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# **Derivative Actions in China**

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## Abstract

The enactment of derivative action was expected to be actively used by shareholders to protect their interests. In fact, it turned out that this reform effort seemed futile as the right to engage in such actions was rarely exercised. This raises a question about the role of derivative actions in China; namely, should a derivative action system play a key role in protecting shareholder interests? If the answer is positive, the next question is how such a system could be improved in order to effectively discipline management. The essence of this thesis is to try to address these issues.

This thesis argues that derivative action should and can play a key role in China's corporate governance. First, minority shareholders in China face double agency problems within the company and thus protective mechanisms must be put in place. Second, this thesis formulates its argument by demonstrating the ineffectiveness of market forces and other legal methods. As a consequence, derivative action ought to retain a central role in regulating the misbehaviour of controlling shareholders and managers.

After demonstrating the need to strengthen and improve derivative actions in China, this thesis starts to explore China's derivative actions system. It first examines derivative action cases before Company Law 2005. Despite the absence of a clear statutory basis for derivative actions in Company Law 1993, such cases have nevertheless appeared in the courts. After almost eight years of implementation, less than 80 cases were raised. Whilst this seems a good figure in comparison to other jurisdictions, closer examination shows this not to be the case. For example, the opacity of the demand requirement constitutes a barrier for shareholders wishing to exercise this right. More importantly, the funding rule of derivative actions is treated as the same with other forms of litigation. In view of the unique economic nature of the derivative action, a new funding rule for derivative action should be established.

After discussing why derivative actions should play a significant role in monitoring management and how they should be improved, this thesis argues that shareholders are increasingly willing to take this action to protect their rights and interests because of the establishment of commercial society and the existence of the traditional culture of Legalist School. Also, the courts are more capable of dealing with derivative action cases because of the enactment of the Judges Law and the increasing recruitment of more qualified people to the judiciary. It is believed that the effectiveness of derivative action can contribute to foster good corporate governance in China.

## Acknowledgment

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## **Statement of Original Authorship**

This thesis contains no material that has been accepted for the award of any other degree or diploma in any university.

To the best of my knowledge and belief this thesis contains no material previously published by any other person except where due acknowledgment has been made

Shaowei Lin  
11 April 2014

## Chapter 1 Introduction

### 1.1 The nature of the derivative action

When directors or officers harm a company, the general principle in company law is that the company itself must bring any legal action against the wrongdoers. Individual shareholders are not entitled to initiate such litigation to redress misconduct. This was established in *Foss v Harbottle* where Foss and other shareholders brought a suit against the directors of a company alleging loss of the company's property occasioned by managers engaging in illegal activities. The court denied this action, pointing out that the company is the proper plaintiff in an action relating to harm done to the company.<sup>1</sup>

This so-called 'proper plaintiff' principle is justified on several grounds. First, the corporation itself is a legal entity and has its own property which therefore entitles it to enjoy the attendant legal rights and responsibilities. Secondly, any legal remedy would go to the company as a whole and thus individual shareholders ultimately benefit if the litigation is successful. Last but not least, trivial or even malicious actions may be generated if individual shareholders are allowed to bring litigation.

It is true that the proper plaintiff principle recognises the legal entity of the corporation and the importance of business judgment. However, without exception, the application of this rule would cause unfairness in some circumstances. Injustice could arise where the majority of a company's shares are controlled by the

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<sup>1</sup> *Foss v Harbottle* (1843) 2 Hare 461.

company's directors or managers. Where these individuals are involved in the alleged misconduct, it is most unlikely that the company in this situation would bring litigation.

In fact, the common law in England and Wales and Scotland, from which the derivative action originated, has recognised the limitations of the *Foss* rule and developed several exceptions under which shareholders are entitled to sue in their own names. For example, in the case of *Prudential Assurance Co Ltd v Newman Industries (No 2)*, the Court indicated that "There is no room for the operation of the rule if the alleged wrong is *ultra vires* the corporation, because the majority of members cannot confirm the transaction."<sup>2</sup> The court further stated that "there is also no room for the operation of the rule if the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority cannot confirm a transaction which requires the concurrence of a greater majority".<sup>3</sup> Among these exceptions, corporate control by a wrongdoer might be seen as typical. This means that courts will allow shareholders to bring the litigation when a wrongdoer has sufficient powers to control a company in order to prevent legal action from being commenced in its name.<sup>4</sup>

As a result, exceptions to the proper plaintiff principle have been developed and adopted not just in the UK, but in numerous countries.<sup>5</sup> Derivative actions are a response to the problem of abuse which might be caused by the application of the proper plaintiff principle and allow individual shareholders to sue wrongdoers on

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<sup>2</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 210 *per curiam*.

<sup>3</sup> *Ibid*.

<sup>4</sup> See *Burland v Earle* [1902] AC 83, 93 (PC).

<sup>5</sup> Many common law jurisdictions have adopted statutory derivative action as an exception to the proper plaintiff principle. The Canadians have adopted the statutory derivative action in sections 238-240 of Canada Business Corporations Act, R.S.C.1985. c. C-44. Singapore and New Zealand have also introduced the statutory derivative action in their respective countries. Eventually Australia adopted it in 2000 in part.2F.1A of its Corporations Act 2001. The US and UK, countries representative of common law jurisdictions, have also introduced this statutory rule.

behalf of the company. As a consequence, the interests of minority shareholders and the company would be protected. Many countries have either adopted, or are considering the introduction of the statutory derivative action.<sup>6</sup> Indeed, the introduction of statutory derivative actions serves many functions, such as deterring mismanagement.<sup>7</sup> It is also, however, most likely to be abused either in the form of strike suits or shifting corporate governance from directors to shareholders owing to the excessive use of the derivative litigation. Thus, there is a general recognition of the need to balance the interests of minority shareholders and corporate efficiency to craft law that permits minority shareholders to raise derivative actions. The solutions in this respect are quite different across jurisdictions.

## **1.2 Derivative Actions versus other Devices Designed to Reduce Agency Costs**

Since Berle and Means first unveiled the theory of control of the corporate form,<sup>8</sup> the economic term ‘agency’ has gradually become utilised in legal scholarship.<sup>9</sup> Two forms of agency costs have been identified: vertical agency costs between shareholders and managers, and horizontal agency cost problems between majority shareholders and minority shareholders. In the case of the former, members of a company do not generally ‘control’ the company; in its day-to-day operations the board of directors is authorised to run the company, thus accruing agency costs.<sup>10</sup> In the case of the latter, this is normally incurred in the jurisdictions with concentrated

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<sup>6</sup> Please refer to n5.

<sup>7</sup> See E. Ferran, ‘Company Law Reform in the UK’ (2001) 5 *Singapore Journal of International & Comparative Law* 516; J. C. Coffee, ‘Privatization and Corporate Governance: The Lessons from Securities Market Failure’ (1999) 25 *The Journal of Corporation Law* 1.

<sup>8</sup> A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (2<sup>nd</sup> revised edn, Transaction Publishers 1991).

<sup>9</sup> For details of agency costs in China, please see Part 1 of Chapter 2.

<sup>10</sup> See R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn, Oxford University Press 2009) 21-23.

ownership as majority shareholders in such jurisdictions have both the ability and incentive to constrain the directors' performance. As such, the managerial agency problem is not a major issue; rather, conflicts between controlling shareholders and minority shareholders are the principal concern.

It is generally thought that shareholder litigation is neither the initial nor the primary protection for shareholders to reduce agency costs. Indeed, various mechanisms can hold majority shareholders or managers accountable and thus some argue that there may be less need to resort to litigation as a means of protecting minority shareholder interests in light of the high costs of such recourse.<sup>11</sup> However, the question emerges as to what role the derivative action should play in reducing agency costs. In the absence of derivative actions, are mechanisms such as market forces and the regulatory authority of governmental agencies strong enough to protect the interests of shareholders, especially minority shareholders?

Law has an important role to play in reducing these costs. As Kraakman *et al* have pointed out, carefully designed rules and procedures can enhance disclosure by agents or facilitate enforcement actions brought by principals against negligent or dishonest agents.<sup>12</sup> The derivative action, as one of these rules, can reduce agency costs operating to deter mismanagement by imposing the threat of liability and therefore aligning the interests of managers with those of shareholders.<sup>13</sup> McDonough also recognises the role of derivative actions and maintains that as one way of addressing agency costs, it enables steps to be taken on behalf of shareholders in order to redress the imbalance in the modern corporate form between control

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<sup>11</sup> S. Deakin, E. Ferran, R. C. Nolan, 'Shareholders' Rights and Remedies: An Overview' (1997) 1 *Company Financial and Insolvency Law Review* 162- 171.

<sup>12</sup> See R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) Chapter 2.

<sup>13</sup> A. Reisberg, *Derivative Actions and Corporate Governance : Theory and Operation* (Oxford University Press 2007) 23.

exercised by managers and shareholders.<sup>14</sup>

Some commentators argue that mechanisms other than derivative action are the rational choice for corporations to diminish agency costs. Agrawal and Knoeber have conducted research into the effects on corporate performance of several alternative mechanisms and their results appear to match up with the notion that different mechanisms of reducing agency costs can complement and substitute for one another.<sup>15</sup> This is also supported by Himmelberg, Hubbard and Palia who state that “firm[s] choose among alternative mechanisms for minimizing agency costs”.<sup>16</sup> Nevertheless, some commentators maintain that derivative actions are a necessary means of dealing with agency costs. As Posner asserts “the derivative suit is a monument to the problem of agency costs; it would make no sense to allow a shareholder to bypass the corporate management in bringing a suit against an officer if one could be confident that management always acted in the shareholders’ interests”.<sup>17</sup> The crux of both these arguments is whether other mechanisms are strong enough to reduce agency costs and hence protect the interests of minority shareholders and the company as a whole.

Considering that many countries have adopted or considered introducing statutory derivative actions, it seems clear that other mechanisms alone may not constitute an effective functional substitute to litigation. This part will thus place the system of derivative actions in the context of market mechanisms and legal mechanisms to

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<sup>14</sup> D. D. McDonough, ‘Proposed New Statutory Derivative Action-Does It Go Far Enough?’ (1996) 1 *Bond Law Review* 47.

<sup>15</sup> A. Agrawal and C. R. Knoeber, ‘Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders’ (1996) 31 *Journal of Financial and Quantitative Analysis* 377.

<sup>16</sup> There are several strategies which a company can choose to reduce agency costs: leverage, increased reliance on outside directors, institutional investors, dividend policy and radical changes in corporate control. See C. P. Himmelberg, R. G. Hubbard, and D. Palia, ‘Understanding the Determinants of Managerial Ownership and the Link between Ownership and Performance’ (1999) 53 *Journal of Financial Economics* 353, 382.

<sup>17</sup> R. A. Posner, ‘Citation Classic - Economic-Analysis of Law’ (1985) 49 *Current Contents/Social & Behavioral Sciences* 389.

demonstrate why it has a key role to play in this setting.

### **1.2.1 Market Mechanisms**

There are a number of market mechanisms that operate to align the interests of shareholders and managers. These include the product market, the capital market, the market for corporate control and the labour market for managers.<sup>18</sup>

The product market means that a company's product should be competitively priced so it can gain market share and increase profit. In order to achieve this, a company must impose rigid controls on all aspects of production and sale to reduce redundant costs which leaves little room for managers to abuse their powers to pursue personal interests. The capital market constrains agency costs by lowering a company's share price and making it difficult for the company to raise finance on the capital market. In order to avoid that, directors must reduce agency costs, thus disincentivising their exploitation of minority shareholder interests. The labour market for managers denotes that managers, like other employees, must look for a job when they are unemployed. Disloyalty or misconducts harmful to a previous (company) employer damages their reputation and thus reduces their ability to obtain a well-paid job. The market for corporate control operates through the threat of a bid that provides management with an incentive to maximise shareholder returns. If managers successfully bring high value to all shareholders, this will make their company bid-proof because they have acted in the interests of shareholders and shown them loyalty. If they fail to do so, the company may be in danger of being taken over and the managers might be replaced.

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<sup>18</sup> E. Ferran, *Company Law and Corporate Finance* (Oxford University Press 1999) 118-122.



Indeed, these market mechanisms play an important role in enhancing managerial efficiency and accountability from the perspective of the modern economic theory of the corporation.<sup>19</sup> The reason why the USA and UK adopt different approaches towards derivative actions may be a vivid example to illustrate the role of the market mechanism. Miller conducts a comparative study and shows that one reason why the USA and UK adopt different attitudes towards derivative actions is that they have divergent regulations regarding takeovers.<sup>20</sup> In the US, where hostile takeovers are rigorously limited, the derivative action has attained greater prominence as a management control device. In the UK, there is a more vigorous and less regulated takeover market than in the US and thus the operation of the derivative action is more restricted. This indicates that in the UK, market forces may be a better alternative to reduce agency costs and thus the derivative action is less needed.

