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From great expectations to an even greater failure - the case of Montenegrin regulatory framework on shareholder derivative suits as an incentive for rethinking the concept itself[1]

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Abstract

The author utilizes a case study of Montenegrin regulatory concept of shareholder derivative suits in order to demonstrate, by comparing its features with such concepts in other legal systems and features marked as favorable factors in legal theory, that its failure, as well as the failure of derivative suits in other countries cannot be a priori considered as result of inadequate approach of the legislator. Along with some other important legal systems, shareholder derivative litigation in United States is also analyzed, since its track record shows that it is virtually the single at least relatively successful system of derivative suits so far. This analysis is made so as to distinguish the particular and in many ways unique features of the shareholder derivative litigation concept in United States that enabled the relative success of it. As result of the research conducted and analyses made, the author argues that there is an inherent flaw in the very foundation of the concept of shareholder derivative suits, which generally hinders the use of this legal mechanism. Finally, the author finds that this flaw is deeply rooted in what is known today in theory of company law as the first agency problem.

Keywords: *shareholder derivative suits; Montenegrin regulatory framework; legislator; first agency problem; incentives, inherent flaw*

JEL Classification: K22

1. Introduction

A. Agency Problems and Derivative Suits as Suggested Solution

From the historical point of view, shareholder derivative suits had emerged as one of the earliest mechanisms used to resolve the first agency problem - conflict between the owners of a company and the appointed mangers, i.e.

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directors. Namely, during the 19th century, as result of industrial revolution and overall progress of global economy, managing big companies had become complex and demanding to the extent that it surpassed managerial abilities of most of their majority owners - shareholders. For this reason, they were forced to hire other people - those possessing very specific managerial skills - in order to take care of their companies' everyday business activities, which led to clear separation of ownership from management. Having had vast powers in managing investments of others, in spite of various incentives for acting otherwise, the managers were bound to misuse these powers on occasion to their own or to the benefit of the third parties. Hence, the first agency problem appeared and became an issue in national *lex societatis* of the economically most developed societies. Among these were both the United Kingdom and the United States – countries whose legal systems gave birth to shareholder derivative suits in response to this problem, in the second part of the 19th century.[3]

Of course, the above is not to suggest that there are no jurisdictions in which shareholder derivative claims may be raised as result of the second agency problem, i.e. conflict between the non-controlling and the shareholder in control. On the contrary, with some notable exceptions,[4] legal systems recognizing them as minority shareholders protection mechanism, allow the lodging of derivative suits against controlling shareholders as well.[5] However, the empirical fact remains that the company directors represent the biggest danger, since they are by far most frequently designated as defendants in shareholder derivative litigation.

The concept of shareholders protecting interests of their company by suing on its behalf those directors they consider responsible for breach of fiduciary duties towards the company and its owners, i.e. the concept of derivative suits, has spread from Anglo-American legal family to Civil Law systems mostly throughout the

[3] It is generally considered that shareholders derivative suits were created almost simultaneously by English courts in case Foss v. *Harbottle* (1843), and the U.S. courts in Dodge v. Woolsey (1855). For more on these cases and on the beginnings and historical development of derivative suits in general, for instance, see Deborah DeMott, *Shareholder Derivative Actions: Law and Practice,* West Publishing Corporation, St. Paul, Minnesota, 1987, Ch. I, p. 7 - 9; Ralph C Ferrara, Kevin T. Abikoff, Laura Leedy Gansler, Shareholder Derivative Litigation: Besieging the Board, Law Journal Press, 2005, Ch. I, pp. 15 - 22.

[4] These are, for example, United Kingdom and Belgium. See Harald Baum, Dan W. Pucniak, *The Derivative Action: An Economic, Historical and Practice Oriented Approach*, in Harald Baum, Dan W. Pucniak and Michael Ewing-Chow (eds.), *Derivative Actions in Asia: A Comparative and Functional Approach*, Cambridge University Press, New York, 2012, p. 8.

