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Paper 13: Ineffective Derivative Suits and Corporate Control Market in Korea

By

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INEFFECTIVE DERIVATIVE SUITS IN KOREA

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I. INTRODUCTION

Among many corporate monitoring tools, derivative suits have distinctive feature: “relatively feasible” ex post remedy for governance failure. Since they can deprive managers of money, prestige, or even their jobs, these suits serve an important threatening or disciplinary function that can deter the management from engaging in wrongdoings. Moreover, such deterrence effect may well be emphasized once the limits of ex ante monitoring measures are taken into account. Recent researches using U.S. data find that ex ante corporate governance devices might not be more efficient than expected: independent directors have little to do with firm performance; design of executive compensation not only fails to reduce agency costs but rather results from such costs; and institutional investors lack sufficient incentive to monitor the management. Even the market for corporate control seems to be ineffective, due to the pro-management Delaware jurisprudence on the use of poison pill and staggered board. In this situation, shareholder litigation might be the last resort for efficient corporate governance system.

The situation is similar in Korea. Recently, Korea also struggled to establish the transparent and efficient corporate governance system. As widely noted, the Korean business law, which includes the Commercial Code and the Securities and Exchange Act, had experienced a rapid change after the East Asian financial crisis in the late-1990s by adopting Anglo-American-styled legal framework for corporate governance issues, and as a result, the Korean corporate law and securities regulation are generally referred to provide next to world-class investor protection.¹ For instance, shareholder proposal, voting by mail, cumulative voting, stock options,

and audit committee had been stipulated in the statute since the financial crisis. Appointment of several outside or independent directors was mandated for listed companies, and large firms should have more than a half of the all directors be independent. Minimum shareholding requirements for certain shareholders’ rights were dramatically diminished. As far as the statutory level of regulation is concerned, it can be fairly said that Korean legal framework is now at least not much different to that of U.S. or western developed countries.

As we can see in the recent SK scandal, however, the corporate governance practice of Korean chaebols seems to persist despite the recent statutory reforms. Still, the shameful description that Shleifer and Vishny made before the above institutional reform for the Korean corporate governance, and for the chaebol system in particular, still holds to some extent. Several observations may explain why. For instance, although outside or independent directors are mandatory for listed firms, there is little evidence that they have something to do with firm performance; in effect, outside directors are likely to be chosen by managers or controlling shareholders, who are supposed to be monitored. Stock option is just a windfall; informational efficiency of Korean stock market has not yet firmly established, and thus firm value is hardly reflected to the stock price of the company. Even the market for corporate control does not work in Korea.

Worst of all, the derivative suits do not discipline managers, just because almost no suits have been filed. To my best knowledge, fewer than 10 derivative suits have been filed since the late-1990s. Contrary to the cases in U.S. or Japan, such lawsuits were not initiated by shareholders or entrepreneurial lawyers, but rather they were filed by an NGO called “People’s Solidarity for Participatory Democracy (PSPD).” Simply put, the derivative suits were operated not by economic animals with pecuniary incentives but rather by a lonely knight with a mission to cure Korean corporate governance system. Due to lack of financial and human resources, the PSPD were only able to bring a few lawsuits against the company who committed a manifest wrongdoing. Therefore, although the lawsuits that the PSPD filed attracted much attention, little threatening function was achieved. At least as of now, when managers and controlling shareholders violated their fiduciary duties, they were

2 “Korean chaebol sometimes sell their subsidiaries to the relatives of the chaebol founder at low prices. . . . In many countries today, the law protects investors better than it does in Russia, Korea, or Italy.” See Andrei Shleifer & Robert W. Vishny, A Survey of Corporate Governance, 52 J. FIN. 737, 742 (1997).

3 See infra note __ and accompanying text.
more likely to be criminally prosecuted, as we can see in the recent SK scandal, rather than to be sued by shareholders.

Given the situation in which the ex ante monitoring or incentive mechanisms such as independent directors, executive compensation, institutional shareholders, and voting system are inherently or practically defective, and the market for corporate control is hard to provide disciplinary function, the shareholder litigation is or should be the last and the most plausible candidate to improve the corporate governance of Korean chaebols. Against this backdrop, this paper examines why derivative suits have been rarely used in Korea—mainly due to failure of legal service market—and argues that, in order to activate shareholder litigation mechanism, it is necessary to provide more pecuniary incentives to plaintiff lawyers. In particular, high attorney fees on contingent basis might be desirable in current Korea. In order to achieve this, however, big statutory reform is never necessary. Rather, making legal service market more competitive and social tolerance for greedy lawyers will be more essential. This observation seems to be timely, since the legal service market in Korea is now under revolutionary change; the number of lawyers has been dramatically increased in recent years, and sooner or later the domestic legal service market is supposed to be opened to foreign law firms. In such more competitive market, my expectation is that several attorneys will find the derivative suits attractive and there will be many lawsuits enough to improve corporate governance practice of Korean chaebols.

Several commentators might be concerned about collusive settlement between defendant managers and plaintiff attorneys, as witnessed in the U.S. derivative suits. Blaming plaintiff lawyers for pursuing private monetary gain is not the point of this debate; in fact, the pecuniary benefits granted to plaintiff lawyers are the driving force of derivative suit mechanism. The problem is that, if the disputes are likely to end up with settlement, which does not depend on the merit of the suits, any threat or deterrence to the management may not be generated. It might be the case that such costly legal process results in almost no improvement in corporate governance. In fact, the collusive settlement problem cannot be easily resolved, since agency problems are involved on both sides; one is plaintiff-attorney relationship on plaintiff’s side, and the other is shareholder-management relationship on defendant’s side. In such case, however, the direct cause of the disappearance of deterrence is not the high compensation for plaintiff lawyers but the possibility of settlement itself. That is to say, the source of this problem is that attorneys are allowed to retain the same monetary benefit when the disputes are settled. Therefore, this paper agrees that, in the long run, when the suits end up with
settlement, elimination of monetary profits—little compensation for the time cost—by means of judicial intervention might be necessary. In the short run, however, I argue that such anti-abuse provisions should not be incorporated in the statute, since such provisions will inevitably paralyze the derivative suit mechanism itself. Moreover, several features of Korean litigation process may be available to prevent frivolous lawsuits.

This paper consists as follows. Part II discusses preliminarily on the theoretical importance of derivative suits in corporate governance practice. In Part III, I compare legal framework of shareholder litigation between United States, Japan, and Korea. This comparison shows that, from the level of statutory provisions, the differences in legal system are quite minimal. Moreover, in several respects, it seems to be easier for shareholders in Korea to file a lawsuit than in United States. Part IV discusses about the puzzle: given more pro-litigation rules in Korea, why are Korean chaebols not threatened or disciplined by shareholders? In terms of such disciplinary function, I argue that it is necessary in this stage to foster the entrepreneurial lawyers. Inevitable abuse of plaintiff lawyers should not be the issue on the table. Finally, Part V is concluding remarks.