However, this does not mean that the market mechanism can replace the legal method. In fact, such market mechanisms are not without their limits. Recent research implies that extra-legal methods designed to control managerial power are less effective than one might have expected.<sup>21</sup> Other studies also cast doubt on the mechanism of the market for corporate control and identify several drawbacks. First, a takeover can happen to any company regardless of its size, though in the real world, it is much easier for larger companies to acquire small companies.<sup>22</sup> From this perspective, takeover regulation is irrelevant to the efficiency of management. Secondly, the cost of takeovers as a means of changing management is high.<sup>23</sup>

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<sup>19</sup> F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press Reprint edn 1996); E. F. Fama and M. C. Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law & Economics* 301.

<sup>20</sup> G. Miller, 'Political Structure and Corporate Governance: Some Points of Contrast between the United States and England' (1998) 1 *Columbia Business Law Review* 51.

<sup>21</sup> S. Deakin, E. Ferran, R. C. Nolan, 'Shareholders' Rights and Remedies: An Overview' (1997) 1 *Company Financial and Insolvency Law Review* 167-169.

<sup>22</sup> A. Hughes, 'Merger and Economics Performance in the UK: A Survey of the Empirical Evidence 1950-1990' In Fairburn and J. A. Kay (eds.), *Mergers and Merger Policy* (Oxford University Press 1991).

<sup>23</sup> See general: A. T. Peacock and G. Bannock, *Corporate Take Overs and the Public Interest: The Hume Report on Corporate Takeovers* (Elsevier Science Ltd 1991).

Prentice has suggested that either mounting, or defending against, a takeover involves substantial transaction costs.<sup>24</sup> Furthermore, there is no evidence to prove that firm performance will be improved after a takeover. As Singh and Weisse have noted, the acquiring company may be motivated by empire-building considerations rather than improving corporate governance.<sup>25</sup>

Other market mechanisms also have their own disadvantages. For example, the mechanism of the labour market for managers may be undermined when managers are at the end of their careers and thus no longer seek to further their careers. In fact, there is already a vast amount of literature questioning the effectiveness of market primacy.<sup>26</sup> The traditional criticism is that such a market may fail to work because of inevitable problems such as informational asymmetry, transaction costs and collective action problems. However, it is not the intention of this thesis to examine all of these problems. The above discussion is simply intended to introduce the limits of market mechanisms and underscore the importance of legal methods to reduce agency costs. The details of these market mechanisms in the context of China will be discussed in the next chapter.

## **1.2.2 Legal Mechanisms**

### **1.2.2.1 The Strengths of Legal Mechanisms**

When the benefits generated by misbehaviour are larger than the costs, a reasonable

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<sup>24</sup> D. D. Prentice, 'Some Aspects of the Corporate Governance Debate' In D. D. Prentice and P. R. J. Holland (eds.), *Contemporary Issues in Corporate Governance* (Oxford University Press 1993) 37.

<sup>25</sup> A. Singh and B. Weisse, 'Corporate Governance, Competition, the New International Financial Architecture and large Corporations in Emerging Markets' ESRC Centre for Business Research, University of Cambridge Working Paper No.250, 28.

<sup>26</sup> For example, see M. A. Eisenberg, 'The Structure of Corporation Law' (1989) 89 *Columbia Law Review* 1461; J. N. Gordon, 'Corporations, Markets, and Courts' (1991) 91 *Columbia Law Review* 1931.

manager may choose to engage in such behaviour where it is monitored simply by the market mechanism alone. In this situation, legal mechanisms have to be in place in order to impose legal liabilities on the misbehaving managers. The power of the State lying behind legal mechanisms has a monopoly on the legitimate use of physical force. As such, misbehaving managers can be involuntarily punished; market mechanisms have no such role. With legal liability, infringed legal rights can be rectified, damaged interests restored, illegitimate gains removed and misappropriated properties retrieved.<sup>27</sup> In addition, legal mechanisms also have the effect of punishing corrupt managers through disqualification, fines and incarceration, etc. It is these unique features that make legal mechanisms distinct from market mechanisms and enable them to deter one-off managerial misappropriation, which is fatal to corporate success.<sup>28</sup> In this sense, it is perhaps not an exaggeration to say that legal mechanisms are the foundation of fostering good corporate governance.

#### **1.2.2.2 Defects of Legal Mechanisms**

Although it is acknowledged that there is a vital role for legal mechanisms to play in deterring managerial misappropriation and ensuring good corporate governance, it is also argued that the defects of legal mechanisms may affect their functioning in this context. For example, it is said that it can be difficult to achieve legislative purposes owing to the limitations of legislation and poor law enforcement. Indeed, it is true that this problem exists in every country, particularly in China where the enforcement of law is often severely criticised. However, the existence of such a problem does not imply that legal mechanisms are less important or are trivial in reducing agency costs. Rather, the correct way to overcome this issue is to solve the problem to the best of our ability. It is undeniable that the problem of legislation and enforcement cannot be

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<sup>27</sup> J. P. Humphrey, 'On the Definition and Nature of Law' (1945) 8 *Modern Law Review* 194.

<sup>28</sup> For details of one-off misappropriation, please see: Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 60-66.

completely eliminated; nevertheless, it also cannot be denied that such problems can be diminished and thus improve corporate governance. In fact, the existence of good and poor corporate governance in different countries reflects their different levels of sophistication in law enforcement and drawing up legislation.

Some commentators also point out that legal liability is limited by the fact that judges are no better qualified than managers to make decisions about commercial affairs. Managers, as businessmen, are business professionals and should thus be more qualified to decide whether a transaction is in the best interests of a company. It is argued that judges, as outsiders, are not capable of making good decisions about such issues. However, this argument is groundless as there is a difference between deciding and assessing. Although courts may experience difficulties in deciding business strategy, they are manifestly capable of assessing the merits of conceivable managerial misconducts; much like people with no knowledge of film-making are nevertheless able to evaluate films. Furthermore, judges are becoming increasingly competent in judging commercial cases. This is especially so in China where there is even a specialist adjudication division responsible for dealing with commercial cases.

### **1.2.2.3 Public or Private Enforcement of Law?**

As demonstrated above, legal mechanisms play a vital role in deterring managerial misbehaviour and building good corporate governance. Nevertheless, the law regulating corporate governance can take different forms and thus result in different liabilities. The common explanation for this difference is public and private enforcement of law. The former relates to the enforcement of law by public authorities, potentially giving rise to criminal or administrative liability. The latter involves law enforced by individuals, particularly shareholders in a company, and can produce civil liability. This part will demonstrate the necessity of the private

enforcement of law by assessing the characteristics of public law enforcement.

Compared to private enforcement, public enforcement has a much more severe deterrent effect on potential wrongdoers as it not only causes economic consequences but may also involve physical confinement. Indeed, criminal liability may not only result in criminal fines, but can also result in incarceration for wrongdoers. Furthermore, imprisonment itself does not simply mean physical agony, but can also affect a manager's future by rendering them potentially unable to find a job in the same profession.<sup>29</sup> Even administrative liability that does not involve incarceration can cause a significant financial loss for a wrongdoer as it normally entails forfeiture, confiscation and administrative fines. As a result, it is widely acknowledged that the public enforcement of law has a very strong effect of deterrence.

However, a strong deterrent does not necessarily lead to an optimal result as the effectiveness of legal sanctions not only depends on the severity of the penalty, but also on the probability of subjection to such a penalty.<sup>30</sup> If the likelihood of discovering and convicting wrongdoers is low, the effectiveness of such a legal mechanism is affected. Unfortunately, the public enforcement of law suffers from this disadvantage and thus is no better than private enforcement.

First, difficulties in proving the guilt of managers makes public enforcement less desirable than private enforcement. The general standard of proof to establish guilt in criminal proceedings is that all elements of the charge are established "beyond reasonable doubt",<sup>31</sup> which is much higher than the standard in civil lawsuits.

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<sup>29</sup> For example, according to article 147 of Chinese Company Law 2005, a person shall not assume the post of a director, supervisor or senior manager of a company if he or she has been sentenced to any criminal penalty due to an offence of corruption, bribery, encroachment of property, misappropriation of property or disrupting the economic order of the socialist market and 5 years have not elapsed since the completion date of the execution of the penalty.

<sup>30</sup> See G. S. Becker, 'Crime and Punishment: an Economic Approach' (1968) 78 *Journal of Political Economy* 169.

<sup>31</sup> See *Woolmington v DPP* [1935] AC 462.

Furthermore, the evidence collected in criminal proceedings is subject to rigorous scrutiny and the so-called illegal evidence exclusion rule is also adopted to invalidate evidence obtained illegally. In civil suits, the procedure and evidence rules are much more relaxed. As those acting criminally in a company are likely to be highly intelligent and act cautiously, it is much more difficult to successfully prosecute white-collar crime.<sup>32</sup>

In addition to the rigorous evidential requirements and complicated procedure of criminal law, there are other drawbacks that make public enforcement impractical in exclusively tackling managerial misbehaviour. As Reisberg points out, the funding and resources of the public organisations charged with the task of enforcement are limited and thus, they cannot pursue all the illegal activities that might arise.<sup>33</sup> Moreover, the enforcement priorities established by corporate regulators may not be appropriate to address wrongdoing in each and every company; this highlights the role of private enforcement.<sup>34</sup> Lastly, it is also argued that the possibilities for public agencies to enforce rights or duties would probably be lower if the private enforcers had a role to play under the legal system.<sup>35</sup>

On the other hand, private enforcement does not suffer from the above problems and thus enjoys some advantages over public enforcement. For example, the gains from private enforcement normally go to the individual, creating a strong financial incentive for shareholders. An empirical study in the US also shows that the

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<sup>32</sup> It has been argued that the main reason why the prosecutions for insider trading in the UK are so low is because of the high standard of proof. See J. M. Naylor, 'The Use of Criminal Sanctions by UK and US Authorities for Insider Trading: How Can the Two Systems Learn from Each Other (Part II)' (1990) 5 *Company Lawyer* 83.

<sup>33</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007) 31.

<sup>34</sup> I. Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales Law Journal* 152.

<sup>35</sup> Seen generally: American Law Institute Principles of Corporate Governance and Structure: Restatement and Recommendations (Tentative Draft No1 1982) 220-221.

development of capital markets is highly correlated to private law enforcement.<sup>36</sup> As such, private enforcement is essential to developing good corporate governance. Nevertheless, this does not negate the importance of public enforcement. In fact, the strong deterrent effect that it generates is essential to protect minority shareholders. The above discussion thus highlights the limitations of public enforcement and demonstrates the need for private enforcement. Both modes of enforcement can and should be used in complement to tackle managerial misbehaviour as neither are sufficient means of doing so alone.

#### **1.2.2.4 Private Enforcement of Law: Derivative Actions or other Methods?**

Law, including securities law, has conferred many rights upon shareholders to protect their interests. If other methods are sufficient to hold managers accountable, the derivative action may lose its justification. However, other mechanisms also have their own disadvantages and thus the derivative action cannot be excluded. For example, the right to vote is thought to be a major enforcement mechanism available to shareholders that does not involve litigation.<sup>37</sup> Here, the assumption is that managers must act in the interests of shareholders because failure to do so means shareholders might vote against and remove them. Indeed, the right to vote allows shareholders to influence the behaviour of managers and therefore, agency costs can be reduced to some extent. However, this analysis is built on the presupposition that shareholders are willing to vote in their own interests. In fact, in many cases shareholders are reluctant to participate or vote in general meetings, even where they can easily vote by electronic means.<sup>38</sup> The reason for this may stem from the

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<sup>36</sup> See R. L. Porta, F. L. Silanes and A. Shleifer, 'What Works in Securities Laws?' (2006) 61 *Journal of Finance* 1.

<sup>37</sup> G. Hertig, 'Convergence of Substantive law and Convergence of Enforcement: A Comparison' In J. Gordon and M. Roe (eds.), *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004) 328, 336-338.

<sup>38</sup> A. Reisberg, *Derivative Actions and Corporate Governance : Theory and Operation* (Oxford

problem of collective action.<sup>39</sup> First, the right to vote is a right conferred upon shareholders and is not compulsory for shareholders. Secondly, shareholders can incur significant costs in seeking to vote wisely because they have to travel to attend the meeting<sup>40</sup> and spend some time reading the related information. More importantly, shareholders are likely to think that their votes are not a crucial element to decide whether a proposal could pass or not, especially in the UK, where the ownership of companies is relatively dispersed.<sup>41</sup> Faccio and Lang have examined the impact of this dispersed ownership in the UK and concluded that this relatively dispersed UK capital market leads most ‘small’ shareholders to choose rational apathy; thus they do not want to take their time to consider proposals put to a vote by shareholders. Instead, they are inclined to vote with management without thinking too much.<sup>42</sup> In addition, research has shown that the operating performance and valuations of corporations have not been influenced by shareholder proposals, and those proposals did not seem to alter the policy of corporate governance.<sup>43</sup> Even if a shareholder’s proposal changes the corporation’s policy and thus increases its profits, he or she would receive only a *pro rata* share of the benefits whereas other shareholders free-ride on his or her efforts. Therefore, the right to vote seems to be an ineffective tool to prevent potential misbehaviour.

Another main protection for minority shareholders is the establishment of independent directors (more commonly known as non-executive directors (NEDs) in

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University Press 2007) 25.

<sup>39</sup> B. R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford University Press 1997) 238-241.