[5] Finally, one should also have in mind that, in a fairly limited number of situations, shareholder derivative litigation had been even provoked by the third agency problem, i.e. conflict between the company and its owners, on one side, and remaining stakeholders, such as creditors and employees, on the other side. For instance, shareholder derivative suits instigated by convertible bonds owners - being one particular type of creditors - on behalf of the issuing company were allowed by the courts in the United States (see Deborah DeMott, *op. cit,* Ch. IV, p. 37). Furthermore, it has been noted that even the policy holders of mutual insurance companies were allowed to initiate shareholder derivative proceedings in this legal system, which is the most developed one by far with regard to use of shareholders derivative suits (see Theodore Allegeart, *Derivative Actions by Policyholders on behalf of Mutual Insurance Companies*, "University of Chicago Law Review", Vol. 63, Issue 3, 1996, pp. 1063 - 1097.

second part of the 20th century. Hence, today numerous civil law countries have derivative suits established as specific legal mechanism predominantly serving for the protection of minority shareholders. However, although they have been representing an integral part of national *lex societetis* in these countries for decades now, the fact is that shareholder derivative suits have not seen much application in Continental Europe. On the contrary, it has been argued by many that the concept itself has failed so far in this part of the world, as well as elsewhere outside the United States.[6]

B. Aims and Objectives

As a European country, and arguably the next EU Member State,[7] Montenegro was not an exception to the above explained tendency of unsuccessful dissemination of the concept of derivative suits throughout Europe.[8] However, being that it transformed its economy from socialist into a market oriented one during the 1990s, just as many other former socialist countries did,[9] it seems that the observation period should be limited objectively to that from the year 2002 onwards, since this is the year in which the first and only national legislative instrument of company - Montenegrin Companies Act ("MCA") was enacted.[10] With this in mind, it must be underlined that one very distinguished feature of Montenegrin *lex societatis* in general is that - due to expert and other assistance of the United States Agency for International Development ("USAID") in course of drafting of the MCA[11] - it was heavily influenced by Anglo-American legal

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6 See *infra* Section II - Shareholders' Derivative Suits at the Crossroad.

7 Ever since Iceland withdrew its application for EU membership in March 2015, Montenegro is not just any candidate country, but the one that has made more progress in accession negotiations with the EU than any other, which arguably makes it the current favorite to be the next EU Member State.

8 See *infra* Section III - Shareholder Derivative Suits in Montenegro.

9 One should have in mind that, although Montenegro did not take any direct part in it, because of Yugoslav civil war in 1990s, this transformation was to a moderate extent slower than in other former socialist countries.

10 The Companies Act, Official Gazette of the Republic of Montenegro, No. 06/02, 17/07, and Official Gazette of Montenegro, No. 80/08, 40/10, 73/10, 36/11, 40/11. It should be stressed, however, that even before this law there was a relatively modern company law regulation which was enacted on the federal level in 1996, at which time Montenegro was a unit of the Federal Republic of Yugoslavia - one of the two, with the Republic of Serbia being the other one. However, for political and various other reasons, 1990s in Montenegro are hardly a period to be taken as any kind of reference point in terms of corporate culture developments and overall activities with regard to aligning of Montenegrin legal and institutional system with that of developed European and other western societies.

11 In the beginning of this century, immediately after the democratic changes in Federal Republic of Yugoslavia that took place in late 1990s, and before Montenegro regained its independence in 2006, not only USAID but regional associations, such as American Bar Association Central European and Eurasian Law Initiative - ABA CEELI, both financially and in terms of expertise, assisted in reforming Montenegrin economic and anti-corruption legislation, educated Montenegrin judges and aided judicial reform. In some instances, however, this resulted with direct, as well as non-critical transposition of various legal concepts from the Anglo-American legal circle into Montenegrin legal system.

tradition. Furthermore, this was most evident with regard to shareholder derivative suits, which eventually made their regulatory framework in Montenegro considerably different from those in other Civil Law jurisdictions. More precisely, before the amendments adopted in 2007, Montenegrin regulatory framework of shareholder derivative suits resembled that of the United Kingdom, while in 2007 it was restructured so as to resemble more that of the United States. But be that as it may, it is exactly for this reason that examining Montenegrin regulatory framework of shareholder derivative suits and its implementation can be of particular importance for understanding the reasons of the apparent failure of shareholder derivative suits in Civil Law countries.

In view of the above, this paper aims to contribute to ongoing debate on what is the cause of the apparent failure of shareholder derivative suites in Civil Law countries by supporting the conclusion that it is not the percentage of share-ownership requirement ("threshold requirement") that should be considered the one *differentia specifica* of European concept of derivative suits "responsible" for its failure, as it has been argued throughout the years. To that end, this paper utilizes a case study of the specific and in many ways unique Montenegrin concept of shareholder derivative suits and its implementation. Namely, along with other specific features, it is a regulatory concept particularly convenient in this regard, since unlike most others in Europe it actually never involved any threshold requirement.