II. THEORETICAL IMPORTANCE OF DERIVATIVE SUITS

1. Ex Post Liability v. Ex Ante Monitoring

To regulate managerial effort, should shareholders hire outside directors (ex ante monitoring) or, instead, file the suits against disloyal managers (ex post liability)? Several researches have explored the optimal mix of ex ante monitoring and ex post liability in various contexts, and the results can be applied to the corporate governance system. One well-known extreme analysis contended that ex post liability scheme is superior, since the damages merely transfer wealth, without imposing any social cost. Ex ante monitoring mechanisms are costly; for instance, mandatory disclosure regime needs much human and financial resources to prepare documents. Outside directors are also costly, because they have to spend their time, and therefore, it is quite hard to find a competent and efficient director who has no.

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commitment at the same time. Arguably, if the person is really “independent,” he or she is likely to be inept. In this case, it is possible that the decision made by independence directors results in some inefficiency on the firm level. Ex post liability regimes such as derivative suits or hostile bids are costless since they are triggered only when corporate mismanagement was found; as long as managers do not engage in wrongdoing, these mechanisms impose no cost on the firm.  

To be sure, such distinction might be illusive or too theoretical. If the derivative suits or hostile bids are to properly function, there must be enough number of such events for people to believe in the threats. To such extent, ex post liability regimes also incur social costs. Arguably, it might be rather safe to say that the trade-off between those two deterrent tools depends on their relative costs for achieving the same level of managerial effort.

2. Ineffective Ex Ante Monitoring

The importance of deterrence effect that derivative suits are likely to generate should be highlighted, if the results of recent researches on ex ante monitoring measures are taken into account. Since the late-1990s, there have been rigorous researches on correlation between corporate governance and firm performance. Among them, several scholars have tried to show how effectively or efficiently the specific ex ante corporate governance devices work. The results were negative, or mixed at best, however. Outside or independent directors, for instance, have little to do with firm performance. Current practice of independent directors shows how difficult it is to


7 See Mookherjee & Png, supra note __, at 557 (arguing that, “if the direct cost of [ex post liability] is sufficiently low and the offense is adequately reported at all levels,” only ex post liability scheme should be adopted).

8 See Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: A n Agenda for Institutional Investors, 43 Stan. L. Rev. 863, 874-875 (1991) (“Good character and financial independence from management may be necessary conditions for effective monitoring [of independent board], but they are hardly sufficient.”); Laura Lin, The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence, 90 Nw. U.L. Rev. 898, 921-939 (1996) (summarizing mixed empirical evidence on the net effect of outside directors); Jill E. Fisch, Corporate Governance: Taking Boards Seriously, 19 Cardozo L. Rev. 265, 276-278 (1997) (same); Ira M. Millstein & Paul W. MacAvoy, The Active Board of Directors and Performance of the Large Public Traded Corporation, 98 Colum. L. Rev. 1283, 1310-1317 (1998) (showing a statistically significant relationship between an active, independent board and superior corporate performance) (emphasis added); April Klein, Firm Performance and Board Committee Structure, 41 J.L. & Econ. 275, 287-296 (1998) (finding that, while there is no positive relation firm performance and board
make the board “at the same time knowledgeable about the company and independent from management.” Executive compensation is also suspicious. In fact, the sensitivity of executive compensation to stock price is hardly established even in the U.S. stock market. Moreover, Recent research on executive compensation argues that the compensation scheme not only fails to reduce agency costs but rather results from such costs. The stock options given to CEOs may have negative impact on shareholder value, since stock options in general do not include a penalty when the firm’s performance is poor, or it is likely that the details of the plan is badly designed. Finally, institutional voices are not so strong. Although several institutional investors have often started proxy contest opposing the issuance of (or seeking the rescission of) poison pills, there remains many barriers. Overall,

composition, insider directors can be more valuable board members, if properly used, than outside directors); Sanjai Bhagat & Bernard Black, The Uncertain Relationship between Board Composition and Firm Performance, 54 BUS. LAW. 921, 940-950 (1999) (showing that the boards with a majority of outside directors do not perform better than firms without such boards). In a sample of Japanese firms, several researches shows such conflicted results. See Steven N. Kaplan & Bernadette A. Minton, Appointment of Outside Directors to Japanese Boards: Determinants and Implications for Managers, 36 J. Fin. ECON. 225, 245-255 (1994) (reporting that top executive turnover increases substantially in years of outside appointment, and firm performance improves modestly after outside appointment); Jun-Koo Kang & Anil Shivasani, Firm Performance, Corporate Governance, and Top Executive Turnover in Japan, 38 J. Fin. ECON. 29, 44-46 (1995) (finding no significant relationship between firm performance and the outside directors).

9 See FRANKLIN ALLEN & DOUGLAS GALE, COMPARING FINANCIAL SYSTEMS, 95 (2000).

10 See Michael C. Jensen & Kevin J. Murphy, Performance Pay and Top-Management Incentives, 98 J. POL. ECON. 225 (1990) (finding that the pay-performance sensitivity has gradually reduced; CEO wealth changes $3.25 for every $1,000 change in shareholder wealth, most CEOs hold trivial fractions of their firms’ stock, and managerial ownership have declined over the past 50 years); Joseph G. Haubrich, Risk Aversion, Performance Pay, and the Principal-Agent Problem, 102 J. POL. ECON. 258 (1994) (showing that low levels of performance pay according to Jensen & Murphy are not inconsistent with the principal-agent model). But see Brian J. Hall & Jeffrey B. Liebman, Are CEOs Really Paid Like Bureaucrats? 113 Q.J. ECON. 653 (1998) (finding that, virtually all of the pay-performance sensitivity is attributable to changes in the value of CEO holding of stock and stock options, and, as a result, pay-performance sensitivity have risen dramatically during the 1980s and 1990s due to the explosion of stock option issuance).


12 See Saul Levmore, Puzzling Stock Options and Compensation Norms, 149 U. PA. L. REV. 1901, 1903-1923 (2001) (pointing out that bonus plans and indexed plans are superior to conventional stock options).

13 See Bebchuk, Fried & Walker, supra note __, at 792 (“The devil is in these details. . . . A badly designed option plan might produce significantly less value for shareholders than a plan constructed to maximize shareholder wealth.”).


15 See JESSE H. CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, CASES AND MATERIALS ON CORPORATIONS, 544-548 (5th, 2000) (such as rational apathy, free rider problem, exit option, and
current role of ex ante monitoring schemes to improve corporate governance is limited to some extent.

In Korea, the situation is even worse. Taking into account the controlling minority ownership structure, the governance tools are hardly able to monitor the controlling shareholders. Although the securities law mandates outside directors for listed companies, there is little evidence that they have something to do with firm performance. As far as independence issue is concerned, outside directors are still appointed by top management or, in fact, by controlling shareholders, who are supposed to be monitored. The limitation of human resources is another big problem. Since a person may not be appointed as outside directors by more than two companies, the resource pool for outside directors is relatively small. As a result, effective monitoring by independent board seems to be hardly achieved. Other ex ante monitoring mechanisms do not seem to be well established; little experience and knowledge about the organization and operation of audit committee, negligible incentive effect of stock option (due to the unestablished correlation between firm performance and stock price), and relatively small shareholdings and inherent passivity of traditional financial institutions.