<sup>40</sup> Even now it is becoming easier to exercise a vote electronically. Nevertheless, some shareholders still prefer to attend a meeting in person.

<sup>41</sup> It is similar in the US where shares in corporations are dispersed while in China, many powerful listed companies are controlled by the government and thus shareholder ownership structure is highly concentrated. See C. Mayer, ‘The City and Corporate Performance: Condemned or Exonerated?’ (1997) 21 *Cambridge Journal of Economics* 298-299.

<sup>42</sup> M. Faccio and L. Land, ‘The Separation of Ownership and Control: An Analysis of Ultimate Ownership in Western European Corporations’ (Working Paper 2000); B. S. Black, ‘Shareholder Passivity Reexamined’ (1990) 89 *Michigan Law Review* 520, 527-528.

<sup>43</sup> J. M. Karpoff, P. H. Malatesta, and R. A. Walkling, ‘Corporate Governance and Shareholder Initiatives: Empirical Evidence’ (1996) 42 *Journal of Financial Economics* 365.



the UK). It is generally thought that the increasing role of NEDs would make managers accountable in the following ways: (1) reviewing the performance of the board and executive; (2) monitoring a company's management; (3) taking the lead where potential conflicts of interest arise; and (4) expressing views and taking decisions in line with shareholder interests.<sup>44</sup> As such, it is expected that NEDs would contribute value to the company and establish good corporate governance.

However, there are mixed views on the effectiveness of NEDs on a board. The first concern is that the empirical evidence shows that there is no significant, or at least no, straightforward link between board composition and firm performance.<sup>45</sup> In fact, Agrawal and Knoeber found that there is a negative relationship between the percentage of outsiders on the board and firm performance, which implied that additional outsiders on a board may reduce firm performance.<sup>46</sup> Secondly, the establishment of NEDs would incur additional costs for a company as they may lack familiarity with the business.<sup>47</sup> Third, managers' innovation may be restricted. As NEDs are expected to assume more roles, managers would have less freedom to serve their own interests. At the same time, they would also have less freedom to make innovative and profit-generating business decisions.<sup>48</sup> Indeed, the financial crisis in 2008 revealed the sad fact that the NED system is only one element in improving corporate governance and its role cannot be exaggerated.

On the whole, it is well recognised that no single technique of accountability is likely to be most favourable under all conditions. Consequently, as a means of protecting

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<sup>44</sup> A. Reisberg, *Derivative Actions and Corporate Governance : Theory and Operation* (Oxford University Press 2007) 32.

<sup>45</sup> A. Cosh and A. Hughes, 'The Changing Anatomy of Corporate Control and the Market for Executives in the United Kingdom' (1997) 24 *Journal of Law and Society* 111.

<sup>46</sup> A. Agrawal and C. R. Knoeber, 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders' (1996) 31 *Journal of Financial and Quantitative Analysis* 377.

<sup>47</sup> D. Fischel, 'The Corporate Governance Movement' (1982) 35 *Vanderbilt Law Review* 1259.

<sup>48</sup> B. R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford University Press 1997) 624-625.

shareholder interests, the derivative action is becoming increasingly important in modern company law. This is particularly so nowadays when shareholder activism is strongly encouraged.<sup>49</sup>

### **1.3 Debates on Derivative Actions: Justifications and Disadvantages**

As demonstrated above, the derivative action has a key role to play in making managers accountable. However, there has been a long debate about this system since its inception. Both sides have their own justifications.

#### **1.3.1 Justifications for Derivative Actions**

The arguments of those who support derivative actions run as follows. The first rationale behind the use of derivative actions is said to be the remedy of compensation. Successful litigation may confer monetary benefits to the company and impose financial penalties on the wrongdoers. However, some argue that this compensatory rationale has limitations. For example, changes in the composition of shareholders means that shareholders at the time of injury, who subsequently sell their shares prior to a court order for recovery, do not gain any compensation while incoming shareholders obtain a windfall gain.<sup>50</sup> In addition, the injury to the company is not necessarily the same as the injury suffered by the shareholders.<sup>51</sup>

This is confirmed by various empirical studies in the USA. Romano concluded, after

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<sup>49</sup> For details of shareholder activism, please see: S. M. Bainbridge, 'Shareholder Activism and Institutional Investors' (2005) UCLA School of Law, Law-Econ Research Paper No. 05-20. The adoption of the UK Stewardship Code is a good example of shareholder activism, though its effectiveness is doubted by some scholars. See B. R. Cheffins, 'The Stewardship Code's Achilles' Heel' (2010) 73 *The Modern Law Review* 1004; D. Arsalidou, 'Shareholders and Corporate Scrutiny: The Role of the UK Stewardship Code' (2012) 9 *European Company and Financial Law Review* 342.

<sup>50</sup> I. Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales Law Journal* 149, 156.

<sup>51</sup> J. C. Coffee and D. E. Schwartz, 'The Survival of the Derivative Suit - an Evaluation and a Proposal for Legislative Reform' (1981) 81 *Columbia Law Review* 304.

his empirical research, that while the total amount of recovery may be considerable, it is commonly *de minimis* on a per share basis.<sup>52</sup> Thus one question emerges: if compensation cannot fully justify derivative actions, what else can validate shareholder litigation?

Ramsay claims that deterrence, as one of the goals of derivative actions, may be seen as a key element in reducing the agency costs inherent in the management of companies.<sup>53</sup> Deterrence generally operates at two levels: The first is that it deters misbehaviour on the part of the management of the company that is subject to such litigation; secondly, it further deters the management of the 'family of companies' as a whole. In the former case managers have to weigh up the costs of litigation if they do something wrong. In the latter case, a successful derivative action is likely to produce a positive externality: it will deter misconduct in other companies.<sup>54</sup> As such, even if litigation brings a net loss to the company in whose name the action is initiated, shareholders still benefit if a derivative action deters potential defendants who are similarly situated at other companies because shareholders normally do not hold shares in a single corporation but own diversified portfolios.<sup>55</sup> Yet it is wrong to think that deterrence provides a sufficient rationale for derivative actions. This is because, first, wrongdoers are usually required to make compensatory reparation to companies, and this may not always amount to an effective sanction.<sup>56</sup> Indeed, some wrongdoers will not be deterred by derivative actions, though undoubtedly not all managers or directors would act as they please without considering the consequences of derivative action. Although it is virtually impossible to identify a general deterrent

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<sup>52</sup> R. Romano, 'The Shareholder Suit - Litigation without Foundation' (1991) 7 *Journal of Law Economics & Organization* 55, 62.

<sup>53</sup> I. Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales Law Journal* 149, 156.

<sup>54</sup> S. Shavell, 'The Social Versus the Private Incentive to Bring Suit in a Costly Legal-System' (1982) 11 *Journal of Legal Studies* 333.

<sup>55</sup> J. D. Cox, 'Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures' (1984) 52 *George Washington Law Review* 745, 764.

<sup>56</sup> D. W. Locascio, 'The Dilemma of the Double Derivative Suit - Comment' (1989) 83 *Northwestern University Law Review* 729, 755.

effect, the logic is the same as in the case of criminal enforcement: the conviction of a company's director presumably deters not only other officers of the same company but also other directors of other companies.

Another merit of the derivative action is the traditional view that it can ensure that directors pay attention to their legal duties.<sup>57</sup> Although directors' duties are owed to the company and not to individual shareholders, shareholders' interests would not be protected without the imposition of these duties. Thus, the enforcement of directors' duties sets limits to the directors' exercise of corporate power and attempts to confine their behaviour to that which is in the interests of the company as a whole. Since the board of directors is normally controlled by directors or managers, duty-based controls depend very much on viable shareholder enforcement. For this reason, the derivative action can be one of the tools to enforce directors' duties.

### **1.3.2 Weaknesses of Derivative Actions**

Notwithstanding the aforementioned cited merits, there are arguments which assert that litigation will leave the company worse off than before. First, there is the danger that a corporation would be burdened with litigation that it does not want; here, the company 'might be killed by kindness.'<sup>58</sup> Secondly, there are also some unseen costs beyond the direct costs of litigation,<sup>59</sup> as litigation may disrupt decision-making processes and thereby impose hidden and undetected costs. Thirdly, it is unpredictable whether the company will successfully recover compensation. The litigation could fail owing to the difficulties of proving a breach of duty, or even where it is successful in securing a verdict against wrongdoers, the defendants may

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<sup>57</sup> A. Reisberg, *Derivative Actions and Corporate Governance : Theory and Operation* (Oxford University Press 2007) 52.

<sup>58</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd* (No2) [1982] 1 Ch 204, 221.

<sup>59</sup> P. F. Banta, 'The New Indiana Business Corporation Law: "Reckless" Statute or New Standard' (1987) *Columbia Business Law Review* 233, 236.

not be in a position to implement the judgment and pay the compensation.<sup>60</sup> Fourthly, derivative actions may discourage managers from developing high-risk business plans and thus may adversely affect profit maximization. Arguably, this is possibly the greatest cost of derivative litigation.<sup>61</sup> Last but not least, the derivative action itself generates agency costs. As many commentators point out, the increased risk of litigation might deter individuals from becoming directors;<sup>62</sup> as such, companies have to pay more in order to attract high-quality managers.

### 1.3.3 Summary

There appear to be a large number of conflicting views regarding the desirability of derivative actions amongst the legal profession. Other mechanisms such as market forces, as indicated above, are inadequate in reducing agency costs and so derivative actions have been introduced as a supplementary means of curbing the behaviour of managers. However, the derivative action itself is not without its disadvantages. For example, managers have to spend their precious time defending such litigation. As a result, in many jurisdictions, especially in the English courts, judges are generally reluctant to accept such claims. The key point of the derivative action is to balance the interests of minority shareholders and managers. In general, such an action cannot provide overprotection to minority shareholders, though it should not give too much freedom to management either. Therefore, striking a balance between corporate efficiency and protection for minority shareholders and the company becomes a key question when it comes to legislation on derivative actions. Given this, a comparative analysis of derivative actions in China, the US and the UK, may prove useful to evaluate whether China's law could be improved by transplanting law from the US

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<sup>60</sup> P. L. Davies, *Principles of Modern Company Law*, (9<sup>th</sup> edn, Sweet & Maxwell 2012) 443.

<sup>61</sup> P. F. Banta, 'New Indiana Business Corporation Law: Reckless Statute or New Standard' (1987) *Columbia Business Law Review* 233, 236.

<sup>62</sup> See R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 39-42.

and UK.

## **1.4. A Comparative Study**

This thesis intends to adopt the comparative method as an instrument to analyse what can be borrowed from other jurisdictions to improve the derivative action system in China. Two jurisdictions are adopted as analysis samples for this thesis: English law and US law. This part will thus briefly introduce derivative actions in the three countries of China, the UK and the US, and point out why the latter two jurisdictions have been chosen as analysis samples.

### **1.4.1 Derivative Actions in China**

The derivative action was introduced into Chinese Company Law for the very first time during the 2005 revision process. Some scholars argue that the derivative action was actually permitted under Chinese Company Law 1993, article 111 providing that shareholders have the right to raise a suit when directors violate the law.<sup>63</sup> However, mainstream scholars object to this view and assert that this article was only intended for personal shareholders actions in joint stock companies.<sup>64</sup>

During the period before the 2005 revision, calls to introduce a new statutory

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<sup>63</sup> Article 111 of Chinese Company Law 2005 states that “where a resolution of a shareholder general meeting or of the board of directors violates the law or administrative rules and regulations, or infringes the lawful rights and interests of the shareholders, the shareholders concerned shall have the right to bring a lawsuit in a people's court demanding that such illegal or infringing action be stopped”.

<sup>64</sup> K. Pistor and C. Xu, ‘Deterrence and Regulatory Failure in Emerging Financial Markets: Comparing China and Russia’ (April 2003), working paper. It is available at <<http://www.wcfia.harvard.edu>> [Accessed 23 August 2013].

derivative action became louder,<sup>65</sup> though some conservatives strongly opposed this proposal preferring to seek alternative mechanisms. This opposition movement argued that in many cases the courts would be reluctant to accept derivative litigation not only because of a lack of procedural rules but also because of economic development in respective local cities. They further argued that if a new statutory derivative action were adopted in the new company law, the courts would become bewildered by the procedure in the absence of a revision of Chinese Civil Procedural Law. Moreover, it was contended that judicial resources were insufficient and that these limited resources should concentrate on cases other than derivative actions.<sup>66</sup>

The derivative action in China did indeed require revision of not only company law but also Civil Procedural Law; however, some argued that we should not waste valuable time waiting for change to Chinese Civil Procedural Law, meanwhile ignoring the interests of minority shareholders. Further, some derivative suits were actually initiated successfully against wrongdoers without the relevant procedures, though their application was very limited as the courts failed to identify the exact requirements for derivative actions.<sup>67</sup> Most legal scholars advocated this approach and this view prevailed in the end.

The first strong justification for introducing derivative actions was that there were too few legal protections for minority shareholders.<sup>68</sup> It was very common in China for the interests of minority shareholders to be infringed by majority shareholders or directors before the revision of Chinese Company Law, and, unfortunately, the protections that did exist were too weak. On the contrary, common law jurisdictions

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<sup>65</sup> See X Huang, "Shareholders Revolt: The Statutory Derivative Action in China" (2009) 09 *Comparative Research In Law & Political Economy* 4-6.