However, before examining shareholder derivative suits in Montenegro, in order to set the stage for it, this paper provides in its second section a brief overview of some of the key national regulatory frameworks of shareholder derivative suits. Particular attention is paid to shareholder derivative suits and their concept in the United States, since it is practically the single one the success of which is not questioned by most. Therefore, considerations are made with regard to success of this system. In relation to that, some of the most frequent explanations offered with regard to non-functionality of derivative suits in Europe are critically revisited as well.

The third section focuses on the mentioned Montenegrin case study, i.e. Montenegrin legislative framework of shareholder derivative suits and its implementation since year 2002, when the MCA was enacted in Montenegrin Parliament. In light of the revisited European experience in developing shareholder derivative suits, this section examines separately the above mentioned original legislative framework embedded in the MCA since 2002 and its modifications introduced in form of amendments to MCA in 2007, so as to provide arguments to support the conclusions offered in that, as well as in the final section of the paper.

The final section of the paper summarizes the arguments and the conclusions offered previously, while at the same time builds on those by supporting the conclusion that it is not the threshold requirement but the clear and strong separation of ownership from management in modern companies that represents original and predominant reason for the lack of success, i.e. non-functionality of shareholder derivative suits in Europe and elsewhere. More specifically, this author argues that it is this "original sin" that led to what is well-

known in derivative litigation and elsewhere as "the free-rider problem" - essentially, lack of economic incentive for shareholders to engage in derivative suits litigation,[12] which he finds to be the biggest hurdle in terms of creating a successful system it.

2. Shareholder Derivative Suits at the Crossroad

A. In General

Shareholder derivative suits are allowed today by corporate laws of the vast majority of developed countries with market oriented economy. During the last decade or so, this legal mechanism has been endorsed even by the two most populous nations in the world, China and India, former socialist countries slowly moving towards establishing free market economies.[13] However, since not much time has passed after derivative suits were allowed in these two legal systems – especially having in mind that China and India, unlike Montenegro, are enormous countries and economies - it is still too soon to assess the results of the concepts introduced and compare them with those in other countries. Therefore, this overview is focused on the mentioned "homelands" of derivative suits - United States and United Kingdom, as well as on some of the most important Civil Law countries and their experience with shareholder derivative suits.[14] More particularly, the objective in this section is not to provide detailed and comprehensive analyzes of each these national concepts, but to briefly examine some of their key features in order to better understand the reasons for their success or for their failure in providing efficient mechanisms for protection of shareholders' interests.

B. Shareholder Derivative Suits in United States

In spite of the fact that various concerns are being raised for decades regarding the future of shareholder derivative suits in the legal system of United

[12] For more elaborate explanation on the notion of free-rider problem, especially in the context of shareholder derivative litigation, see Harald Baum, Dan W. Pucniak, *op. cit.*, p. 34.

[13] In China, derivative suits were introduced around a decade ago, in 2005, while in India they were permitted only in 2013. For an overview of the derivative suits concept and the first, i.e. preliminary results of its implementation in China, which are actually not encouraging, see Zhong Zhang, *The Shareholders Derivative Actions and Good Corporate Governance in China: Why the excitement is actually for nothing*, "Pacific Basin Law Journal", Vol. 28(2), 2011, pp. 174 - 209. As for the concept of shareholders derivative suits in India, see Tanvi Kini, *The Significance of Derivative Action in India: An Analysis of Section 245 of the Companies Act*, 2013, "Law Mantra Journal", Vol. 2(5), 2014.

[14] Having in mind the importance of this economy on the global level, as well as the very well developed concept of shareholder derivative suits, Japan should be at least mentioned here as well. However, just as other Civil Law countries, Japan has not had much success in developing this segment of its corporate culture. See Gen Goto, *Legally "Strong" Shareholders of Japan*, "Michigan Business & Entrepreneurial Law Review", Volume 3(2), 2010, pp. 126 - 164.

States,[15] the fact still remains that this is virtually the sole legal system in which these suits are widely used and considered a relatively successful legal mechanism for the protection of minority and other shareholders' ownership interests.[16] On the other hand, although there were numerous efforts, there is no clear and universally accepted explanation of this apparent success. However, in view of this author, it is the result of synergy of several key factors, the importance of which in the said context has been underlined by different authors through years.

