹⁴. In fulfilling both conditions, the shareholder will be considered as proper plaintiff⁹⁵. It is not necessary to apply to JSC in written form⁹⁶, if JSC before expiration of this term, probably, refuses to file a suit. According to the Model Business Corporation Act of USA, refusal is done by managing body, which may be in the conflict of interests with regard to the contract, which creates right to claim for JSC or preservation of the term may cause irreversible damage to JSC (for instance, expiration of the term determined for claim). Fulfillment of such preconditions is not required in case of proceeding individual suit.

The suit addressed against infringement of fiduciary duty by managing person, in fact, must be derivative suit, as far as management has obligations towards JSC and not towards shareholders individually⁹⁷. Hence, the claim and its outcomes directly impute to JSC and not shareholder⁹⁸.

One of the legal causes is related to the substantial and procedural preconditions of filing derivative suit. Prerequisite of proceeding derivative suit lies on fulfillment of substantial requirements. In particular, derivative suit may be filed by shareholder, who owned JSC share during the period of imposition of damage to JSC and preserves status of shareholder during the legal proceeding of the suit⁹⁹. Otherwise, his/her status of proper plaintiff will be revoked. In case of continuous damage towards JSC¹⁰⁰ and in case of

93 Revised Model Business Corporation Act, 2021, § 7.42, Official Comment No. 3.

94 Compare: Company Act 2006, S. 261. See: Dignam and Lowry, *Company Law*, 8th ed., 201-208.

95 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 222.2.

96 Georgian Supreme Court Decision №-687-658-2016, 06/11/2018, field 75.

97 Georgian Supreme Court Decision №-766-766-2018, 10/06/2019, field 25; Georgian Supreme Court Decision №-437-436-2015, 06/06/2016, field 43. See also: Dignam and Lowry, *Company Law*, 8th ed., 190; Company Act 2006, S. 170.

98 Pinto, Branson, *Understanding Corporate Law*, 3rd ed., 458.

99 Allen, Kraakman, Subramanian, *Commentaries and Cases on the Law of Business Organization*, 4th ed., 378. Compare: Revised Model Business Corporation Act, 2021, § 7.41, Official Comment.

100 Home Fire Ins. Co. v. Barber, 93 N.W. 1024 [1903].

so-called double derivative suit, there is exception from imperative requirement to hold the share¹⁰¹.

Compared to USA, Georgian corporate law does not provide detailed description of requirements for being shareholder and in practice there is no definition with regard to legal form of JSC¹⁰². The law of Georgia „on Entrepreneurs” gives shareholder a possibility¹⁰³ to file a (derivative) suit in favor of JSC and in his/her name even when shareholder holds one share, and indicates existence of claim coming from JSC as a ground for the legal proceeding of the suit, in comparison to the law „on companies” from 2006, which lists grounds for filing derivative suit¹⁰⁴.

The solution of the question regarding ensuring compatibility of derivative suit and corporate interests of shareholder by the JSC management is legally relevant¹⁰⁵. If JSC requests ceasing legal proceeding of derivative suit, JSC loses possibility to file this claim in court for the second time. A similar conclusion was made by the Supreme Court of Georgia¹⁰⁶. There is a different occasion when there is a ground for the futility of demand¹⁰⁷ addressed to JSC¹⁰⁸. By applying to JSC the shareholder automatically „admits” the existence of grounds for the futility of demand and gives the possibility to JSC management (in case of Model Act of USA – board¹⁰⁹, in case of Georgia – shareholders’ General Meeting) for wide-range discussion to decide on the legal proceeding of the suit and refuse the demand¹¹⁰. However, JSC management is not obliged to respond to the presented demand¹¹¹. Refusal

101 Pinto, Branson, *Understanding Corporate Law*, 3rd ed., 467-469.

102 Compare: Company Act 2006, S. 260(5)(c).

103 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 222.1; Company Act 2006, S. 260 (1).

104 Company Act 2006, S. 260 (3).

105 Allen, Kraakman, Subramanian, *Commentaries and Cases on the Law of Business Organization*, 4th ed., 401-405.

106 Georgian Supreme Court Decision №-687-658-2016, 06/11/2018, field 92. Compare: Georgian Supreme Court Decision №-766-766-2018, 10/06/2019, field 28, 29.

107 Regarding the judicial test for examining futility of demand, see: Aronson v. Lewis, 473 A.2d 805 [Del. 1984].

108 Jugheli, *Capital Protection in a Joint Stock Company*, 211.

109 Revised Model Business Corporation Act, 2021, § 7.42, Official Comment No. 2.

110 Spiegel v. Buntrock, 871 A.2d 767 [Del. 1990].

111 Revised Model Business Corporation Act, 2021, § 7.42, Official Comment No. 4.

of demand without initiating legal proceedings is performed on internal corporate level¹¹². Refusal of demand implies the refusal of realization of its own claim by JSC, which in case of refusal by the board, is protected by the principle of freedom of corporate decision¹¹³.

Georgian corporate law includes responding to shareholders' demands regarding the competence of shareholders' general meetings. Shareholders must apply JSC in writing¹¹⁴, which may refuse or agree on using the right to claim belonging to JSC itself. On the second occasion, it is the competence of the shareholders' general meeting to decide on participating against JSC managing body/persons or members of the supervisory council in the court proceeding, including a decision on the appointment of a special representative for such process¹¹⁵. In case of refusal to realize of demand of the shareholders' general meeting, minority shareholders may challenge the fairness, impartiality of the decision made by majority shareholders (if any) at the general meeting and also argue about infringement of fiduciary duty by the shareholder.