3. Ineffective Market for Corporate Control

Two major ex post measures for governance failure is derivative suits and hostile bids. Arguably, when the ownership of the company is dispersed, one of the most important monitoring mechanisms is the market for corporate control. As widely noted, however, the recent U.S. market for corporate control seems to be paralyzed, due to the pro-management Delaware jurisprudence on the use of poison pill and staggered board. Since defensive tactics are perfect and, as a result, the incumbent
target managers are able to be fully insulated from the takeover threat, the "disciplinary" function of market for corporate control disappeared.

Under the Korean corporate law, by contrast, it is relatively hard for target management to employ several defensive strategies developed in U.S.\textsuperscript{20} Consider, for example, major defensive tactics from the U.S. perspectives: white knight, poison pill, and staggered board.

(a) **White Knight.** Korean corporate law stipulates the preemptive right of shareholders; unless the charter provides otherwise, the shareholders are entitled to receive, pro rata, newly issued shares of the company.\textsuperscript{21} Therefore, most charters of public companies have a provision that enables the company to issue new shares to non-shareholders in certain cases. The problem is that the amendment of Korean Commercial Code in 2001 explicitly restricted such third-party issuance of shares to the case where the company has certain “business purposes” such as R&D or capital raising.\textsuperscript{22} It is not yet clear, however, whether such restriction will be strictly applied or not, but it is evident that, if the incumbent managers have to adopt the white knight strategy, they must bear high risk for the court to invalidate such tactic for the reason that the tactic is adopted for the purpose of defense, which does not fall into the “business purpose.” Since too much legal uncertainty is involved in the white knight strategy, the defensive role is limited.

(b) **Poison Pill.** It is widely accepted that pills in original format—dividend of call options to buy shares at negotiated price—cannot be issued in Korea. Under the Korean corporate law, the concept of “asset (except for cash) dividend” does not exist, and thus it is believed—I don’t know exactly why—that any rights or securities cannot be issued “in the form of dividend.” Moreover, although there are no statutory grounds and in fact several scholars argue otherwise, it is also believed that competition is likely to produce rules that excessively protect incumbent managers and, as a result, “Delaware law has gradually evolved so as to allow directors . . . to ‘just say no’ to potential bidders with the poison pill defense in place”); Lucian A. Bebchuk, John C. Coates & Guhan Subramanian, The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, 54 STAN. L. REV. 887, 927-930 (2002) (finding that not a single hostile bid won a ballot box victory against an effective staggered board in the five-year period 1996-2000, and that an effective staggered board nearly doubled the odds of remaining independent for an average target, from 34% to 61%).

\textsuperscript{20} On bidder’s side, Korea imported almost all the elements of Williams Act. See Korean Securities and Exchange Act §§ 200-2 (5% reporting obligation), 21-2 to 27-2 (substantive regulation on tender offer), 199 (with Presidential Decree § 84) (proxy rule).

\textsuperscript{21} See Korean Commercial Code § 418(1).

\textsuperscript{22} See Korean Commercial Code § 418(2).
the issuance of warrants—call options to buy issuer’s shares—is prohibited under Korean Commercial Code. Even if the issuer tries to directly issue poison pills to certain shareholders, not in the form of paying dividends, still such transaction is likely to be invalidated by the court. Finally, the discriminative feature of poison pill is hard to be endorsed under Korean corporate law, since the equal treatment of shareholders is quite strictly enforced. Taken together, the most powerful defensive tactic is not available in Korea.

(c) Staggered Board. A few companies started to adopt staggered board provisions in their charters, but it seems nearly impossible to have staggered board be effective. In an effective staggered board, directors may only be removed for cause, and shareholders may not pack the board by increasing the number of directors and filling the vacancies. Korean Commercial Code provides that two thirds of attending voting shares and at the same time one thirds of voting shares can remove directors “without cause,” and general understanding is that the charter cannot provide otherwise. As a result, obtaining proxy of more than two third—sometimes less than two thirds are enough because all shareholders do not attend the meeting—can destroy staggered board.

In short, Korean big companies might be much more vulnerable to hostile takeovers than the U.S. counterparts; once hostile bids are launched, it is quite hard for incumbent managers to find adequate and costless defensive tactics. In such case, a number of hostile bids are expected, but that’s not the case. Hostile bids are quite rare—almost none—in Korea.

There are several reasons. First, it is mainly because there are controlling shareholders who already established their control block of over 40% of shares through pyramids and circular shareholding. Although direct family ownership is

23 See, e.g., KT, Articles of Incorporation § 26 (as of April 2004).
24 See Bebchuk, Coates & Subramanian, supra note __, at 894.
26 In fact, lack of hostile bids is distinctive feature of several countries, such as Germany and Japan, in which corporations are owned by controlling families. See Julian Franks & Colin Mayer, Corporate Ownership and Control in the U.K., Germany, and France, in STUDIES IN INTERNATIONAL CORPORATE FINANCE AND GOVERNANCE SYSTEMS: A COMPARISON OF THE U.S., JAPAN & EUROPE, 281, 292-293 (DONALD H. CHEW ED., 1997) (suggesting several explanations for the low level of hostile takeovers in Germany; bank control, voting right limitations irrespective of size of the shareholding, and difficulty in removing members of the supervisory board); J. MARK RAMSEYER & MINORU NAKAZATO, JAPANESE LAW: AN ECONOMIC APPROACH, 121-122 (1999) (mentioning legal barriers, cross-shareholding, and transformation of hostile bids into friendly ones).
less than 10%, controlling shareholders are able to make use of the inter-company ownership of more than 30% of shares. Bidders do not attempt to start bidding war, because they have to buy almost all the remaining shares traded in the market. Second, again, the stock market is under-developed and information on managerial efficiency is hardly reflected to the stock price. In such case, bidders cannot find inefficient managers, and, even if they are more efficient managers, they are not sure that the market will know about it after they acquire a target. Under such uncertainties, bidders might well give up to bear risk. Finally, undeveloped legal system is a problem. The ineffective takeover market deters the development of a sophisticated judiciary and legal doctrines, and this failure of judicial development, in turn, restricts the effectiveness of the market for corporate control in Korea.

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Given the situation in which the ex ante monitoring or incentive mechanisms inherently or practically defective, and the market for corporate control is hard to provide disciplinary function, the shareholder litigation is a final candidate on the table that needs close examination.