First, in contrast to general "American Rule" on litigation expenses, it has gradually become common in shareholder derivative litigation that the losing party pays the prevailing party's attorneys' fees, which provides obvious incentive for both the shareholders and their attorneys. But this is the case in Civil Law countries as well. However, it remains unnoticed by most that in Civil Law countries this is a general rule, while it is an exception in the United States. Therefore, attorneys in United States have had far more reason to see this as an opportunity to earn money. Put differently, compared to European attorneys, they had much higher incentive to make use of such opportunity, and they did so by actually taking initiative and teaming up with suitable shareholders that are willing to share the "earnings".[17]

Second, unlike this type of disputes in Civil Law countries, when it comes to shareholder derivative litigation in the United States, a concept of pre-trial discovery exists and it plays a major role. Namely, it allows to plaintiffs and their attorneys to commence shareholder derivative litigation with virtually just a hint of something suspicious going on and then - before actually starting the trail - to get more detailed information and evidence they need for the trail itself, or even to settle.[18] Hence, this is yet another significant and specific easement for the plaintiffs in the United States in terms of making a decision to venture into shareholder derivative litigation.[19]

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[15] For instance, with regard to corporate law reform after the "Enron scandal", see Ann Scarlet, *Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals*, "Florida Law Review", Vol. 60(3), 2011, pp. 589 – 641; For earlier challenges, see John C. Coffee, Jr. and Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, "*Columbia Law Review"* Vol. 81, No. 2 1981, pp. 261-336.

[16] For instance, see Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, "William and Mary Law Review", Vol. 51, 2010, pp. 1749 – 1831, arguing that shareholder derivative suits in United States are actually very resilient legal mechanism, one which is increasingly used in the federal courts in this century.

[17] There is a long-lasting debate on the abuse of shareholder derivative litigation in United States as result of such practice and mechanisms to be used by the courts in United States to subdue this tendency. For instance, see Keneth J. Munson, *Standing to Appeal: Should Objecting Shareholders be Allowed to Appeal Acceptance of a Settlement?* "Indiana Law Review", Vol. 34, 2001, pp. 455 – 478, at 458.

[18] For an overview on differences between civil proceedings in United States and European countries, such as Germany or France, see Hein Kötz, *Civil Justice Systems in Europe and the United States*, "Duke Journal of Comparative & International Law", Vol. *13(3), 2003*, pp. 61–77.

[19] It should not remain unnoted here that it is exactly incentives as such that had given rise to appearance of the so-called "strike suits", i.e. frivolous litigation aiming to scare off companies and directors sued and force them to settle in order to avoid bad publicity. See Tim Oliver, *The Strike Suit: A common problem of the derivative suit and shareholder class action*, "Dickinson Law Review", Vol. 98(3), 1994, pp. 350 - 400, at 370.

Third, another important factor encouraging the shareholders and the attorneys in United States to file shareholder derivative suits is unprecedented level of development of the financial markets in United States, which is in direct correlation with their high sensitivity to bad publicity provoked by pending shareholder derivative litigation. Although it is virtually impossible to prove this empirically, the author finds that this fact should be considered as one of the most important reasons for the long-lasting tendency regarding shareholder derivative litigation that majority of disputes instigated with shareholder derivative suits are being ended with settlement agreement.[20] Put differently, because companies are sensitive to bad publicity, its directors in general - hence, not only the once sued - have strong incentive to settle, unless the case is a very strong one and the damages sought are very high and obviously recoverable. In view of the above, even the remaining shareholders, who generally have the right to oppose the proposed settlement,[21] are usually more inclined to preserve the public image of their company and with it the value of their shares than they are to oppose the settlement proposed. Finally, attorneys, which were often *de facto* plaintiffs in the past, are well aware of these facts and regard them as an additional incentive to venture into derivative actions with suitable shareholders and try to earn "easy money".[22]

Fourth, as mentioned earlier, each shareholder has the right to file a derivative suit in the United States, since there are no threshold requirements such as in Civil Law countries. Although this author does not find this to be the single most important factor contributing to success of shareholder derivative claims in the United States, it is usually the most emphasized one.[23] Be that as it may, the fact remains that it is easier to "launch" a derivative suit without having to find shareholders representing the minimum share capital required that are willing at the same time to stand behind the initiator.