<sup>66</sup> For the conservative opinions against the enactment of derivative actions, please see: F Ma, "The Deficiencies of Derivative Actions in China" (2010) 31 *Company Lawyer* 150.

<sup>67</sup> X. Zhang, 'Practical Demands to Update the Company Law' (1998) 28 *Hong Kong Law Journal* 251, 253.

<sup>68</sup> J. Liu, *Xiandai Gongsi Fa* [Modern Corporate Law] (Falv Chubanshe [Law Press] 2008) 276.

have systems such as ‘unfair prejudice’, ‘oppressive’ or ‘unfairly discriminatory’ rules which provide strong weapons for minority shareholders –concepts that were absent in China. Secondly, the opportunities for majority shareholders to abuse their powers were much greater owing to the special ownership structure of Chinese corporations. The ownership structure of Chinese listed companies is quite complicated as over 60% of all outstanding shares in most listed companies are represented by non-tradable, state-owned shares.<sup>69</sup> This provides substantial scope for majority shareholders to ignore rather than consider minority shareholders’ interests. Thirdly, internal mechanisms failed to effectively monitor corporate management. Before the 2005 revision, China had introduced and encouraged companies to establish independent directors, and many listed companies had set up this system. However, this renovation incurred numerous criticisms owing to its lack of effectiveness. Lastly, whilst takeovers might be a strong weapon in protecting minority shareholders in western countries, this is certainly not yet the case in China. The special ownership structure of Chinese corporations means that it would be very difficult to acquire a company without the support of the majority shareholders.<sup>70</sup>

Calls for the introduction of the derivative action were finally successful and the mechanism was adopted in the recent revision. This is a major development in Chinese company law and has been regarded as a milestone in reform.<sup>71</sup> The 2005 revision provides a general legal framework for the initiation of derivative actions, intended to function so as to control management to some extent. However, there are

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<sup>69</sup> Although there has been a split-share reform aiming to reduce the ratio of state-owned shares since 2005, the success of this reform remains doubtful. See Shangshi Gongsi Guquan Fenzhi Gaige Guanli Banfa [Measures on Reforming the Ownership Structure of Listed Companies] (promulgated by China Securities Regulatory Commission on 4 September 2005). Also see X. Huang, ‘Shareholders Revolt: The Statutory Derivative Action in China’ (2009) 09 *Comparative Research In Law & Political Economy* 6; H. Huang, ‘The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform’ (2007) 4 *Berkeley Business Law Journal* 233.

<sup>70</sup> H. Huang, ‘China’s Takeover Law: A Comparative Analysis and Proposals for Reform’ (2005) 30 *Delaware Journal of Corporate Law* 145.

<sup>71</sup> N. Krause and C. Qin, ‘An Overview of China’s New Company Law’ (2007) 28 *Company Lawyer* 316.



still problems with this new rule: as Li and Ho argue, its provisions are ‘simple and impractical’.<sup>72</sup> For example, the scope of eligible plaintiffs is not clear and the funding of the costs of litigation is not addressed. This lack of guidance on the substantive and procedural rules of derivative actions needs to be clarified by future judicial interpretation.

#### 1.4.2 Derivative Actions in the UK

Individual shareholders were allowed to bring derivative actions only in some limited circumstances under English common law before the enactment of the statutory procedure in sections 260 to 269 of the Companies Act 2006. These provisions originate from the case of *Foss v Harbottle* which, interestingly, in principle denies an individual shareholder the right to initiate actions on behalf of a company.<sup>73</sup> Two principles must be mentioned in relation to the rationales behind this rule. The first is the majority rule, which reflects the English courts’ historical reluctance to involve itself in the internal management of companies.<sup>74</sup> The second is the ‘proper plaintiff’ principle, which has been described as ‘the elementary principle’.<sup>75</sup> This latter principle recognises that a company is a separate legal entity and is thus the proper party to raise a legal action for recovery when it suffers injury. However, the common law also developed some exceptions whereby individual shareholders were permitted to commence derivative actions.<sup>76</sup> These exceptions included ‘fraud on the minority’, ‘wrongdoer control’, ‘ultra vires transactions’, ‘breaches of special

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<sup>72</sup> A. Y. S. Li and S. S. M. Ho, ‘Rebuilding Market Confidence: China’s Revised Company Law’ (2006) 27 *Company Lawyer* 311-312.

<sup>73</sup> *Foss v Harbottle* (1843) 2 Hare 461.

<sup>74</sup> See *Carlen v Drury* (1812) 1 V & B 154,158; 35 ER 61, 62 *per* Lord Eldon LC who said: ‘This Court is not to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom’.

<sup>75</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1982] Ch 204, 210.

<sup>76</sup> These exceptions were set out in the case of *Edwards v Halliwell* and then restated in *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2).

resolution procedures' and the 'interests of justice'. The first exception was regarded as the only true exception to the rule in *Foss v Harbottle*, while the last was controversial.<sup>77</sup> As Reisberg points out, these exceptions reflected the common law's attitude that the derivative action

*is not to be regarded as a normal part of the enforcement apparatus of the law, but as a weapon of last resort, carefully controlled, and limited to the case where the company had been prevented from taking a truly corporate view of the prospects for litigation.*<sup>78</sup>

As such, the common law was criticised for being ineffective and the need for revision widely accepted. The Law Commission of England and Wales and the Scottish Law Commission undertook an extensive inquiry into the common law regime and recommended that the rule in *Foss v Harbottle* be abolished. It perceived four major problems that required to be addressed, concluding that the rule in *Foss* was complicated and unwieldy and therefore, a more 'modern flexible and accessible criteria for determining whether a shareholder can pursue an action' should be adopted to permit suits to continue in appropriate circumstances.<sup>79</sup>

Derivative actions were finally adopted into law in sections 260 to 269 of the Companies Act 2006.<sup>80</sup> In this new procedure the scope of derivative actions was broadened, leading to concerns about directors' responsibilities. The fear was that people would be unlikely to take directorships if there was a perception that they could be easily sued through derivative claims. Hannigan also emphasised the need to maintain a balance between promoting higher standards and not deterring people from accepting directorships.<sup>81</sup> Bainbridge shared Hannigan's view that 'the system

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<sup>77</sup> See *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257, 323 and *Eastmanco (Kilner House) v Greater London Council* [1982] 1 WLR 2, 10-11.

<sup>78</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007) 103.

<sup>79</sup> Law Commission Report, para 6.14-15.

<sup>80</sup> Ss. 260-264 apply to England and Wales and Northern Ireland while ss. 265-269 apply in Scotland.

<sup>81</sup> B. Hannigan, *Company Law* (2<sup>nd</sup> edn, Oxford University Press 2009) 229.

of corporate governance is designed to function largely without shareholder input' and thus there should be freedom from shareholder interference.<sup>82</sup> These concerns were not only raised by scholars and directors: the UK legislature had the same concern. This led Lord Goldsmith to state during the legislative process that the new derivative action would be a delicate balancing act that allowed directors to take business decisions freely and in good faith whilst also permitting individual shareholders to initiate meritorious claims against directors and dismissing malicious suits at the earliest possible stage.<sup>83</sup> As a consequence, the new statutory derivative action developed into a two-stage process that aims to balance the interests of management and shareholders.

Since the new statutory derivative action has been in effect for over three years, several cases have been decided. These cases were examined by Keay and Loughrey, who concluded that they have not 'clarified the operation of the legislation in many respects. Rather, they have made the situation somewhat confusing'.<sup>84</sup> However, Keay and Loughrey also note that over time as more judges deal with the new regime in cases before them, the law on this subject will develop.<sup>85</sup> Reisberg also argues that it is still too early to predict how derivative actions will develop owing to the lack of extensive cases and the unpredictable discretion of the courts.<sup>86</sup> Indeed, until the empirical facts have been investigated extensively, it will remain unclear what the impact of statutory derivative actions on directors and society will be. Overall, as Davies indicates, all will depend on how the courts exercise their discretion.<sup>87</sup>

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<sup>82</sup> S. M. Bainbridge, 'Shareholder Activism and Institutional Investors' (2005) UCLA School of Law, Law-Econ Research Paper No. 05-20

<sup>83</sup> Hansard HL Vol 681, Official Report, 9/5/2006, col883.

<sup>84</sup> A. Keay and J. Loughrey, 'Derivative Proceedings in a Brave New World for Company Management and Shareholders' (2010) 3 *Journal of Business Law* 151.

<sup>85</sup> Keay and Loughrey, *ibid.*

<sup>86</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007) 159.

<sup>87</sup> P. L. Davies, *Principles of Modern Company Law*, (9<sup>th</sup> edn, Sweet & Maxwell 2012) 627.

### 1.4.3 Derivative Actions in the US

Although they both belong to the common law tradition, US law has developed a system of derivative action different from that of English law. It is generally believed that derivative actions in the US play a more important role than in the UK.<sup>88</sup> However, this does not mean that it is popular either in the legal profession or in judicial practice. Rather, its role as ‘the chief regulator of corporate management’<sup>89</sup> has been challenged by many scholars. The nature of derivative actions means that it is easy for non-meritorious actions to be brought. Perversely, this regime also encourages settlement between plaintiff’s lawyers and managerial defendants, thus creating strike suits.<sup>90</sup> In practice, Romano suspects that derivative actions are ineffective. Having explored this system, she has concluded that ‘there is a greater likelihood that more of these suits are frivolous’.<sup>91</sup> Romano conducted empirical research and found that the rate of settlement in derivative actions was high while the amount of compensation paid to corporations was small.<sup>92</sup> Romano also investigated the relationship between the stock price of companies and derivative actions, concluding that those changes in stock price ‘do not provide compelling support for the propositions that shareholders experience significant wealth effects from litigations’.<sup>93</sup> This was supported by Fischel and Bradley’s research. Fischel and Bradley used econometric techniques to study the effect of derivative actions on the wealth of a corporation’s stockholders. Their study showed that a successful derivative claim has a minor effect on the wealth of the firm’s shareholders, leading

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<sup>88</sup> X. Li, *A Comparative Study of Shareholders’ Derivative Actions* (Kluwer Law International 2007) 96.

<sup>89</sup> *Cohen v Beneficial Industrial Loan Corp*, 337 U.S. 541, 548, 69S.Ct.1221,1226 (1949).

<sup>90</sup> See generally R. Kraakman, H. Park and S. Shavell, ‘When Are Shareholder Suits in Shareholder Interests’ (1994) 82 *Georgetown Law Journal* 1733; J. R. Macey and G. P. Miller, ‘The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform’ (1991) 58 *The University of Chicago Law Review* 1.

<sup>91</sup> R. Romano, ‘The Shareholder Suit - Litigation without Foundation’ (1991) 7 *Journal of Law Economics & Organization* 61.

<sup>92</sup> Romano, *ibid.*, 60-61.

<sup>93</sup> Romano, *ibid.*, 60-61.

them to conclude that ‘derivative suits are not an important monitoring device to curb managerial malfeasance’.<sup>94</sup>

Nevertheless, these empirical studies have been doubted and criticized. The American Law Institute, for example, have questioned Fischel and Bradley’s methodology in conducting their research, pointing out that their data might not be reliable owing to the methodology used.<sup>95</sup> Even if the data were reliable, the indifference of the stock market price should not of itself point towards the conclusion that derivative actions are ineffective.<sup>96</sup> Cox argues that the derivative action should not be judged simply by its compensatory function, and should be judged by its other functions also.<sup>97</sup> Scott even suggests that the obstacles to derivative actions should be removed in order to enable more ready enforcement of the duty of loyalty.<sup>98</sup> Overall, it is widely acknowledged that US law takes a lenient approach towards derivative actions despite being challenged by many scholars.

#### **1.4.4 Why Choose the UK and US as the jurisdictions for Comparison?**

In this thesis, the UK and US law will be adopted as analysis samples for comparative study. This is because, first of all, these two countries are the most important commercial law jurisdictions and they have significant influence in the world. A comparative reflection on China’s legal systems cannot avoid reviewing the relevant rules in these two jurisdictions. Secondly, they have a long history of the derivative action, particularly in the UK where the derivative action was originated. Thirdly, although both the UK and the US have provided for the derivative action by

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<sup>94</sup> *Fischel v Bradley* (1986), p. 282.

<sup>95</sup> ALI(II), Part VII, Chapter 1, Introductory Note, Reporter’s Note, p.12.

<sup>96</sup> *Ibid.*

<sup>97</sup> J. D. Cox, ‘The Social Meaning of Shareholder Suits’ (1999) 65 *Brooklyn Law Review* 16.

<sup>98</sup> K. E. Scott, ‘Corporation Law and the American-Law Institute Corporate Governance Project’ (1983) 35 *Stanford Law Review* 927.

legislation, they function differently. As Dannemann argues, ‘similarity of the basis of comparison is essential for achieving each of the main aims of comparative enquiry.’<sup>99</sup> Thus these two countries make a good reference for China. Fourthly, the UK and the US have different attitudes towards the application of the derivative action. In the UK, the courts are relatively unwilling to accept the application of derivative claims while in the US the courts are more inclined to grant permission. This difference undoubtedly provides a rich field of study to be compared and explored. Last but not least, the basic legal framework of the new statutory derivative action in China was transplanted partly from the US; on the other hand, English and Chinese law enacted the derivative action around the same time (2006 in English law and 2005 in Chinese law). Therefore, it would be interesting to have a comparative analysis of these three countries.