III. LEGAL FRAMEWORK: COMPARISON

The first step is comparative analysis. For the comparison purpose, Japanese law and experiences should be closely examined, because Japanese law on derivative suits quite resembles that of Korea but the actual pattern of derivative lawsuits in Japan is much like that of U.S. In fact, the derivative suits had been ineffective also in Japan; shareholders in Japan had also filed only fewer than 20 derivative suits from 1950 to 1990. In 1993, however, Japan reduced the filing fees to about $80 (about 8,200 Yen), and such change had brought about an explosion in derivative litigation. Relying on this fact, commentators tend to believe that the reducing litigation fee can cure the problem. Not that easy, however. The filing fees in Korea has been a fixed and nominal amount for a long time since early-1990s; about $40 (about 50 thousand

27 See Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110, 112-114 (1965) (arguing that the most “fundamental premise underlying the market for corporate control is the existence of a high positive correlation between corporate managerial efficiency and the market price of shares of that company”).


29 See Mark D. West, Why Shareholders Sue: The Evidence from Japan, 30 J. Legal Stud. 351, 352, 355-356 and table 1 (2001) (reporting that 84 suits were pending in 1993, but there were 174 suits in total by the end of 1996, and 286 suits by the end of 1999, including 95 filed in 1999 alone).
Won) prior to financial crisis, and currently about $190 (about 230 thousand Won). The phenomenon like “explosion of derivative suits,” however, has not been witnessed. In fact, the filing fees have never been a critical issue in Korea; the nominal increase in filing fees did not attempt to block lawsuits, but just to catch up the general price increase. Still, the burden of filing fees to bring a derivative suit is quite negligible. If the answer is not the filing fees, what then prevents Korean shareholders from bringing lawsuits? To examine whether the law bars derivative suits, this Part III will be devoted to compare basic legal structures of derivative suits between Korea, Japan, and U.S.

1. Who Can Bring a Suit?

Traditionally, the minimum shareholding requirement has been regarded as the most significant barrier that prevents shareholders from bringing a derivative suit. Prior to the financial crisis, the statutory threshold to bring a suit was 5% of shares of the company. Comparing to U.S. and Japan, where a shareholder with only one share may bring a derivative suit, such requirement was blamed for paralyzing the derivative suits. Considering the fact that controlling families in Korean chaebols directly own, on average, less than 10% of controlled firms, the threshold of 5% seemed to be too high. Right after the financial crisis in 1997-1998, the shareholding threshold for filing a derivative suit was dramatically reduced to 0.01% in case of listed companies. It is not yet possible for a shareholder owning only one share of the company to file a derivative suit. Moreover, the magnitude of money to acquire more than 0.01% of the listed companies might be large. It is not clear, however, the necessity of gathering more than 0.01% is still a significant hurdle for lawsuits.

Another seemingly barrier to bring a suit is “holding period” requirement, which

30 See Korean Civil Action Filing Fees Act § 2(1) (providing that if the litigated amount is more than 10 million Won and less than 100 million Won, the filing fee is “the litigated amount \(\times\) 45 / 10,000 + 5,000 Won”); Supreme Court Regulation on Civil Action Filing Fees §§ 15(1), 18-2 (providing that, regardless of the amount of damages alleged, 50 million and 100 Won is regarded as the litigated amount of derivative suits). The filing fees are thus calculated as 50,000,100 \(\times\) 45 / 10,000 + 5,000. Prior to the year of 2001, the same provisions of the Act and Regulation provided that the litigated amount of derivative suits were 10 million and 100 Won, and the ratio to be multiplied to this amount is 5 / 1,000. As a result, the filing fees prior to the crisis were 10,000,100 \(\times\) 5 / 1,000 = 50,000 Won.

31 See, e.g., REV. MODEL BUS. CORP. ACT § 7.41 (no limitation).


33 See Korean Securities and Exchange Act § 191-13(1). In case of non-listed companies, the shareholding threshold was also reduced to 1%, which seems to be still high. See Korean Commercial Code § 403(1).
was also found in Japan. The Korean Securities and Exchange Act requires that a shareholder should hold shares “continuously” for 6 months before bringing a suit. On the other hand, Korean corporate law, like in Japan, does not provide “contemporary shareholder rule,” which is universal in the U.S. corporate law. Under this rule, the plaintiff shareholder must have been a shareholder “at the time of the alleged wrongdoing.” Since there is no such rule in Korea, the individuals can bring a suit simply by purchasing a few shares—but the amount must be over 0.01% of total shares and they must wait for 6 months after purchasing shares—after noticing managerial wrongdoing in a listed company.

2. How Can Board Interrupt?

Under the Delaware corporate law, the plaintiff shareholder, prior to bringing a suit, must make a demand on the corporation’s board of directors to take action, “unless the demand would be futile.” In the Korean corporate law, like in Japan, however, demand on board is universal, as the RMBCA and the ALI’s Principles of Corporate Governance provided. Only if the demand—and required interval of 30 days for board’s response—might cause the company “irreparable damage,” shareholders can bring a suit without demand on board. In other words, so-called “demand required, demand excused” distinction in Delaware jurisprudence has not been adopted in Korea; even though the demand would be “futile,” shareholders must make a demand unless irreparable harm—which, arguably, is hard to define—to the corporation would be caused. The result is that the directors have enough time

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34 See Japanese Commercial Code § 267(1) (also six months).
35 See Korean Securities and Exchange Act § 191-13(1). In case of non-listed companies, instead of requiring high shareholding ratio, there is no requirement regarding holding period. See Korean Commercial Code § 403(1).
36 See, e.g., DEL. CODE ANN. tit. 8, § 327; CAL. CORP. CODE § 800(b)(1); N.Y. BUS. CORP. LAW § 626(b); REV. MODEL BUS. CORP. ACT § 7.41(a).
37 There are two rationales for the contemporaneous shareholder rule. One is a concern with individuals purchasing shares simply for the purpose of bringing a frivolous suit. The other is that, since the market price reflects the losses that the directors’ wrongdoing might incur, granting recovery to individuals who buy stock after wrongdoing damaged the corporation is allow them to obtain a windfall. See generally, FRANKLIN A. GEVERTZ, CORPORATION LAW, 396-399 (2000) (concluding that “the contemporaneous shareholder rule is a mistake”), ROBERT C. CLARK, CORPORATE LAW, 650-652 (1986) (mentioning that “it is difficult to justify the continued existence of the contemporaneous ownership rule”).
38 See GEVERTZ, supra note __, at 401.
39 See Korean Commercial Code § 403(1).
40 See REV. MODEL BUS. CORP. ACT § 7.42; American Law Institute, Principles of Corporate Governance § 7.03.
41 See Korean Commercial Code § 403(4).
to take defensive measures at corporate expenses, and the lawsuit is at least delayed
for 30 days. In this regard, this rule creates delay and expense on shareholders' side,
and thus may deter the shareholder litigation itself to some extent.