C. Shareholder Derivative Suits in United Kingdom

The concept of shareholder derivative suits in United Kingdom has long been dominated by "Foss v. Harbottle rule", under which a shareholders right to file a suit on behalf of the company has been regarded as an exception to the general rule that the company itself is the proper plaintiff - since fiduciary duties are owed by directors to it and not to shareholders. In addition, "Foss v. Harbottle doctrine" has been developed during the 19th century in a way that included another rule, the so-called "majority principle" under which shareholder derivative

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[20] For instance, see Ralph C Ferrara, Kevin T. Abikoff, Laura Leedy Gansler, *op. cit.*, Ch. XIV, p. 2.

[21] For more on the right of other shareholder to oppose the settlement and take part in the proceedings, see Keneth J. Munson, *op. cit.*

[22] This, of course, raises the risk of abuse of derivative litigation settlement procedures. See Suzzana M. Kim, *Conflicting Ideologies of Group litigation: Who May Challenge Settlements in Class Actions and Derivative Suits*, "Tennese Law Review", Vol. 66, 1998, pp. 81 - 121.

[23] In fact, some authors find it to be the key reason for derivative shareholder suits not being successful in continental Europe. For instance, see Kristoffel Grechenig, Michael Sekyra, *No derivative shareholder suits in Europe: A model of percentage limits and collusion*, "International Review of Law and Economics", Vol. 31(1), 2011, pp. 16 - 20.

suit will not be allowed by a court if the alleged wrong could be ratified by simple majority of the shareholders, since the court should not be allowed to interfere in usual business activities of companies.[24] Hence, the consequence of this approach was that shareholders were allowed to sue on behalf of their companies only in four exceptional situations established in the case law. More precisely, this was possible in case of:

- *ultra vires and illegal acts;*
- *qualified majority requirement for adoption of a resolution not being met;*
- *an act infringing on personal rights of a shareholder;*[25]
- *fraud of minority shareholders by the wrongdoers that are in control of the company.*[26]

In 2006, new regulatory framework was introduced by Companies Act, under which the Foss v. Harbottle rule was departed from. However, in order to avoid proliferation of shareholder derivative suits, the courts were given very broad authorities in terms of rejecting the shareholder's request to proceed with the derivative claim.[27] Hence, in spite of creation of a new concept, it seems at this point that shareholder derivative suit will remain an exceptional occurrence, which will practically lead to preserving the "spirit" of the Foss v. Harbottle rule in laws of England, Wales and Scotland.[28]

D. Shareholder Derivative Suits in Civil Law Countries

As mentioned already, Civil Law countries do not have much positive experience with shareholder derivative litigation. Before all, compared to Anglo-American legal systems, there is little tradition in regulating shareholder derivative suits, and on top of that, compared to countries such as United States and United Kingdom, different litigation cultures exist. Then, of course, a threshold requirement exists in majority of these countries, such as Germany, Italy, Spain,

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[24] For more detailed elaboration origins and development of Foss v. Harbottle rule, for instance, see Anthony J. Boyle, *Minority Shareholders' Remedies*, Cambridge University Press, 2002, 1 - 23.

[25] This one, in fact, could not be considered as genuine exception to Foss v. Harbottle rule, since it entails the use of direct and not of derivative suit.

[26] This was not only the broadest, but it was also considered by most as the single actual, i.e. real exception in which the use of shareholders derivative suits was allowed in United Kingdom.

[27] For more on the new regulatory framework of shareholder derivative suits in UK, see Frank Wooldridge and Liam Davies, *Derivative claims under UK company law and some related provisions of German law*, "Amicus Curie", Issue 90, 2012, pp. 1 -10.

[28] The question is still open whether the legislator departed essentially from "Foss v. Harbottle rule" in Companies Act of 2006, or it has only modified the rule to a significant extent. See David Kershaw, *The Rule in Foss v Harbottle is Dead; Long. Live the Rule in Foss v Harbottle*, LSE Law, Society and Economy Working Papers 5/2013, the document is available online at https://www.lse.ac.uk/collections/law/wps/WPS2013-05_Kershaw.pdf (last visited in October 2016).