## **1.5 Legal Transplant**

This thesis intends to employ the comparative method as an instrument to analyse what can be borrowed from other jurisdictions to improve the derivative actions system in China. However, the debate on legal borrowing is a long-standing issue in the area of comparative law. As such, it is worth briefly introducing this debate and discussing why such a legal transplant is possible in China.

### **1.5.1 The Debate on Legal Transplants**

Although there is a long history of legal borrowing between jurisdictions, the concept

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<sup>99</sup> G. Dannemann, ‘Comparative Law: Study of Similarities or Differences?’ In M. Reimann and R. Zimmermann (eds.), *The Oxford Handbook of Comparative Law* (Oxford University Press 2006) 407.

of the 'legal transplant' was created by Watson only in the 1990s. Watson characterises a legal transplant as 'the moving of a rule or a system from one country to another, or from one people to another'.<sup>100</sup> He suggests that borrowing is 'the most fruitful source of legal change', because a good knowledge of the law of other jurisdictions is helpful for providing legislators and scholars with new insights into how to reform their own legal systems.<sup>101</sup> Watson further argues that the 'voluntary transplant' can be very effective in accelerating legal reform in receiving jurisdictions as the legal transplant of individual rules or part of a legal system is largely common.<sup>102</sup> With these arguments, he attempts to demonstrate that 'law is autonomous', 'legal transplant is socially easy' and 'the idea of a close relationship between law and society is a fallacy'.<sup>103</sup>

However, Watson's analysis of legal transplants has been criticised by many scholars. There are generally two schools challenging Watson's reflection: contextualist and culturalist. The contextualist school criticise Watson's approach for its lack of concern for social context. They argue that law is deeply embedded in context and thus any legal reform or change has to be pursuant to the demands of external forces. Contrary to Watson's bold argument, they assert that law is not autonomous, but a mirror of society. For example, Otto Kahn-Freund, a representative of contextualist thought, argues that 'any attempt to use a pattern of law outside the environment of its original country entails a risk of rejection... its use requires a knowledge not only of the foreign law but also of its social and above all the political, contexts'.<sup>104</sup>

Watson's thoughts on legal transplant are even more vigorously attacked by

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<sup>100</sup> A. Watson, *Legal Transplant: An Approach to Comparative Law* (2<sup>nd</sup> edn, University of Georgia Press 1993) 21.

<sup>101</sup> A. Watson, 'Aspects of Reception of Law' (1996) 44 *American Journal of Comparative Law* 335.

<sup>102</sup> Watson, cite. n.98, 29-30.

<sup>103</sup> Watson, *ibid.*, 108.

<sup>104</sup> O. Kahn-Freund, 'On Uses and Misuses of Comparative Law' (1974) 37 *Modern Law Review* 1, 27.

culturalists, who argue that ‘law is a culturally determined artefact, which cannot be transplanted’.<sup>105</sup> Legrand even asserts that ‘legal transplants are impossible’ because what Watson focuses on – statutory rules – are not simply transplantable in the way that Watson believes to be the case.<sup>106</sup> Seidman shares this view, arguing that the likelihood that copying any country’s model will ensure development is non-existent.<sup>107</sup>

## **1.5.2 Why Legal Transplants could be Successful in China**

The above debate on legal transplants raises two questions. The first one is whether legal transplant is possible in China. If the answer to this question is positive, then the second question arises: how can this legal transplant be successful or effective?

### **1.5.2.1 Why a Legal Transplant is Possible and Necessary in China**

With regard to the first question, it is recognised that a legal transplant is not only possible but also necessary in China. Several reasons justify this argument.

First, borrowing is regarded as an efficient means of legislating. China has witnessed rapid economic development for the past thirty years because of its ‘Reform and Opening up’ policy. In contrast to this rapid economic development, the law, particularly commercial law, is lagging behind. In order to fill this gap and thus better regulate emerging economic activities, it is essential to enact and accelerate the legislative process. Here, borrowing from foreign law is favourable as it is faster and easier than creating new law by itself.

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<sup>105</sup> N. Foster, ‘Transmigration and Transferability of Commercial Law in a Globalized World’ In A. Harding and E. Orucu (eds.), *Comparative Law in the 21<sup>st</sup> Century* (Kluwer 2002) 59.

<sup>106</sup> P. Legrand, ‘Impossibility of “Legal Transplant”’ (1997) 4 *Maastricht Journal of European and Comparative Law* 111.

<sup>107</sup> A. Seidman and R. B. Seidman, *State and Law in the Development Process* (St. Martin’s Press 1994) 44.



Second, internationalisation and globalisation make legal transplant possible and easier. Its rapid economic development and its rise as an economic superpower not only make China the second largest economic entity in the world, but also integrate it into the international background. Its entrance into the World Trade Organization (WTO) also strengthens this process. In fact, the People's Republic of China (PRC) has committed itself to the process of globalisation, which obviously requires domestic law to be more liberal in order to accommodate international practice. As a consequence, borrowing from foreign law, particularly from the law of developed countries, becomes necessary or inevitable for China.

Third, legal transplant in the area of commercial law would not generally encounter substantial resistance in a receiving country. Public law sectors such as criminal law or constitutional law are closely linked to local conditions like the political system, ideology and cultural tradition. However, this is not the case for commercial law. Whilst every law more or less has its own local supportive resources, commercial law relies less on local conditions. The debate on the convergence of corporate governance itself has at least shown that legal transplant is highly possible in the area of commercial law.<sup>108</sup>

Last, China has a long history of legal transplant. When the first Opium War broke out in 1840, the Qing Dynasty started to borrow laws from foreign countries to improve its capacity to compete with Western countries. Thereafter, legal transplants continued until the outbreak of the Cultural Revolution. When China began to

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<sup>108</sup> For the details of the debate on comparative corporate governance, please see: H. Hansmann and R. Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Journal* 439; L. Cunningham, 'Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance' (1999) 84 *Cornell Law Review* 1133; R. Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function' (2001) 49 *American Journal of Comparative Law* 330; A. Pinto, 'Globalization and the Study of Comparative Corporate Governance' (2005) 23 *Wisconsin International Law Journal* 477.

rebuild its legal system in 1978, it had to start afresh as most legislation had been abolished during the Cultural Revolution. As such, China had to learn legal rules or institutions from other countries so as to match economic development. The current Company Law 2005, as the Vice - President of China's Supreme Court Xi Xiaoming admitted, is 'a mixture of the Western experience and local resource'.<sup>109</sup> In fact, as Cheng argues, the development of Chinese law was a process of learning from, making use of, absorbing and digesting foreign experience for the whole of the twentieth century.<sup>110</sup>

### 1.5.2.2 How Legal Transplants could be Effective in China

As noted above, if legal transplants are necessary or indeed inevitable in China, how can its success be ensured? As highlighted by contextualist and culturalist theories, legal transplants are not simply about copying the law from one country to another country; it has to pay considerable attention to the legal culture and other non-legal factors to achieve effectiveness. It is argued that a transplanted legal rule is likely to function less effectively than in its original country if it does not accommodate local resources, or have a population that is similar to the country of origin.<sup>111</sup>

Although the transplantation of commercial laws is generally less difficult than in other areas owing to economic globalisation, it should be noted that not every single transplant rule in commercial law can function as well as in its home soil.<sup>112</sup> As a

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<sup>109</sup> *Zuigao Renmin Fayuan Guanyu Gongsifa Sifajieshi Yi Er de Lijie yu Shiyong* [Understanding and Applying the Supreme Court's Interpretation I and II on the Company Law] (Renmin Fayuan Chubanshe [The People's Court Press] 2008) 10.

<sup>110</sup> J. Cheng, 'The Transformation of Chinese Law: From Formal to Substantial' (2007) 37 *Hong Kong Law Journal* 689.

<sup>111</sup> See D. Nelken, 'Legal Transplants and Beyond: Of Disciplines and Metaphors' In A. Harding and E. Orucu (eds.), *Comparative law in the 21<sup>st</sup> Century* (Kluwer 2002) 26-27; D. Berkowitz, K. Pistor and J-F. Richard, 'The Transplant Effect' (2003) 51 *American Journal of Comparative Law* 163.

<sup>112</sup> It is argued that the borrowing of independent director in China is regarded as a failure legal transplant. For details of this, please see: L. Zhou, 'The Independent Director System and its Legal Transplant into China' (2011) 6 *Journal of Comparative Law* 262-291. Also, Clarke argues that the proponents of the institution of independent directors misconceive the nature of the corporate

result, when this thesis conducts a comparative study on derivative actions, it has to bear in mind that other factors which may affect the function of this legal institution should be paid attention to. In fact, this will be discussed in the following chapters.

## **1.6 Derivative Actions in Public and Private Companies**

Companies can generally be divided into two types: public companies (or publicly held corporations) or private companies (or close corporations). Although there are no precise definitions of these two types of corporation, it is widely accepted that they have their own distinctive features. Private corporations generally have a few shareholders, their shares cannot be traded on the public market or transferred freely and their managers are normally themselves the shareholders of the company. By contrast, public companies normally have a vast number of shareholders whose shares can be freely traded on public securities exchanges. Moreover, the ownership and management of public corporations is normally separate.

Of course these two types of company have both different and shared characteristics. Whilst it is not the function of this thesis to explore these differences and similarities, one feature is relevant to the context of derivative actions. It might be argued that shareholders do not need to use derivative actions in public companies because they can simply leave the company by selling their shares. The transferable nature of shares in public companies means that there is no restriction on their transferability, making them easily sold by shareholders. Here, there is no need for shareholders to bring derivative actions to protect the interests of the company as the initiation of such litigation would cost time and money. By contrast, shareholders in private

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governance problem in China and have not taken into account specific features of the Chinese institutional environment – particularly the legal environment – that affect the viability of any proposed solution. See: D. C. Clarke, ‘The Independent Director in Chinese Corporate Governance’ (2006) 31 *Delaware Journal of Corporate Law* 125-228.

companies may have to use derivative actions as their shares cannot be publicly transferred.

Whilst transferability of shares in public companies allow shareholders to leave when the interests of a company are damaged, this does not mean derivative actions are unnecessary for such shareholders. First of all, even where a shareholder chooses to sell their shares and leave a company, this does not mean that they are not affected by the alleged wrongdoing. In fact, the value of the shares may be affected by the wrongdoing and thus the price of those shares reduced. Here, selling the shares means that the shareholder would have to bear an immediate loss. Moreover, such a sale only resolves the problem of leaving the company, and does not address the fundamental issue of how to recover damages and deter managers. If every minority shareholder believed that selling their shares could resolve a problem, they may encounter the same problem when they buy another company's shares on the public market. Last but not least, some shareholders may just wish to stay as members of the company. Indeed, some shareholders can undeniably wish to stay with the company in which they hold shares for a number of reasons. For example, they may think that the company has excellent prospects in the long run and consider that remaining in the company as members would be in their best interests. As such, bringing a derivative action against wrongdoers would be the right and natural choice since their intention is to stay with the company.

An empirical study in the US has revealed the astonishing fact that derivative actions in public companies are more frequent than such actions in closed companies. This research, conducted by Thompson and Thomas, collected and studied all the derivative actions in Delaware from 1999 to 2000. They found that eighty percent of such cases were filed against wrongdoers in public companies while only twenty

percent were raised in respect of closed corporations.<sup>113</sup> This surprising result undoubtedly provides strong evidence against the argument that the derivative action is not needed in public companies.

## 1.7 Original Contribution

Prior to identifying the original contribution made by this thesis, it is necessary to clarify how this thesis relates to previous doctoral dissertations on similar subjects. As far as this research has been able to gather, there are three dissertations in this area: *The Derivative Action and Good Corporate Governance in China*;<sup>114</sup> *A Comparative Study of Shareholder's Derivative Actions*;<sup>115</sup> and *A Study of Shareholder's Derivative Actions* (Chinese).<sup>116</sup> It seems that the topic of this thesis is covered by the above doctoral dissertations and that it is thus difficult to make an original contribution. However, there are some differential elements in this thesis that make it distinctive from these previous studies. Zhang's study focuses mainly on corporate governance and the role of derivative action in establishing good corporate governance. Li's study explores derivative actions by comparing four countries, namely the UK, US, Germany and China. Her research was completed before 2006 and thus an empirical study of derivative actions both in England and China was not conducted. Liu's research was written in Chinese and suffers from the same problem as Li's research in as much as it did not examine cases of derivative actions owing to the insufficient time over which Company Law 2005 had been implemented.

As such, the original contributions made by this thesis can be found mainly in three

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<sup>113</sup> R. B. Thompson and R. S. Thomas, 'The Public and Private Faces of Derivative Lawsuits' (2004) 57 *Vanderbilt Law Review* 1764.