It is worthwhile to notice that such rule only creates delay. Although Korean
corporate law provide automatic delay as stated above, most part of the procedural
complexity in relation to the demand issue in the U.S. derivative suits does not exist.
In particular, the board has almost no power to bar the complaint from proceeding
to the court. The U.S. board has two major tools to interrupt shareholders and
prevent them from proceeding; refusal to bring a suit and special litigation
committees. (1) The board may refuse to take action. Applying business judgment
rule to such refusal, courts in general held that the litigation might go forward if, for
example, the plaintiff can prove directors’ conflicts of interest or bad faith.42 Such
proof might not be that hard, but in any event, the shareholders in Korea can
proceed without showing directors’ conflicts of interest or bad faith.43 (2) The U.S.
corporate management can ward off derivative suits by appointing special litigation
committees. Since mid-1970s, such committees, almost without exception, have
concluded that the derivative suits were not in the corporation’s best interest.44 Such
practice is not expected in Korea, and in Japan as well.

Taken together, the U.S. shareholders must be concerned about the strategies that
the board can employ to drop the suit, while in Korea, the demand requirement is
merely procedural. The only way for the Korean board to bar the suit by plaintiff
shareholders is to accept the demand and file a suit by the corporation itself.
Therefore, derivative suits are more easily brought in Korea rather than in U.S.

3. Litigation Costs

To bring a suit, a plaintiff shareholder incurs filing fees—currently about $190—and
attorney’s fees. Theory tells that such costs may significantly prevents a shareholder
from suing directors, since it is the injured company that receives the actual recovery,
a plaintiff shareholder can obtain only a proportional—typically de minimis—benefit
from a “corporate” recovery in a suit. Accordingly, the U.S. rule is that a shareholder
“prevailing” in a derivative suit should be fully reimbursed by the company for the

42 See GEVURTZ, supra note __, at 408; CLARK, supra note __, at 644.
43 See Korean Commercial Code § 403(3).
44 See GEVURTZ, supra note __, at 412. For judicial review of the committee’s recommendation
to drop suits, see Auerbach v. Bennett, 47 N.Y.2d 619 (1979) (minimal review); Zapata Corp. v.
filing fees and attorney's fees incurred. Economically, the full reimbursement of litigation costs by the corporation is equivalent to the imposition of litigation costs on all the shareholders, pro rata, and therefore free-rider problem can be solved. Basically, such reimbursement is thus statutorily provided in Korea,\textsuperscript{45} as well as in Japan.\textsuperscript{46} In Korea, however, the extent to which the corporation should reimburse is not yet clear. Most importantly, if plaintiff attorneys are paid more than the Supreme Court Rule provides,\textsuperscript{47} it is not yet clear whether the total amount paid may be reimbursed or not.

In addition, it should not be ignored that a plaintiff shareholder in Korea bears one more risk in relation to litigation costs. Korea follows the British rule in allocating the litigation costs; a plaintiff losing the suit must pay the litigation costs—including attorney's fees—reasonably incurred by the defendant.\textsuperscript{48} Overall, the uncertainty with regard to the litigation costs in Korea may deter derivative suits for two reasons: if a plaintiff shareholder wins, he or she is not sure of being fully reimbursed; if, on the other hand, a shareholder loses, he or she might pay the litigation costs of the defendants.

On the other hand, mainly due to a concern about strike or frivolous suit, roughly one third of the U.S. states require that the plaintiff shareholder should post security to cover the expenses that the corporation might incur. New York enacted the first security for expenses statute in 1944,\textsuperscript{49} but Delaware did not follow yet. Although Korean corporate law is not much concerned about the abuse of derivative suits, the security of expense clause has been in the statute from the beginning.\textsuperscript{50} The company, however, must show the bad faith on the plaintiff's side, and therefore, a shareholder who brings a meritorious suit does not have to post security.

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The following table shows the basic legal framework of derivative suits in three

\textsuperscript{45} See Korean Securities and Exchange Act § 191-13(6) (reimbursement of “full” litigation costs); Korean Commercial Code § 405(1) (reimbursement of “reasonable or appropriate” litigation costs).

\textsuperscript{46} See Japanese Commercial Code § 268-2(1).

\textsuperscript{47} See Korean Civil Procedure Act § 109.

\textsuperscript{48} See Korean Civil Procedure Act § 98. The British rule does not apply if the parties agree to settle. In case of settlement, American rule—each party bears their own costs—applies. See Korean Civil Procedure Act § 106.

\textsuperscript{49} See N.Y. BUS. CORP. LAW § 627.

\textsuperscript{50} See Korean Commercial Code § 403(7), 176(3), (4).
countries.

<Summary: Comparison of Statutes>

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
<th>Japan</th>
<th>Korea</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Shareholding</td>
<td>X</td>
<td>X</td>
<td>0.01%</td>
</tr>
<tr>
<td>Holding Period</td>
<td>X</td>
<td>6 Months</td>
<td>6 Months</td>
</tr>
<tr>
<td>Contemp. Shareholder</td>
<td>O</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Demand on Board</td>
<td>Futility Test</td>
<td>30 Days Delay</td>
<td>30 Days Delay</td>
</tr>
<tr>
<td>If Board Refuses</td>
<td>BJR Applies</td>
<td>Can File Suit</td>
<td>Can File Suit</td>
</tr>
<tr>
<td>Litigation Committee</td>
<td>O</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Filing Fees</td>
<td>$100 (Fixed)</td>
<td>$80 (Fixed)</td>
<td>$190 (Fixed)</td>
</tr>
<tr>
<td>Attorneys’ Fees if Prevail</td>
<td>Reimbursed</td>
<td>Reimbursed</td>
<td>Reimbursed</td>
</tr>
<tr>
<td>Litigation Cost Allocation</td>
<td>American Rule</td>
<td>American Rule</td>
<td>British Rule</td>
</tr>
<tr>
<td>Security for Expenses</td>
<td>O</td>
<td>O (if bad faith)</td>
<td>O (if bad faith)</td>
</tr>
</tbody>
</table>

Closely examining this, an immediate response is, why derivative suits are not common in Korea, while U.S. and Japan have trouble with too much suits? Korean law exactly resembles Japanese rule, except that a shareholder must have more than 0.01% of outstanding shares. Such minimum shareholding requirement is that much burdensome? In particular, a general understanding that the reduction of filing fees brought the explosion of derivative suits is not persuasive. Compared to the U.S. rule, on the other hand, a shareholder in Korea has several advantages; he or she does not have to be contemporaneous shareholder, the board cannot block the suit, and in ordinary cases security of expenses is not required. Only disadvantages of shareholders of Korean company are minimum holding requirement and holding period of six months requirement. Uncertainty involved in litigation costs might be another disadvantage. Again, such requirements cause that much trouble to a shareholder who intended to bring a derivative lawsuit?