Czech Republic, Slovakia, Slovenia, Austria, Serbia and others.[29] However, there are some civil law countries, such as France and Switzerland,[30] which have no threshold requirement but still have negative experience with shareholder derivative suits. This indicates that it is not only this procedural hurdle that caused this phenomenon, as some would argue,[31] but the combination of various other factors.

It has been argued by different authors examining shareholder derivative suits in Europe that there are several key factors the absence or the presence of which is responsible for the failure or the success of these suits in a national legal system. Those which could be considered as common denominator in this regard are litigation cost structure supporting the use of shareholder derivative suits, information rights conceptualized in accordance with the highest corporate standards and broad range of potential defendants that includes controlling shareholders.[32] However, as is shown bellow, along with the non-existence of threshold requirement, all of the mentioned "success factors" were present in case Montenegrin shareholder derivative suits from 2007 onwards, and yet this concept has been a failure so far. It is for this reason that the following case study may be considered a valuable addition to ongoing debate on what may be the problem with shareholder derivative suits in Europe.

III. Shareholder Derivative Suits in Montenegro

Montenegrin legal profession, as well as general public had high expectations from numerous new legal concepts introduced with the first ever national company legislation in 2002. New concept of shareholders suits was not an exception in that regard. As for shareholder derivative suits, the key provisions were those in Article 30 Paragraph 4 and Paragraph 5 of the MCA:

> **"***(4) When it is determined that there have been irregularities in management or operations of a company, the company, not its shareholders, shall be entitled to sue the officer responsible before the Commercial Court, save for the instances set forth in paragraph 5.*
> *(5) Any shareholder of a company or his successor shall have a right to submit a complaint to a Commercial Court where:*

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[29] See, Kristoffel Grechenig, Michael Sekyra, *No Derivative Shareholder Suits in Europe - A Model of Percentage Limits, Collusion and Residual Owners*, German Working Papers in Law and Economics: Vol. 2007: Article 2, the document is available online at http://www.bepress.com/gwp/default/vol2007/iss2/art2 (last visited in October 2016).

[30] Martin Gelter, *Why Do Shareholder Derivative Suits Remain Rare in Continental Europe?* "Brooklyn Journal of International Law", Vol. 37(3), 2012, pp. 843 – 892, at 859.

[31] See Kristoffel Grechenig, Michael Sekyra, *op. cit.*.

[32] See Dario Latella, *Shareholder Derivative Suits: A Comparative Analysis and the Implications of the European Shareholders' Rights Directive,* "European Company and Financial Law Review", 2009, 1 – 17, emphasizing the significance of litigation costs and information rights; See Martin Gelter, *op cit.*

1) any action of the company is illegal or outside the powers of the company;
2) where the majority shareholders discriminate the minority shareholders;
3) where a shareholder's individual rights have been harmed;
4) where those persons who control the company, whether the Board of Directors, or the majority shareholders, commit a fraud on the minority shareholders."

Hence, it seems obvious that Montenegrin legislator had tried to introduce into Montenegrin company law the English law concept of the shareholder derivative lawsuits, which is the above explained Foss v. Harbottle rule. Moreover, this rule was virtually directly transposed into Montenegrin company law.[33] This, however, proved to be a mistake. Namely, due to the fact that it was only broadly defined, i.e. incorporated in insufficient detail in the MCA, as well as due to the fact that it had been imported from a legal system substantially different from Montenegrin and other Civil Law systems, this rule could not have taken hold in the practice of Montenegrin courts or in Montenegrin legal system in general. The best proof of this is the fact that not a single shareholder derivative suit had been filed in Montenegro since the adoption of MCA in 2002 until 2007, when changes to this regulatory framework were introduced.

For the above explained reasons, in 2007, the regulatory concept of shareholder derivative suits was amended. More precisely the old Article 30 Paragraph 5 remained unchanged but the new Paragraph 4 was introduced in order to replace the old one:

(4) "When it is determined that there have been irregularities in management or operations of a company, the company shall be entitled to sue a responsible person before the Commercial Court. In the case the company does not sue a responsible person, a shareholder shall be entitled to sue, in his name and on behalf of the company, a responsible person in the company that is responsible for irregularities in management or operations of the company (derivative complaint). A shareholder shall be entitled to a derivative complaint, if he previously requested in writing from the company to sue a responsible person, and the company refused that request or did not submit the complaint within 30 days from the day of the submission of the request. Realized damage compensation based on derivative complaint shall belong to the company, and the shareholder who submitted the derivative complaint shall be entitled to compensation of costs."