<sup>114</sup> Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011)

<sup>115</sup> X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007)

<sup>116</sup> See J. Liu, *Gudong Paishengsusong Yanjiu* [A Study of Shareholder's Derivative Actions], PhD thesis (Chinese University of Political Science and Law 2007)

aspects: first, it provides a deep theoretical examination to enrich current legal scholarship on China's derivative action system. Second, it conducts a comprehensive empirical study of China's derivative action cases from 1993 to 2013. As there are few articles examining these cases, interpretations of and reflections upon these cases provide new insight on China's derivative actions. Lastly, this thesis proposes a new legal framework to improve the derivative action system in China.

## **1.8 Structure**

This thesis aims to improve China's derivative action by making comparative reflections. In order to conduct this study, this thesis is structured as follows: chapter 1 is the introductory part which basically provides some knowledge and identifies the main issues to be addressed in this thesis. Chapter 2 attempts to demonstrate why the derivative action is necessary in the context of China. As such, this chapter first examines the double agency costs in China and the non-legal mechanisms and legal protections are also assessed. Chapter 3 starts to examine China's derivative action. Before doing so, the relationship between direct actions and derivative actions is discussed. Chapter 4 continues to examine China's derivative action with a comparative view to reform. Chapter 5 principally focuses on the funding issue which is significantly important for encouraging shareholders to initiate derivative actions. Chapter 6 concludes.

## Chapter 2 The Need of Enhancing Derivative Actions in China

### 2.1 Double Agency Costs in China

#### 2.1.1. Introduction

The separation of ownership from management is recognised as one of the core structural characteristics of a business corporation.<sup>117</sup> This key distinctive feature is the necessary consequence of rising capital and economic development as the modern economy requires companies to be professionally managed and investors to be free to concentrate on expanding their investments rather than participating in management. However, this separation also means that those who run companies do not own them whilst those who are members of corporations do not control them. Here, agency costs, (derived from economic jargon), may arise where the interests of shareholders and managers are not aligned. It is thus recognised that the central objective of company law is to reduce agency costs; good corporate governance would achieve this target.

China has been experiencing unprecedented economic and social development owing

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<sup>117</sup> Five core structural characteristics of the business corporation have been identified by Reinier Kraakman, et al: legal personality, limited liability, transferable shares, centralized management under a board structure and shared ownership by contributors of capital. See R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn, Oxford University Press 2009) 5. Davies has found out that there are ten elements that make corporations distinct from other organizations: legal entity distinct from its members, limited liability, property, perpetual succession, transferable shares, management under a board structure, borrowing, taxation and formalities. However, these aspects are basically the same as the above characteristics simply interpreted differently. See P. L. Davies, *Principles of Modern Company Law* (9<sup>th</sup> edn, Thomson Sweet & Maxwell 2012) 33-52.

to its economic reform and open policy. During this process, the reform of the company--the basic component of the business world--has been and remains a key issue. The significant economic achievements of the recent past could not have been attained without corporation reform, though this also creates a number of difficulties that must be addressed. Prevalent reports of exploitation by majority shareholders and managers have enhanced the view that agency costs in Chinese companies are exceptionally severe. Thus capital market and economic development would be negatively affected if agency costs were not properly addressed.

This part does not aim to examine China's agency costs from an economic perspective as there is already a vast amount of literature which does so.<sup>118</sup> Rather, the purpose is to explore the historical causes and development of Chinese agency costs. Indeed, unusually, there are currently two forms of agency costs prevalent in China: vertical and horizontal. This is a rarity as other countries normally only experience one of the major forms of agency cost. As such, it highlights the need for and value of this part in exploring the causes and development of these two types of agency costs. In discussing this issue, this part will first introduce the theory of and background to agency costs. It will then go on to introduce vertical agency costs, namely the agency problem between shareholders and managers, exploring State-owned Enterprises (SOEs) reform and the development of insider control. The third section will address horizontal agency costs, namely the agency problem between majority shareholders and minority shareholders. This part concludes that the severe agency costs in China undoubtedly generate need for the establishment of strong protective methods for minority shareholders. Further, mechanisms to reduce agency costs cannot be properly established without acknowledging these double

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<sup>118</sup> For example, see: X. Wang, 'A Study on the Factors Affecting the Agency Cost of SOEs' (2008) 5 *Economic Survey* 101-107; J. Chen, 'The Empirical Analysis of Affection from Executive Compensation to Agency Costs in Family Business' (2010) 32 *Economic Management* 72-77; J. Lv and H. Den, 'Effect of Ownership Governance Structure of Listed Company on the Agency Cost on the Condition of Full-Circulation---Based on the Empirical Data of Manufacture Listed Company From the SMEs Board' (2010) 11 *China Soft Science magazine* 136-143.



agency costs in China.

### 2.1.2. Background to Agency Costs

Since Berle and Means first unveiled the theory of control over the corporate form,<sup>119</sup> the economic term ‘agency’ has gradually become utilised in legal scholarship. In *The Modern Corporation and Private Property* they highlighted that those who control large public companies do not necessarily have substantial ownership interests in them, while conversely, those who own such corporations do not manage them.<sup>120</sup> This separation of ownership from management is justified on several counts. First, management/control of a company is vested in its board of directors. As a corporation itself is a non-natural person, it is incapable of expressing its will and conducting business without human mediation. Since it is impossible for all the shareholders to run the company, particularly when shares are widely distributed, it becomes necessary to delegate management to the board of directors in order to make the company work in reality. Secondly, the rapid development of the capital market signifies that the profits of a company do not depend on investor energy and initiative but on management. Formerly, investment in property tied a person to that property. However, the modern capital market renders property less concerned with investors, allowing them to invest in various companies without worrying about the actual status of their property. In this sense, a shareholder in a listed company has now ceased to be a quasi-partner and has become a mere supplier of capital.<sup>121</sup> Thirdly, the separation of ownership from management also creates opportunities for professional managers to run companies and thus increase their benefits. In the

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<sup>119</sup> A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (2<sup>nd</sup> revised edn, Transaction Publishers, 1991).

<sup>120</sup> See also P. Redmond, *Companies and Securities Law: Commentary and Materials* (3<sup>rd</sup> edn, Law Book Co 2000) 181.

<sup>121</sup> R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn, Oxford University Press 2009) 46.

modern economy, a company must respond quickly to market reactions, taking decisive measures by which to compete; without professional management a company is unlikely to achieve a competitive advantage. The employment of professional persons with managerial skills is therefore both important and necessary, even if they are not themselves members of the company. Fourthly, this separation also benefits investors themselves. Shareholders would barely have the time or energy to look for other investments if they had to participate in the management of every venture. Indeed, it is almost impossible for an individual shareholder with a large portfolio personally to manage every company in which he or she holds shares. In allowing investors to focus on investments, separation therefore expands the capital market and the economy.

Whilst the separation of ownership from management can ultimately increase company benefits and promote the capital market, this separation can also create conflicts, referred to by economists as ‘agency problems’, when the interests of managers and shareholders are not aligned.<sup>122</sup> No agency problems arise if an ‘agent’ acts in the interests of their ‘principal’, though this is rare without proper legal and extra-legal constrain. Crucially, agents normally have better access to information than principals, making it difficult for principals to ensure that agents are acting in their interests.<sup>123</sup> Here, agents may be encouraged to pursue their own interests over their principals, leading them to act opportunistically by taking advantage of their powers. Such abuse of power would undoubtedly affect an agent’s management performance, thereby reducing the principal’s confidence. Such divergence of interests generates both monitoring cost for principals wishing to police agent performance, and bonding costs for agents to assure principals that their interests are

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<sup>122</sup> See, e.g., S. Ross, ‘The Economics Theory of Agency: The Principal’s Problem’ (1973) 63 *American Economic Review* 134.

<sup>123</sup> R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn, Oxford University Press 2009) 35.

being pursued.<sup>124</sup> Given the risks borne by principals, it is argued that one of the functions of corporate law is to control conflicts between the various interests of company constituencies to reduce these agency costs.<sup>125</sup>

Three agency problems have been identified in business firms: vertical agency problems between shareholders and managers, horizontal agency problems between majority shareholders and minority shareholders, and agency problems between a firm itself and the other parties with whom that firm contracts.<sup>126</sup> As the latter agency problem does not constitute an agency cost internally within the company and is therefore beyond the scope of company law,<sup>127</sup> it will not be addressed in this chapter. Concerning the first two agency problems, various studies have identified a relationship between ownership structure and agency cost.<sup>128</sup> In jurisdictions where share ownership is dispersed, such as the UK and the USA, managerial agency costs are generally much more serious. That is because managers have much greater power to control a company as scattered shareholders mean that no blockholders are able to monitor management.<sup>129</sup> Conversely, for those jurisdictions with concentrated

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<sup>124</sup> M. Jensen and W. Meckling, 'The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305; I. Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales Law Journal* 151.

<sup>125</sup> R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn, Oxford University Press 2009) 35.

<sup>126</sup> R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn, Oxford University Press 2009) 36.

<sup>127</sup> The agency problem between a company and a third party with whom the company contracts can be treated as a dispute between two parties and thus is regulated by other laws, such as contract law and tort law.

<sup>128</sup> See E. Berglöf, 'A note on the typology of financial systems'. In K. Hopt and E. Wymeersch (eds.), *Comparative Corporate Governance: Essays and Materials* (Walter de Gruyter 1997) 151–164; J. Armour, S. Deakin and S. Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41 *British Journal of Industrial Relations* 531, 533; B. Cheffins, 'Putting Britain on the Roe Map: the Emergence of the Berle–Means Corporation in the United Kingdom' In J. McCahery and L. Renneboog (eds.), *Convergence and Diversity in Corporate Governance Regimes and Capital Markets* (Oxford University Press 2002) 147–170.

<sup>129</sup> See R. L. Porta, F. Lopez-De-Silanes, A. Shleifer and R. Vishny, 'Corporate Ownership around the World' (1999) 54 *Journal of Finance* 475; M. Aoki, 'Controlling Insider Control: Issues of Corporate Governance in Transition Economies' In M. Aoki & H. Kim (eds.), *Corporate Governance in Transition economy, Insider Control and the Role of Bank* (EDI Development Studies 1996) 5.

ownership, such as Germany, the managerial agency problem is not a major issue; rather, conflicts between controlling shareholders and non-controlling shareholders are of principal concern.<sup>130</sup> In these ownership-concentrated countries, majority shareholders have both the ability and incentive to constrain the directors' performance. At the same time, agency problems between majority and minority shareholders are created as the former can impose their influence on the company to benefit themselves at the expense of the latter. Although these two types of agency problems can coexist, they are usually mutually exclusive as countries generally have dispersed ownership or concentrated ownership structures. However, this is not the case in China owing to its special policy on SOEs, discussed in the next part.

### **2.1.3. Vertical Agency Costs between Shareholders and Managers**

As mentioned above, the agency problem between managers and shareholders is not a dominant issue where ownership structure is very concentrated, as blockholders are better able to influence management. This might appear to be the position in China as many listed companies are still controlled by the government which will be discussed below. This perception might be strengthened by the observation that although these two forms of agency cost can coexist, they are normally exclusive. Unfortunately, however, these suppositions are not applicable to China. Aside from the agency costs arising between majority and minority shareholders, managerial agency problem remain a crucial issue in today's China owing to SOE reform and insider control.

#### **2.1.3.1 The SOE Reform**

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<sup>130</sup> See B. Cheffins, 'Putting Britain on the Roe Map: the Emergence of the Berle–Means Corporation in the United Kingdom' In J. McCahery and L. Renneboog (eds.), *Convergence and Diversity in Corporate Governance Regimes and Capital Markets* (Oxford University Press 2002) 147-170; For more discussion on this, please see: R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2<sup>nd</sup> edn, Oxford University Press 2009) 29-32.

Following the opening up policy of 1978, SOE reform was recognised increasingly to be extremely important to the Chinese economy. The tax system at that time was very simple and financial revenue was limited, as the primary source of public revenue was SOE profits.<sup>131</sup> Unfortunately, SOEs suffered from chronic inefficiency and low productivity, incurring numerous debts and losses.<sup>132</sup> Fears about the ever-deteriorating performance of SOEs threatening the nation's entire economy were growing and a consensus reached for reform. Initial reform separated ownership and management proclaiming that SOEs should become independent entities and thus be responsible for their own profits and losses.<sup>133</sup> Levels of government interference were thereby reduced. However, this reform was not implemented effectively owing to the mixed political climate of that time. Fears about the peaceful infiltration of Western ideology and structuralism remained widespread owing to the cold war. Therefore SOE ownership stayed with government, rather than SOEs themselves. In 1988, state administration was split from SOE management in a bid to improve SOE performance, using a contract system. This system required SOE directors to sign contracts with their supervisory authorities to set performance targets; this initiative turned out to be another failure.

Concern about the inefficiency of SOEs remained ongoing and the collapse of the Soviet Union intensified the anxiety that economic failure would lead to a breakdown of the political system. Therefore, following Deng Xiaoping's southern tour speech, the socialist market economy was established and SOE-oriented reform was launched. The target for SOEs was to establish a modern enterprise system; that,

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<sup>131</sup> Z. Lin, 'Recent Development of Tax System Reforms in China: Challenges and Responses' (2001) 27 *International Tax Journal* 92-93.