IV. DISCUSSION: SOCIAL DESIRABILITY OF DERIVATIVE SUITS

1. Why Not Common in Korea?

A. Few Cases

Despite the above statutory similarities or even advantages, Korea has not witnessed any “explosion” of derivative suits; although the filing fees had been a fixed amount
of $40 (about 50 thousand Won) since 1992, no derivative suit had been filed for 5 years since then. The first derivative suit in history was filed in 1997 by the PSPD, and the defendant was the directors and officers of Korea First Bank. In this case, Korea First Bank made a decision to lend large amount to Han-Bo Steel, which went bankrupt in early-1997, and minority shareholders alleged that the directors and officers of the bank violated their duty of care (no investigation on the overall risk of Han-Bo Steel) and duty of loyalty (bribery from Han-Bo Steel). One year later, the Seoul District Court rendered a decision that the former directors are liable for 40 billion Won, and at long last the Supreme Court decision was rendered very recently, in 2002.

In 2001, another high-profile derivative suit was reviewed by the court; lawsuit against Samsung Electronics brought by, again, the PSPD. It was filed in 1998, and the plaintiffs alleged that the controlling shareholder and directors of Samsung Electronics are liable for breach of duty of care in acquiring a company, which eventually went bankrupt. The Soowon District Court held that the defendants are liable. This case might be called, “Korean Van Gorkom,” because the board, like Trans Union management, were not informed on the risk of a target firm, and the court particularly emphasized the board-decision making process, and uninformed, hasty conclusion in particular. Recently, the Seoul Appellate Court substantially reversed the decision (applying business judgment rule), and we have to wait another two or three years for final decision of the Supreme Court.

In addition to these two high-profile cases, there are two cases pending in the Seoul District Court, and one case pending in the Supreme Court. Two or three more cases were closed, without drawing attention from public.

Overall, fewer than 10 derivative suits have been filed since 1997. To be sure, it is true that the above cases—First Korea Bank and Samsung Electronics—gave great impact on the business law and practices, but it is true as well that such impacts

51 See supra note and accompanying text. Supreme Court Regulation on Civil Action Filing Fees was enacted on November 23, 1991, and was effective on January 1, 1992.
52 See Seoul District Court, 97 Ga-Hap 39907 (July 24, 1998).
53 See Supreme Court, 2000 Da 9086 (March 15, 2002).
54 See Soowon District Court, 98 Ga-Hap 22553 (December 27, 2001).
57 See 99 Ga-Hap 47193 (against Daewoo); 2003 Ga-Hap 1176 (against LG).
58 See 2003 Da 41784 (against Korea Media).
were limited. The number of derivative suits is too small for corporate management to feel pressure or threat to be sued. Most importantly, such suits were not initiated by shareholders or entrepreneurial lawyers, but rather by the PSPD. Although the activities performed by the PSPD have been generally evaluated as successful to improve corporate governance in Korean chaebols, the PSPD lacks human and financial resources to monitor all the major companies in Korea. In such case, the derivative suits initiated by the PSPD attached little threatening function, because managers of the companies not monitored by the PSPD do not believe that their shareholders also attempt to do the same thing.

B. Difficulties in Shifting Litigation Costs to Professional Lawyers: Japanese Solution

In retrospect, there would have been no shareholder litigation but for the PSPD. Given the similarities compared to Japanese system and several advantages compared to the U.S. framework, why are derivative suits much fewer in Korea? In fact, however, the question must be reversed: why are many derivative suits filed in U.S. or Japan? It is easy to figure out why a shareholder is very unlikely to attempt to sue managers. Obviously, a shareholder lacks incentives to file a derivative suit even if he or she knows about the managerial wrongdoing, because a shareholder bearing total litigation costs can obtain only a fractional benefit of increase in firm value. Since each shareholder has only a small portion of shares, he or she is not willing to take part in the suit unless the costs on his or her side are minimal or negligible. Taking into account this simple economic rationale, the right question is why many derivative suits have been actually filed in U.S. or Japan.

Cultural difference is often suggested, but the argument cannot stand on the solid ground. 59 When there was no shareholder litigation in Japan, for instance, the belief that Japanese people have an "inherent" aversion to litigation is remarkably pervasive among scholars, but such observation turned out to be false. Cultural argument does not explain the sharp increase in the number of derivative suits since 1993. The Japanese culture was changed all of sudden? Probably not.

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59 See West, supra note __ (1994), at 1439-1441 ("Ending the inquiry with a cultural explanation avoids the next logical query; namely, why does culture dictate nonlitigiousness, if it does at all? If this second-order question remains unanswered, a satisfactory response to the primary inquiry is impossible."); J. Mark Ramseyer, Takeovers in Japan: Opportunism, Ideology and Corporate Control, 35 UCLA L. Rev. 1, 39-40 (1987) ("Cultural values are fragile things. . . . Whether hostile takeovers will eventually become as common in Japan as in the United States, therefore, ultimately may depend on the extent to which Japanese firms find . . . that takeovers pay. . . . [M]ost writers have overestimated its uniformity and coherence and underestimated the extent to which individuals manipulate it strategically.").
In United States, lack of incentive problem stated above is resolved by professional lawyers. A derivative suit is typically brought by a plaintiff attorney, and if the action is unsuccessful, it will be the attorney and not the nominal plaintiff shareholder who bears the litigation costs. It might not be the case in Korea, however. Setting aside the filing fees that may be easily shifted to lawyers, a plaintiff shareholder in Korea must bear two significant litigation costs—in particular, associated with losing the suits—which is hard to be shift to professional attorneys.

1. The one is a nonrefundable “retainer” practice. It is quite common that attorneys demand payment in the form of a “retainer” before the litigation begins. Although the retainer might be also reimbursed by the corporation if a plaintiff prevails, it is, by nature, not refundable to a plaintiff in case of losing the suit. Thus, if the expected amount of retainer not to be refunded is large enough, a shareholder is discouraged to undertake such risky business.

2. The other is the British rule. Korea follows the British rule in allocating the litigation costs; a plaintiff losing the suit must pay the litigation costs—including attorney’s fees—reasonably incurred by the defendant. Korea follows the British rule in allocating the litigation costs; a plaintiff losing the suit must pay the litigation costs—including attorney’s fees—reasonably incurred by the defendant. It is to the plaintiffs, and not to the plaintiff attorneys that the court order is rendered. Therefore, the plaintiff shareholders are likely to bear such costs, unless there is a “confidential” agreement that the attorneys will bear full litigation costs—including the costs incurred by the defendant according to the court order—and such agreement is effectively enforced by the court or at least by reputation mechanism. Taken together, it is hard to perfectly eliminate the possibilities for shareholders to bear any costs associated with losing the suits.

In this regard, recent research on the derivative suits in Japan shows several interesting empirical results. According to Mark West, a plaintiff usually loses in derivative suits. Therefore, the risk of losing a retainer fee is quite significant in Japan (Japan does not follow the British rule). Arguably, such expected costs on plaintiff-shareholders’ side might not exceed the expected value of a pro rata increase in the value of his or her shareholding. Why then do shareholders in Japan file so many derivative suits? Mark West reported several interesting changes in the

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61 See Korean Civil Procedure Act § 98. The British rule does not apply if the parties agree to settle. In case of settlement, American rule—each party bears their own costs—applies. See Korean Civil Procedure Act § 106.