It must be noted that after receiving approval on the shareholder's demand by JSC management, shareholders move away¹¹⁶ from the legal proceeding (or shareholder acting as the plaintiff may be substituted by JSC at any time)¹¹⁷ and they will not have any access to a court trial in any manner¹¹⁸.

6. Terms for filing the suit

Terms for filing suit are important procedural aspects. The Georgian law on „Entrepreneurs” stipulates a period of limitation and terms for

112 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 222.2 (a). Compare: Revised Model Business Corporation Act, 2021, § 7.44.

113 Zapata Corp. v. Maldonado, 430 A.2d 779, 784 [Del. 1981]. See: Cahn and Donald, *Comparative Company Law*, 612-617.

114 Revised Model Business Corporation Act, 2021, § 7.42.

115 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 184.1 (m).

116 Cahn, Donald, *Comparative Company Law*, 607.

117 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 222.3.

118 Pinto, Branson, *Understanding Corporate Law*, 3rd ed., 479. See: Revised Model Business Corporation Act, 2021, § 7.42, Official Comment No. 4.

rescission¹¹⁹. According to the systemic definition of the norm, the period of limitation of the claim deriving from a legal relationship – 5 years and the term for rescission – from 1 month up to 1 year, naturally, are general and relate to participants of internal corporate relations, as well as third persons, but in both dimensions, they define admissibility of the suit in terms of timing. Georgian corporate law does not define the form of a suit for exercising the right to rescission. However, it classifies structural rights deriving from the member's status, and in case of their infringement partner has the right to file a suit (individual or derivative)¹²⁰. Interpretation of general terms of filing suit prescribed normatively brings us to the logical conclusion that it must be used for any suit if otherwise is not stipulated in the law. For instance, the law of Georgia „on Entrepreneurs” prescribes internal organizational terms according to which, when applying to the court with the derivative suit, the shareholder is considered a proper plaintiff if 90 days have passed since the written notification was presented to JSC¹²¹.

7. Other procedural aspects of the suit: costs of trial, restitution of damages, and subject receiving compensation for the damage

Court proceeding consolidates two economic-legal aspects: compensation of trial costs and, in case of consideration of the claim, subject receiving compensation.

According to Georgian corporate law, in case of a derivative suit, when the court considers the shareholder a proper plaintiff, the JSC is obliged to compensate their expenses relating to filing the suit if the JSC has received essential profit because of the suit¹²². But if the shareholder will not be considered as proper plaintiff, they are obliged to compensate those expenses incurred by JSC in reasonable limits, which were caused by shareholder's claim¹²³.

Compared to a derivative suit, the issue of imposing costs of the trial is quickly decided in the case of the individual suit: the problem of imposing

119 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 92, 93.

120 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 93.

121 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 222.2 a).

122 Revised Model Business Corporation Act, 2021, § 7.46.

123 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 222.4.

expenses on the respondent is determined by the court procedure law and the suit¹²⁴.

The second economic aspect of the suit is the identification of receiving subject after satisfaction of the claim. The modeling of the situation in case of the individual suit is not necessary, as far as the shareholder suffered the damage individually. Hence, the right to claim belongs to them particularly, and in case of satisfaction of the claim by the court, the subject of compensation is the shareholder individually. As for the derivative suit, the abovementioned reasoning about identifying the subject receiving compensation gives us an answer. In particular, the suit belongs to JSC, which is „technically” ensured by the shareholder. Therefore, after the satisfaction of the claim, the outcome is imputed to JSC¹²⁵ and not the shareholder, who holds the status of the proper plaintiff in the trial. In case of satisfaction of claim through a court trial, the defendant is obliged to compensate the damage caused for JSC or give received benefit to JSC¹²⁶. It is natural that if the suit is directed against the managing person, he/she must restore damage from his/her assets if his/her liability is not insured¹²⁷. Obligation to compensate damages to JSC is normatively regulated within the Georgian legal sphere¹²⁸.

8. Concluding theses

In conclusion, we may say that a shareholder suit is a solid corporate strategy for controlling investment, which is essentially used as a legal protection mechanism for the investment package of minority shareholders.

The corporate legal classification of suits is based on procedural and substantial-legal requirements, out of which derivative suit is distinguished by its extraordinary nature. The motive of filing a derivative suit must be altruistic as it does not receive any benefit directly from the outcome of the suit¹²⁹.

124 The Civil Procedure Code of Georgia, Parliament's Gazette, 47-48, 31/12/1997, articles 37-55.

125 Cox, Hazen, *The Law of Corporations*, vol. 2, 3rd ed., 118.

126 Allen, Kraakman, Subramanian, *Commentaries and Cases on the Law of Business Organization*, 4th ed., 407.

127 Pinto, Branson, *Understanding Corporate Law*, 3rd ed., 510; Allen, Kraakman, Subramanian, *Commentaries and Cases on the Law of Business Organization*, 4th ed., 408.

128 Law of Georgia on Entrepreneurs, Legislative Herald, 04/08/2021, Article 222.1.

129 Dignam, Lowry, *Company Law*, 8th ed., 213.

Further development of the shareholder suit depends on practice, which must be analyzed, and results used for improvement-modification of legislative regulations related to the suit.

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