<sup>132</sup> W. W. Wang, 'Reforming State Enterprises in China: the Case for Redefining Enterprises Operating Rights' (1992) 6 *Journal of Chinese Law* 89, 131.

<sup>133</sup> Zhonggong Zhongyang Guanyu jingji Tizhi Gaige de Jueding [Decisions of the CPC Central Committee on the Economic Structure Reform], adopted by the Third Plenary Session of the CPC Twelfth National Congress on October 20, 1984.

according to the 1993 Decision, would “clarify property rights, designate authorities and responsibilities, separate government and enterprise functions and establish scientific management”.<sup>134</sup> The principal approach in achieving this objective was to sever government intervention from company management by corporatising SOEs, thus releasing the government from its unlimited responsibility. It anticipated SOEs could thereby plan their own productivity in line with market demand and raise funds through capital markets to expand their business. Indeed, corporatisation did improve efficiency and significantly increased overall value.<sup>135</sup>

While the separation of ownership and management was a solution to prevalent problems, it also raised fundamental issues where discretion and power could be abused by managers, incurring managerial agency costs. This was particularly so in China, which then lacked an efficient system to supervise management conduct and protect the interests of shareholders, and indeed still does. In recent years, news of SOEs losses occasioned by mismanagement has been widely reported. A notorious example was the China Aviation Oil (Singapore) Corporation (CAO) scandal. CAO announced a US\$ 550 million loss in oil derivatives trading, exceeding the company’s registered capital of US\$ 549 million, owing to poor management. This scandal, as Jackson highlights, revealed internal control failures at virtually every level of management.<sup>136</sup> Moreover, CEO, Chen Jiulin, who was subsequently imprisoned, had been receiving the highest salary of any chief executive in the country.<sup>137</sup> Another example was the scandal of the China National Cotton Reserves

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<sup>134</sup> Zhonggong Zhongyang Guanyu Jianshe Shehui Zhuyi Shichang Jingji Tizhi Ruogan Wenti de Jueding [Decisions of the CPC Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economy System], adopted by the Third Plenary Session of the CPC Fourteenth National Congress on 14 November 1993.

<sup>135</sup> Q. Ye, ‘Xinzhongguo Chengli 60 Zhounian lai Woguo Guoyouqiye Gai ge de Licheng yu Chengxiao’ [The Historical Development of SOEs Reform after the Establishment of PRC] (2009) 67 *Jingji Yanjiu Cankao* [Review of Economic Research] 10-25.

<sup>136</sup> K. T. Jackson, ‘The China Aviation Oil Scandal’ In S. Matulich and D. M. Currie (eds.), *Handbook of Frauds, Scams and Swindles: Ethical Failures in Leadership* (CPC Press 2008) 151-160.

<sup>137</sup> China Daily News < [http://www.chinadaily.com.cn/english/doc/2004-12/23/content\\_402605.htm](http://www.chinadaily.com.cn/english/doc/2004-12/23/content_402605.htm)> [lasted visited 29 April 2014]

Corporation (CNCRC), which is also a state-owned enterprise. It was reported that CNCRC had lost almost 1000 million yuan making false bets on prices after failing to sell its expensive cotton stocks when prices plunged. Reports also indicated that the cotton speculative trading decisions were being made by only a few executives rather than a formal decision-making procedure.<sup>138</sup> Investigations conducted by the Key Laboratory for Management, the Decision and Information Centre and the Virtual Economy and Finance Research Centre have found that lack of accountability of managers to shareholders (namely the government), poor corporate governance and the ineffectiveness of binding mechanisms, led to this tragic loss.<sup>139</sup> The above facts, which are only a part of the whole picture, vividly illustrate the negative implications of SOE reform, despite its improvement of SOE performance in general. Furthermore, SOE reform in the absence of a legal system and other binding mechanisms inevitably induces insider control problems in China.

### **2.1.3.2 Insider Control**

The insider control problem accompanies the evolution of SOE reform in China. Before exploring this problem, some conceptual issues should be clarified. Owing to the socialist nature of the market, SOEs are managed or controlled by different levels of organ. At least six strata can be identified in practice: central government leadership, local state government,<sup>140</sup> relevant central ministries, local organs supervising SOEs, managers and workers.<sup>141</sup> Within this framework, SOE insiders are managers and workers while all other organs are outsiders. Although workers are

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<sup>138</sup> Sohu news < <http://news.sohu.com/20050113/n223916814.shtml>> [lasted visited 29 April 2014]

<sup>139</sup> Available at < <http://madis.iss.ac.cn/dct/page/65574>> [lasted visited 29 April 2014]

<sup>140</sup> Strictly speaking, not only the government, central or local, controls the SOEs, but importantly, the Party. It is common sense, particularly in Western countries, for the Party and the state to be different entities. In China, however, there is no need to separate the concepts of party and state as they are intermingled. This is confirmed by the Constitution in stating that “the State should be led by Chinese Communist Party”.

<sup>141</sup> K. Lee and D. Hahn, ‘From Insider-Outsider Collusion to Insider Control in China’s SOEs’ (2004) 40 *Issues & Studies* 1-45.

regarded as insiders, their ability to participate in the management of SOEs is strictly limited. This seems absurd given the Chinese government's declaration that the People's Republic of China was established under the leadership of the working class, whilst trade unions now serve a mere decorative function within SOEs without any practical input. From this perspective, there is in fact only one effective insider organ within an SOE: management. For outsiders, some government agency reform has taken place. During the planned economy era, SOEs were controlled by central government, or local governments delegated or authorized by the central state. With the initiation of the market economy, control rights were first transferred from central government to the Commission for Managing State Properties, and then to the Ministry of Personnel. The most recent supervising agency is the State-owned Assets Supervision and Administration Commission of the State Council (SASAC).<sup>142</sup>

Having clarified the concepts of insider and outsider in China, the notion of insider controls must now be addressed. "Control" in corporations means the right and power to make decisions about important issues like business strategy, dividend distribution and personnel arrangements. According to Aoki's theories of the firm,<sup>143</sup> the concept of insider control in China is quite different from other jurisdictions. In Japan, insider control normally refers to controlling shareholders and affiliated companies in a business group (*keiretsu*), with the labour unions taking second place. Under an Anglo-Saxon company model, the power of labour unions is relatively weak compared to workers in Japan and thus controlling shareholders and their representatives on the board are the only predominant insiders.<sup>144</sup> However, insider control in China's firms was varied at different stages. The evolution of insider

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<sup>142</sup> The SASAC has central and local agencies which supervises central SOEs and local SOEs respectively.

<sup>143</sup> M. Aoki, 'The Japanese Firms in Transition' In K. Yamamura and Y. Yasuda (eds.), *The Political Economy of Japan* (Stanford University Press 1987) 263-88; M. Aoki, 'Towards an Economic Model of the Japanese Firms' (1990) 28 *Journal of Economic Literature* 1-27.

<sup>144</sup> M. Aoki, 'Towards an Economic Model of the Japanese Firms' (1990) 28 *Journal of Economic Literature* 1-27.



control in Chinese SOEs can be classified into four periods, as table 1 below shows.

Table 1

| <b>The Evolution of Insider Control in Chinese SOEs</b> |                           |   |  |                            |
|---|---------------------------|---|--|----------------------------|
|   | <b>1978-1984</b>          | <b>1985-1993</b>                          | <b>1994-1999</b>                                       | <b>2000-</b>               |
| <b>Controller</b>                                       | Outsider                  | Outsider--Insider                         | Insider--Outsider                                      | Insider                    |
| <b>Problems</b>   | Inefficiency and deficits | Inefficiency and expropriation of profits | Expropriation of profits and diversion of state assets | Undervaluation of property |

The first phase covers the initiation of economic reform promoted by Deng Xiaoping after the Cultural Revolution. However, economic reform during this period was not expanded to SOEs. Instead, the regulations governing SOEs stipulated that all important decisions such as production quotas and business operations should be conducted under the leadership of government agencies.<sup>145</sup> In addition, the CEO or managers of SOEs were appointed and dismissed by those outsiders and any decision made by managers could not be contradicted by outsiders. In return, SOE managers were entitled to privileged political and economic treatment as if they were serving in the government or the Party.<sup>146</sup> The result of this bizarre management system was a huge inefficiency problem incurring substantial deficit.

The second period denotes the beginning of the separation of ownership from management. A proposal was made that managers be given powers and rights to run SOEs, legally safeguarded by a law prohibiting any state organ from encroaching

<sup>145</sup> References to government agencies in this context are references to the outsiders mentioned above: central government leadership, local state government, relevant central ministries. See the Interim Regulations on State-Owned Industrial Enterprise, which was issued by the State Council on April 1, 1983.

<sup>146</sup> C. A. Schipani and J. Liu, 'Corporate Government in China: Then and Now' (2002) *Columbia Business Law Review* 1-69.

upon managerial discretion.<sup>147</sup> However, this reform was not thorough and many powers were retained by the government agencies leaving room for outsider interference in order to achieve “appropriate” rather than “complete” reform.<sup>148</sup> This stage was therefore characterised by outsider domination while the tendency towards insider control was crystallising. In consequence, SOE inefficiency remained ongoing owing to government agency intervention though the expropriation of profits was also emerging as a result of the profit retention system.<sup>149</sup>

The third stage was marked by the enactment of the Company Law 1993. This remarkable legislation recognised for the first time that all Chinese companies had full entitlement to the “property right of a legal person”,<sup>150</sup> paving the way for insider control. Practical research conducted by China Entrepreneurs Survey System (CESS) has shown (see table 2) that managerial autonomy increased after the Company Law 1993.<sup>151</sup>

Table 2

| <b>The Managerial Autonomy After the Company Law 1993</b> |             |             |             |             |
|---|-------------|-------------|-------------|-------------|
| <b>Items</b>  | <b>1993</b> | <b>1994</b> | <b>1995</b> | <b>1997</b> |
| <b>Production decisions</b>                               | 88.7        | 94          | 97.3        | 98.3        |
| <b>Pricing of products</b>                                | 75.9        | 73.6        | 85.4        | 92          |
| <b>Sale of products</b>                                   | 88.5        | 90.5        | 95.9        | 96.8        |
| <b>Procurement</b>  | 90.9        | 95          | 97.8        | 98.8        |

<sup>147</sup> The Law on Industrial Enterprises Owned by the Whole People, article 58. The SOEs could appeal to the government if their operational rights were infringed by any organ or individual, according to the regulations on Transforming Operational Management Mechanisms of Industrial Enterprises Owned by the Whole People, article 22.

<sup>148</sup> C. Xi, *Corporate Governance and Legal Reform in China* (Wildy, Simmonds & Hill Publishing 2009) 21.

<sup>149</sup> See D. Bachman, ‘Implementing Chinese Tax Policy’ In D. M. Lampton (eds.), *Policy Implementation after Mao* (University of California Press 1987) 119-53; and K. Lee and S. Mark, ‘Privatization in China’s Industry’ (1991) 2 *China Economic Review* 157-173.

<sup>150</sup> This provision was equivalent to the nature of separate legal personality in both common law and civil law jurisdictions. See Chinese Company Law 1993, Article 4(2).

<sup>151</sup> Zhongguo qiyejia diaocha xitong, [The sources are from China Entrepreneurs Survey System] available at < [www.cess.gov.cn](http://www.cess.gov.cn) > (last visited 28 May 2013).

|                                 |      |      |      |      |
|---------------------------------|------|------|------|------|
| <b>Foreign trade</b>            | 15.3 | 25.8 | 41.3 | 54   |
| <b>Investment decisions</b>     | 38.9 | 61.2 | 72.8 | 82.5 |
| <b>Use of retained profits</b>  | 63.7 | 73.8 | 88.3 | 90.6 |
| <b>Asset disposal</b>           | 29.4 | 46.6 | 68.2 | 76.5 |
| <b>Mergers and acquisitions</b> | 23.3 | 39.7 | 59.7 | 61.4 |
| <b>Hiring</b>                   | 43.5 | 61   | 74.8 | 84.3 |
| <b>Personnel management</b>     | 53.7 | 73.3 | 83.5 | 90.3 |
| <b>Wages and bonuses</b>        | 70.2 | 86   | 931  | 96   |
| <b>Organizational changes</b>   | 79.3 | 90.5 | 94.4 | 97.3 |

Increasing managerial autonomy did not however mean that outsiders no longer cast shadows over SOEs as the property of a company is still not separate from the State.<sup>152</sup> In order to secure dominant ownership in SOEs, some SOE shares were designed to be non-tradable, as discussed in the next section. Despite this, it is apparent that insider control occupied the predominant position at this stage. The phenomenon of profit expropriation and state asset diversion became more serious during this period in light of increasing managerial rights over SOEs' asset disposal.<sup>153</sup>

The fourth stage was occasioned by a resolution emphasising that SOE ownership should be diversified with a view to improving corporate governance.<sup>154</sup> Privatisation in favour of insiders through management buyouts (MBOs) was adopted as one of the main policies to achieve this target. This reform, as Lee and Hahn argued, constituted the transformation of insiders from being in *de facto* to *de*

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<sup>152</sup> Article of Chinese Company Law 1993 stated that "the ownership of state-owned assets in a company shall vest in the state".