62 See West, supra note __ (2001), at 357-358 (reporting that, from a database consisting of 73 derivative suits filed between 1993 and 1999, only 2 cases resulted in victory for plaintiffs and 4 cases are pending because of appeals by defendants).
legal service market. Most importantly, many attorneys reduced their retainers.\textsuperscript{63} Small retainers and large contingent fees becomes a standard of legal practice. Besides, to avoid risk, attorneys—especially elite attorneys such as Shareholder Ombudsman founded in 1996—select their cases carefully and avoid poor investment cases that the business judgment rule governs.\textsuperscript{64} To reduce the risk on plaintiff shareholders’ side and thus induce them to file a suit, several attorney’s made confidential agreement on fee-kickback; giving plaintiff a part of attorneys’ fee received from the corporation.\textsuperscript{65} Taken together, we can conclude that the attorney-driven market for derivative suits already emerged in Japan, although the size of market is relatively small compared to the U.S. counterpart.\textsuperscript{66} Findings in U.S. and Japan are the same: “call for the professional lawyers” for activating derivative suits.

It should be noted that, in Japan, the possibilities for shareholders to bear litigation costs has been eliminated by private arrangements, not by statutory reform. If such arrangements are invalidated for unfair or deceptive practices, probably it is the knell of derivative suits. This is the point.

2. Activating Derivative Suits in Korea

To cure lack of incentive of a plaintiff shareholder, two alternatives have been suggested. The one is to allow a shareholder to have more pecuniary benefit than the pro rata increase in the firm value. Recent research on Korean corporate governance, for instance, proposed to give shareholders more pecuniary compensation or incentives; the court should award to the shareholders who prevail in a derivative suit a portion of the damages payable to the company as compensation to the shareholders.\textsuperscript{67} I argue that this proposal went too far. Such reform not only looks weird (in light of “derivative” feature of the suit) but also may merely increase unnecessary complexities. First of all, such compensation to nominal shareholders

\textsuperscript{63} Id. at 368-369 (a retainer of $30,000 for the damages claimed of $1.5 billion; under the Fee Rules, the retainer would be over $30 million).

\textsuperscript{64} Id. at 370.

\textsuperscript{65} Id. at 371 (mentioning that, although there is no specific prohibition of such practice, the legal ground is “shaky”).

\textsuperscript{66} Id. at 369 (showing that the level of attorneys’ fees averages about 11% of the total settlement award).

\textsuperscript{67} See Bernard Black, Barry Metzger, Timothy J. O’Brien, Young Moo Shin & International Development Law Institute, Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness, 26 J. CORP. L. 537, 601-602 (2001) (arguing that the full reimbursement of litigation costs is not enough because shareholders must still incur significant costs, especially “the shareholders’ time”).
can be achieved by private arrangement—fee kickback—as Japanese legal practice developed. Moreover, it is almost impossible to determine how much portion of the damages should be awarded to the shareholders; it will be abused if too much, and it will be useless if too small.

As noted above, in fact, the experiences of U.S. and Japan tell the same: if you want to activate the derivative suit mechanism, you cannot help but rely on the professional lawyers. It is necessary to establish the fee arrangements under which the plaintiff attorneys are able to not only be fully compensated but also get pecuniary profits. From these perspectives, high attorney fees on contingent basis are desirable. To that end, several issues must be cleared in relation to shifting two litigation costs associated with losing the case.

First, the contingent fees should be ultimately paid by the corporation. Current Korean corporate law—the Securities and Exchange Act in particular—already provides that a shareholder prevailing in a suit should be fully reimbursed by the company for attorney’s fees, but it is not clear whether the contingent fees exceeding actual costs incurred may be included in the costs to be reimbursed. It is highly probable for the court to assume that the contingent fee arrangement amounted 20-30% of total recovery is too high and to regulate the fees by using lodestar approach—based on hourly rate—or by directly cutting off the percentage of contingent fee arrangement. Such judicial intervention is quite dangerous for derivative suits. Even if there is a reasonable ceiling for contingent fees, such ceiling should not be too low. In any event, the court must allow the attorneys to pursue reasonable profits.

Second, if the large amount of contingent fees are approved by the court, it is predicted that attorneys’ requiring a retainer will disappear in derivative suits, as we can see in Japan. Korean attorneys are able to change their fee practices, because the Korean Bar Association already repealed the Fee Rules—which once provided a nonrefundable retainer—and treated the attorney fees in terms of legal ethics.

Finally, as stated above, Korea follows the British rule in allocating the litigation costs. If a plaintiff loses the suit, he or she has to pay the filing fees and attorney fees reasonably incurred by the defendant. Therefore, the possibility of losing the suit

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68 See supra note __ and accompanying text.
69 See supra note __ and accompanying text.
70 See supra note __ and accompanying text.
deters shareholders from being involved in the litigation. Arguably, the legislation may alter the rule specifically in case of derivative suits, but it is not easy to give persuasive rationale for such diversion. Given that the British rule is effectively enforced in principle, the only way to relieve shareholders from bearing significant risks is to allow the plaintiff attorneys to bear such costs. Since lawyers must gather a few nominal shareholders in order to have a chance to get a high contingent fee, lawyers are willing to make a confidential agreement that they will pay the defendant’s litigation costs including attorney fees prescribed by the Supreme Court Rule. In this case, it is very important for the court not to invalidate the agreement. If such an agreement is continuously enforced by the court, attorneys may calculate their private costs and benefits taking into account the cost incurred on defendant’s side. Notice that it is not clear whether such private calculation can also result in social optimality; it needs further research.

The private arrangement between plaintiff shareholders and their attorneys has been available from the beginning, but profit-seeking lawyers have not yet attempted to do this because, in order to get high returns, they have to invest first. The attorneys have to incur search cost (for finding managerial wrongdoing) and administrative cost (for inducing a number of shareholders). Since derivative suits are in general much more complicated than ordinary litigations, the costs incurred during the litigation tend to be also higher. Even in such case, if positive returns are predicted with high certainty, attorneys, to be sure, might nevertheless bring a lawsuit. However, the ambiguity and uncertainties of business judgment rule and fiduciary duty law barred attorneys from calculating expected payoffs. In this situation, Korean lawyers decided to avoid risks, because entry to the legal service market was severely regulated by the government and thus there was much room for finding jobs with same returns but lower risks. Lawyers didn’t have to look for another opportunities or client groups to do their business.