Hence, the rule of the exclusive authority of the company to sue was *de facto* abandoned, since in an unusually wide range of instances that may fall under the wording of the new Article 30 Paragraph 4, in addition to the company itself, shareholders were given the right to sue the persons responsible for irregularities in

[33] For instance, see Dragan Radonjic, *Commentary to Companies Act* (Montenegrin: *Komentar Zakona o privrednim društvima*), CID, 2002, pp. 159 - 160, attesting such legislator's approach as one of the authors of this legislative instrument.

management in their own name and on behalf of the company. This is so provided that the plaintiff, prior to filing a derivative suit, requested the company to sue the wrongdoers itself and provided that such request was not accommodated, i.e. the suit was not filed by the company within 30 days period since it was made. Put differently, the demand requirement has been introduced as well with the 2007 amendments to MCA.

Given that under the aforementioned amendments to the regulatory framework of the shareholder derivative suits in Montenegro the initial idea of introducing Foss v. Harbottle rule in the MCA and developing it through the case law was abandoned, it is not clear what the motives of the legislator were for allowing Article 30 paragraph 5 to remain unchanged. Namely, the grounds for a derivative shareholder suit set forth therein fall anyhow under the broad phrase of the Article 30 Paragraph 4 designating factual grounds for shareholder derivative suits (“*irregularities in management or operations of a company*”).

On the other hand, due to above cited Article 30 Paragraph 5 Point 4 remaining in its original form, a regulatory solution survived in Montenegrin corporate law that not only corporate directors and officers but controlling shareholders could be designated as defendants in a shareholder derivative suit, too.[34]

As to other factors underlined in legal theory as necessary for creating favourable regulatory environment for the success of shareholder derivative suits in a legal system,[35] Montenegrin corporate law apparently also stayed on the “right track”. First of all, there is no threshold requirement for filling a shareholder derivative suit. In addition, as one of the results of Montenegrin legislator's efforts and Montenegro in general to align its laws with the *acquis*, that were made since Montenegro regain its independence in 2006, for years now, information rights are regulated mostly in line with highest corporate standards, just as corporate financial reporting is. As for the issue of favourable litigation cost structure, the one existing in Montenegro pretty much resembles those in most of the Civil Law countries, meaning that the party that has lost the litigation in its entirety is obligated to cover the winning party’s costs, with the attorney's fees being covered under the prescribed tariff for remuneration of attorneys.[36]

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[34] For the sake of precision, it has to be underlined that, in the above cited Article 30 Paragraph 5 Point 4, Montenegrin legislator has not used the term "controlling shareholder", but instead the term "majority shareholder" was used. However, although the former is the term narrower than the latter one, in most of the circumstances these terms would actually overlap, especially so in Montenegrin case law which is without much tradition in delineating between these two notions.

[35] See *supra* Section II - Shareholders' Derivative Suits at the Crossroad, C. - *Civil Law Countries*.

[36] When deciding on the costs that are to be compensated to the wining party, the court must thoroughly evaluate all circumstances and take into account only the costs necessary for conducting the litigation (Article 152 of the Law on Civil Procedure, Official Gazette of Republic of Montenegro, No. 22/04, 28/05, 76/06 and Official Gazette of Montenegro, No. 48/15). Hence, it seems that at least certain level of flexibility is secured for Montenegrin courts, which may be considered positive development in terms of creating favorable regulatory environment for shareholder derivative suits.

However, in spite of the regulatory concept of shareholder derivative suits in Montenegro having virtually all the characteristics noted in academic literature as necessary for the success of one such concept, this author's research of the relevant case law failed to produce evidence of a single shareholder derivative suit actually trialed before Montenegrin courts for the last decade.[37] More precisely, the research has showed that the farthest that Montenegrin shareholders have gone in a handful of instances was to have their alleged derivative suits dismissed for failing to meet the demand requirement. Hence, for the last decade, a single judicial decision on merits has not been rendered by Montenegrin courts as a result of shareholder derivative litigation.

In view of the above findings, the research could also be regarded as an evident proof that Montenegrin legislator has failed so far in attempting to invigorate shareholder derivative litigation. However, although the failure of the concept of shareholder derivative suits introduced in Montenegrin *lex societatis* a decade ago is a matter of fact demonstrated with his research, this author finds that the blame for such failure should not be *a priori* "pinned" on Montenegrin legislator. Moreover, the author trusts that this apparent failure could not be considered as the fault of the legislator to begin with, at least not predominantly. The arguments provided in this regard are summarized in the concluding remarks that are presented below.

4. Conclusions

The case study presented above has demonstrated one interesting circumstance. Notwithstanding the fact that apparently very favorable regulatory environment has been created for the growth in shareholder derivative litigation, and notwithstanding that the social circumstances suggested that factual causation could have been established in numerous instances, results were still disappointing - there was no shareholder derivative litigation in Montenegro at all. In light of these findings and in light of shareholder derivative suits failure in numerous other countries, a suggestion is made here that, as a legal tool, shareholder derivative suits have an inherent limitation that generally hinders their use.

It is the position of this author that the problem with making the concept of shareholder derivative suits work has pretty much the same roots as the first agency problem - the problem for the solution of which these suits are created to begin with. More precisely, clear separation of ownership from management in 19th century had led to companies being awarded legal personhood and the property of

[37] It should not be overlooked in this regard that the last decade in Montenegro has been a period of both big expansion and sharp decline of Montenegrin stock market, which was largely caused by global financial and economic crisis that has hit Montenegro hard, especially so in 2008 and 2009. Hence, in correlation with still developing corporate culture in Montenegro and numerous insider information being evidently misused during the Montenegrin stock market expansion, it seems fair to assume that there was a considerable number of fairly evident occasions for Montenegrin shareholders to make use of derivative suits in order to protect their own and legitimate interests of their companies.

companies getting clearly separated from that of their owners. At the same time, in light of the necessity for their particular skills becoming stronger with dynamic market development, managers had become aware of their increased importance and started to demonstrate that in various manners, both legal and illegal. On the other hand, for the exact same reason, company owners, i.e. shareholders, especially the ones representing a minor part of the share capital, started to feel too detached from their companies and realized that the company's wellbeing could not be equaled with that of their own - especially not on the short run. Put differently, most owners, minority shareholders in particular, had started failing to directly match their own interest with that of their company.

In light of the above, although an indirect connection between the success in a trial initiated with a shareholder derivative suit and the benefit of the shareholder-plaintiff is generally evident, one can hardly contest that getting such benefits is almost never as strong incentive as it is to protect one's property directly (e.g. as in case of direct shareholder suits). Hence, this author finds that shareholder derivative suits as a legal concept have one inherent flaw that lies in the very foundations of this concept. Essentially, shareholder derivative suits are created in order to provide one person with the means to protect the legitimate interests of another. For this reason, in spite of the key incentive for making use of such means - circumstantial connection explained above – as a general rule, an average minority shareholder will have trouble pursuing protection of his company's interest as vigilantly as he would pursue the protection of his own interest.

On the other hand, the relative success of shareholder derivative suits in United States, as already explained, is largely attributable to certain specific circumstances, such as involvement of attorneys in this type of litigation. Historically, attorneys there have often positioned themselves as real plaintiffs – as opposed to their clients, i.e. formal plaintiffs – which was the result of shareholder derivative litigation being an exception to above explained "American rule" Hence, attorneys were not necessarily pursuing the indemnification of damages inflicted on the companies involved but a quick settlement resulting in payment of their fees out of the funds received by the corporation involved. Also, the unprecedented level of development of the financial markets, as well as their particular sensitivity to bad publicity have represented historically another equally important and specific incentive for the relative proliferation of shareholder derivative suits in United States. However, these, as well as other particular incentives mentioned with regard to this legal system are either very hard to create through regulatory development, or predominantly depend on the general litigation culture in a society. In other words, they may not be directly transposed into another national legal system or created over a short period of time.

Finally, the above conclusions are not made here so as to imply that shareholder derivative suits are useless. On the contrary, their availability to shareholders presents a strong preventive factor in terms of various types of abuse of managerial powers and other types of mismanagement. In addition, incentives to

use derivative suits as a legal tool for remedying an actionable wrong done to the company are on occasion simply more than enough to actually provoke their use. Therefore, especially with regard to cases of gravest abuses of managerial authority made in collusion with controlling shareholders, which usually involve the infliction of grave monetary damages on the company, these suits have strong both preventive and indemnification function.

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