Such rent-seeking behaviors are no longer available in the recent legal service market in Korea. The government already raised the annual number of successful applicants in the national bar exam; the annual slots were only 300 six or seven years ago (it had been fixed at 300 for more than 15 years since early-1980s), but two years ago there were 1,000 slots. Considering that, among them, about 200 persons have been appointed as judges or prosecutors, it is not much difficult to figure out how much

71 With population of about 48 million, the number of lawyers in Korea is only less than 8 thousand. Moreover, about a half of them are located in Seoul. In the U.S. legal service market, about more than 800 thousands of lawyers do their business with population of about 220 million. See __.
impact such increase in number can give on the legal service market. It is not yet clear whether such dramatic increase in the number of lawyers may eliminate the rents described above and thus result in fee reduction, since the informational asymmetry between lawyers and clients enables lawyers to induce the client. Nevertheless, it is highly probable that the number of lawyers looking for another type of litigation or business will increase. In addition, sooner or later the domestic legal service market is supposed to be opened to foreign law firms. In such a more competitive market, several attorneys will find the derivative suits profitable in spite of the high risks, and they can induce shareholders with the private agreement described above.

3. Criticism: Collusive Settlement

Many U.S. researchers have warned the abuse of derivative suits. They seem to argue that the idea of relying on derivative suit mechanism to threaten or monitor managers might be naïve. The point is that the derivative suits are very likely to end up with settlement, which does not depend on the merit of the suits, and therefore they have no effect of improving corporate governance system. Since the final outcome does not depend on the merit of the suit, no threat or deterrence may not be generated. If, for example, the managers are sued regardless of their violation of duty of care, only taking less than due care will save the total costs. In the same context, several empirical studies report that there is no significant shareholder gain associated with filing a derivative suit, both in U.S. and Japan.

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In the context of derivative suits, in fact, both parties have strong incentives to settle. On plaintiff’s side, the attorneys are usually compensated on contingent fee basis even if the suits end up with settlement, and moreover, early settlement recovery eliminates the possibility of losing the suit—the possibility of not being compensated by the corporation. Attorneys are likely to prefer the early settlement because they don’t want to bear downside risks. On defendant’s side, on the other hand, directors and officers who are named as defendants may expect indemnification by the company or compensation by D&O insurance. Unfortunately, however, such indemnification or insurance is hardly available to the defendants if they are found liable for a breach of their fiduciary duties “by the court.” Details might vary. In any event, however, the defendant directors and officers prefers settlement to trial, because they don’t want to bear the risks of not being indemnified or compensated. Thus, settlement is of mutual interest; it eliminates the down side risk on both “agent”—attorneys for plaintiff and managers for shareholders (or company).

Such practice of collusive settlement deteriorates the disciplinary function of derivative suits, but is hard to regulate. Several measures could be suggested to regulate “managerial” incentive to settle. For instance, mandatory cap of settlement amount ratio may prevent managers from paying too much. If D&O insurance does not compensate the settled amount of damages, managerial incentives to settle will decrease. In both cases, however, the regulation has ex ante externalities on the market for directors. In other words, “any” effort to regulate managerial incentive to settle—and, as a result, to increase the probability of managers’ actually paying the damages from their pocket if they are negligent—may raise the reservation price for managers to be willing to work for the corporation. Arguably, due to such regulation to threat managers, the expenses that corporations must incur in order to attract “good and capable” managers must be raised. If company fails to recruit good

75 In the U.S., for example, Federal Rules of Civil Procedure 23.1 and relevant state statutes or case law require any settlement of the derivative suits should be approved by the court and that notice of the proposed settlement be given to all shareholders, but it has been quite rare for the court to closely examine the settlement and reverse it. See, e.g., Macey & Miller, supra note __, at 44-48.

managers for those reasons, the costs associated with bad management in turn will reduce the shareholder wealth.

On the other hand, the regulation of plaintiff attorney’s incentives is relatively feasible. It is worthwhile to note that the source of the disappearance of deterrence is not that the plaintiff attorneys are granted large profits, but that the attorneys are allowed to retain the same monetary benefit when the disputes are settled. In case of settlement, therefore, the attorneys should be deprived of their negotiated-for profits. While the court should be generous in enforcing contractual arrangement of contingent fee if the suits are finally adjudicated, more strict scrutiny for attorney fees should be made if the suits end up with settlement. Courts, for instance, might employ much more strict approach than lodestar method and grant reimbursement only the costs actually incurred and proved by evidence. Such implementation of rules does not necessarily reduce the attorneys’ profits and thus influence the incentive to sue, because attorneys instead are able to negotiate higher contingent fees and keep the same expected profits. In such case, the plaintiff attorneys will select the cases with higher probability of winning. Thus, it is possible to activate derivate suits without sacrificing the disciplinary function.

For the time being, however, strict scrutiny for the settlement practice might not be desirable. In the long run, I agree that it is important for plaintiff attorneys to believe that the settlement is never profitable. In the short run, however, such anti-abuse regulation should not be incorporated in the statute or be taken by the court, since such provisions are likely to paralyze the derivative suit mechanism itself. Allowing attorneys to pursue adequate profits is more important than depriving them of the profits in case of settlement, if the legal system decided to adopt a derivative suit. Moreover, although concerns about the abusive practice and disappearance of deterrence have proper economic grounds described above, there are at least two reasons why the probability of filing strike suits is relatively low in Korea. (1) The one is the lack of discovery process. Simply put, while attorneys are able to look for managerial wrongdoings after filing the suits in the United States, the Korean lawyers must have evidence for the violation of managerial duty prior to bringing the lawsuits. Without discovery, the frivolous suits are hardly filed. Recently, Korean Civil Procedure Act was amended to emphasize the pre-trial procedure, which can be regarded as the American discovery equivalent, but judges’ policing the process can bar the plaintiff attorneys from filing the frivolous suits. (2) The

other is the British rule, under which the loser pays the costs incurred by the winner. To the extent that the British rule increase the risk of plaintiff attorneys in case of losing the suit, the frivolous suits are likely to be prevented. Although not perfect, these two features of the Korean litigation procedure may mitigate the problems of filing strike suits.

V. CONCLUSION

A decade ago, professor Fischel and Bradley contended that the derivative suits could not play a fundamental role in corporate law. Does it mean that non-existence of derivative suits is better? In fact, derivative suits are controversial. Although the bottom line is that they are core legal mechanism to cure corporate governance failure, there are several incentive problems. While shareholders have too little incentive to use them, while attorneys have too much incentive to abuse them. After all, all of the corporate governance mechanism are inherently or practically defective to some extent, and derivative suit mechanism is not an exception. In such situation, this paper argues that, in order to activate shareholder litigation mechanism, it is necessary to provide more pecuniary incentives to plaintiff lawyers. Relying on NGO activities has its own limitation. A decade later, Korean corporate law scholars might also confess that shareholder litigation has no significant impact on corporate governance practice of chaebols, but my expectation—in fact, my hope—is that several features of Korean judicial process may prevent excessive use of lawsuits.

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79 See Fischel & Bradley, supra note __, at 292 (“We have shown that this widespread assumption [that liability rules enforced by derivative suits play a fundamental role in aligning the interests of managers and investors] is not supported by either the theory of liability rules, the available empirical evidence, or the structure of corporate law. Proposals to reform corporate law which rest on this assumption are thus highly suspect.”).