<sup>153</sup> K. Lee and D. Hahn, 'From Insider-Outsider Collusion to Insider Control in China's SOEs' (2004) 40 *Issues & Studies* 1-45.

<sup>154</sup> Zhonggong Zhongyang Guanyu Guoiyouqiye Ruogan Zhongda Wenti de Jueding [Decisions on Some Important Matters Related to SOE Reform and Development], adopted at the Fourth Plenary Session of the Chinese Communist Party's Fifteenth Central Committee in September 1999

*jure* control.<sup>155</sup> Lack of external checks and balances in this reform resulted in many negative consequences including the undervaluation of enterprise assets, which significantly damaged the interests of minority shareholders and the State as a majority shareholder.<sup>156</sup>

It is undeniable that the direction of this reform was the proper course to take as separation of corporate ownership from management seemed to be the only solution to address SOE inefficiency at that time. At the same time, expanding enterprise autonomy also created the agency costs outlined above, particularly managerial agency costs, creating enormous opportunities for managers to expropriate assets and infringe the interests of shareholders.<sup>157</sup> Two factors account for this consequence. The first and primary factor is owner absence. The State, as the delegation of the Whole People, is expected to play a monitoring role over SOEs. However, in practice, several agencies (outsiders) were delegated shareholder's rights, as mentioned above. This led these agencies, on the one hand, into a race to maximise their own department's interests, and on the other hand, to evade their supervision responsibilities concerning the internal governance of SOEs.<sup>158</sup> In addition, officials within government agencies generally lacked the necessary skills and information to keep an eye on the performance of managers. Furthermore, the politically-oriented bureaucratic system provided few incentives for agencies to fulfil their duties to oversee the management of SOEs.<sup>159</sup>

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<sup>155</sup> K. Lee and D. Hahn, 'From Insider-Outsider Collusion to Insider Control in China's SOEs' (2004) 40 *Issues & Studies* 1-45.

<sup>156</sup> Q. Dou, 'MBO zai Woguo de Bianyi jiqi Guizhi Jianyi' [Alienation of MBO in Our Country and Regulatory Proposals] *Jingji Cankao Bao* [Economic Reference News], June 11, 2003.

<sup>157</sup> It was reported that nearly 100 billion RMB were misappropriated or misused illegally in 1290 SOEs from 2002 to 2005. See Q. Shao, 'Toushi Zhonghangyou Shijian: Chanquan Buqing Daozhi Neiwei Fengxian Jiankong Quanshi' [The Scandal of CAOS: Absent of Supervision] available at <<http://www.cnki.com.cn/Article/CJFDTotal-CQDK200503019.htm>> (last visited 29 April 2014)

<sup>158</sup> Y. Liu, 'Hexin shi Zhengzi Fenli' [The Core is the Separation of the Government from Assets], *Caijing* [Journal of Caijing], April 25, 2003.

<sup>159</sup> Y. Qian, 'Enterprise Reform in China: Agency Problems and Political Control' (1996) 4 *The Economics of Transition* 422, 427.

The second factor identified by Xi, is that personnel arrangements are still tightly controlled by the Party.<sup>160</sup> Indeed, the authority of the Party could counterbalance managerial discretion which may therefore constrain misbehaviour. However, the benefits of this arrangement are outweighed by its disadvantages when considering the value of SOEs. This is because the Party system for the appointment or promotion of managers is not entirely based on their performance. Other political elements such as an individual's connections (*Guanxi*) with the higher authorities have a significant role to play in appointment and promotion. As such, even if a manager's performance is poor, he may still be promoted or rewarded because of other political factors. Under this selective system, it is little wonder that autonomy and discretion are abused, thus generating managerial agency costs.

In light of the failures of various levels of government agency SOE supervision, a new agency was established in 2002 aimed exclusively at monitoring SOEs: the State-owned Assets Supervision and Administration Commission (SASAC). This establishment, authorised by central and local government, was created to address the problem of owner absence, though it remains unclear whether it will be able to monitor SOE managers effectively. What is certain is that the Party's selection system remains unchanged, which means that even if this establishment works, success is still a long way off.

#### **2.1.4 Horizontal Agency Costs between Majority Shareholders and Minority Shareholders**

The second form of agency cost in China is the conflict between majority shareholders and minority shareholders. It is widely accepted that this kind of agency

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<sup>160</sup> C. Xi, *Corporate Governance and Legal Reform in China* (Wildy, Simmonds & Hill Publishing 2009) 59.

cost is very common in concentrated ownership jurisdictions. This is particularly so in China as SOEs are widespread. According to research conducted by the Chinese State-owned Assets Supervision and Administration Commission (SASAC), by the end of 2008 almost 900 listed companies were controlled by the government, of 1600 companies on the Chinese stock exchange. Further, these state-owned enterprises occupied over 80 percent of the total share value of all listed corporations.<sup>161</sup>

However, it is argued that because the state, rather than other investors, is the sole controlling shareholder in listed SOEs, it is unlikely that the government will act against the interests of minority shareholders. Generally, it is true that the government has a legitimate concern to protect the interests of the company as a whole, including those of minority shareholders. However, this might not always be the case as government interests may not always align with the interests of minority shareholders or even the company itself.<sup>162</sup> Therefore, agency costs arise when the state, as a controlling shareholder, attempts to maximise its own benefits to the detriment of the interests of minority shareholders.

Three major forms of tunnelling activity engaged in by controlling shareholders have been identified in China.<sup>163</sup> The first is where listed companies are forced to provide soft loans or guarantees to controlling shareholders.<sup>164</sup> The second is where the

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<sup>161</sup> ‘Guo Zi Wei Dui Shangshi Gongs Zuo de Buchong Guiding’ [A Survey on Listed Companies by State-Owned Assets Supervision and Administration Commission of the State Council], available at <<http://finance.qq.com/a/20091219/001279.htm>> (last visited 29 April 2014)

<sup>162</sup> A. Shleifer and R. W. Vishny, ‘A Survey of Corporate Governance’ (1997) 52 *Journal of Finance* 737, 758-61.

<sup>163</sup> The term of “tunnelling” was originally used to describe the expropriation of minority shareholders in the Czech Republic and was then expanded to characterize the transfer of assets or resources belonging to a company to its majority shareholders. See S. Johnson et al., ‘Tunnelling’ (2000) 90 *American Economic Review* 22.

<sup>164</sup> See Shanghai Zhengquan Jiaoyi Suo [Shanghai Stock Exchange], ‘Guanyu Dui Shanghai Lengguang Shiye Gufen Youxian Gongs Gongkai Qianze de Gonggao’ [Notice on Public Criticism on Shanghai Lengguang Shiye plc] (November 6, 1999); available at <<http://business.sohu.com/history/990613/stock/file/853security.html>> (last visited 29 April 2013); Shenzhen Zhengquan Jiaoyi Suo [Shenzhen Stock Exchange], ‘Guanyu dui Beijing Zhongguancun Keji Fazhan (Konggu) Gufen Youxian Gongs Yuyi Gongkai Qianze de Gonggao’ [Notice on Public Criticism on Beijing Zhongguancun Keji Fazhan plc] (28 September 2001) available at: <

assets of listed companies are transferred at an under-value or unfair price to a third party who is involved with a controlling shareholder.<sup>165</sup> The last is where the assets of listed companies are appropriated or misused directly by the controlling shareholders.<sup>166</sup> Although new ways of tunnelling have been found,<sup>167</sup> the above three activities remain the main popular methods. In light of the deteriorating situation, many measures have been adopted to tackle these problems though they have generally proved futile in the face of the expanding scale of tunnelling. Practical research conducted by Li has found out that RMB 96.7 billion was appropriated by controlling shareholders in 2002,<sup>168</sup> with this figure doubling in 2003.<sup>169</sup> Another study has also revealed that 37 percent of the 173 listed companies had experienced the tunnelling phenomenon.<sup>170</sup>

With economic reform has come proposals for decentralisation and thus the power of

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<http://www.cnstock.com/ssnews/2001-9-29/sanban/200109290171.htm>> (last visited 29 April 2014); Also see G. H. Jiang, C.M. Lee & H. Yue, 'Tunneling in China: The Surprisingly Pervasive Use of Corporate Loan to Extract Funds from Chinese Listed Companies' Johnson School Research Paper Series 31-06, available at <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=861445](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=861445)> (last visited 24 June 2013).

<sup>165</sup> See Shanghai Zhengquan Jiaoyi Suo [Shanghai Stock Exchange], 'Guanyu Dui Hubei Xingfu Shiye Gufen Youxian Gongsi Gongkai Qianze de Gonggao' [Notice on Public Criticism on Hubei Xingfu Shiye plc] (February 23, 2001) available at <<http://finance.sina.com.cn/stock/company/sh/600743/24/30.shtml>> (last visited 29 April 2014).

<sup>166</sup> Zhongguo Zhengjianhui [CSRC] 'Guanyu dui Hubei Meiyerya Gufen Youxian Gongsi Ji Yougian Renyuan Yuyi Gongkai Piping de Gonggao' [Notice on Public Criticism on Hubei Meiyerya Gufen Youxian plc] (12 September 2001) available at <<http://www.csrc.gov.cn/pub>> (last visited 24 June 2013); Zhongguo Zhengjianhui [CSRC] 'Guanyu dui Ningxia He Minzu Huagong Gufen Youxian Gongsi Ji Yougian Renyuan Yuyi Gongkai Piping de Gonggao' [Notice on Public Criticism on Ningxia He Minzu Huagong plc] (31 October 2001) Available at <<http://www.csrc.gov.cn/pub>> (last visited 24 June 2013).

<sup>167</sup> See M. Sheng, 'Taokong Shangshi Gongsi Xin Dongxiang' [New Ways of Tunnelling Listed Companies], *Xin caifu* [New Fortune], 5 November 2006. Available at <<http://www.qikan.com.cn/Article/xicf/xicf200611/xicf20061120.html>> (last visited 29 April 2014)

<sup>168</sup> S. Lin, 'Dagudong Qianyi Zhankuan Qiaoxiang' [Appropriation of One Hundred Billion by the Controlling Shareholder Alarms the Bell], *Shanghai Zhenquang Bao* [Shanghai Securities News], 2 April 2004. Available at <[http://www.cnstock.com/ssnews/2004-4-2/touban/t20040402\\_541330.htm](http://www.cnstock.com/ssnews/2004-4-2/touban/t20040402_541330.htm)> (last visited 29 April 2014)

<sup>169</sup> Y. Zhang, 'Dagudong Zhanyong Shangshi Gongsi Zijin Xu Biaoben Jianzhi' [Appropriation of the Listed Companies' Assets by the Controlling Shareholders Should be Addressed Fundamentally], *Zhengquan Shibao* [Securities Times], 7 December 2004. Available at <[http://money.163.com/economy2003/editor\\_2003/041207/041207\\_263134.html](http://money.163.com/economy2003/editor_2003/041207/041207_263134.html)> (last visited 29 April 2014)

<sup>170</sup> H. Zhang and Z. Wu, 'Woguo Shangshi Gongsi Zijin Zhanyong de Xianzhuang Ji Tezheng Yanjiu' [The Characteristics of Appropriation of Public Companies' assets in China] (2003) 5 *Shangshi Gongsi* [Journal of Public Companies] 17, 24

local government has been expanded significantly in the past few decades.<sup>171</sup> A majority of SOEs are now controlled and monitored by local government, save some extremely important SOEs.<sup>172</sup> The local authority therefore plays a key role in protecting or exploiting the interests of the SOEs. First, in promoting the listing of local SOEs, local governments want their “best” corporations for consideration, though the “best” standard is determined not just by profitability but social or political importance. Thus, the most profitable SOEs may not be selected by local governments for listing, while less profitable or even profit losing but socially or politically important companies may be listed. Here, false listing documents may be produced. Secondly, the quality or core assets of a parent SOE may be injected to its subsidiary so as to list it, with non-core or bad assets and redundant employees being left with the parent company. This sacrifice on the part of parent companies obviously ignores and hampers the interests of small shareholders and the company itself. Indeed, as Tang and Wang point out: “many SOEs are debt-ridden enterprises ‘repackaged’ for listing and continue to be controlled by their parent companies who, having successfully seen to their IPO, look towards them as cash cows for ready milking.”<sup>173</sup> Thirdly, as China’s current top priority is to maintain stability, SOEs are obliged to bear part of this responsibility. For example, unemployment must be kept low, even if the redundant employees have affected the performance of a company; the decision to fire employees is therefore strictly limited by local government. Furthermore, SOEs are sometimes forced to rescue other local SOEs when they are in financial crisis in order to stabilise local society and economy.<sup>174</sup> Such attempts may be motivated by the theory that the stock market would “localise the benefits

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<sup>171</sup> S. Lubman, *Bird in a Cage: Legal Reform in China after Mao* (Stanford University Press 1999) 103-106.

<sup>172</sup> Only those SOEs with significantly important economic resources are controlled by central government. Such as China Petroleum & Chemical Corporation.

<sup>173</sup> L. H. Tang and J. Y. Wang, ‘Modelling an Effective Corporate Governance System for China’s Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy’ (2007) 7 *Journal of Corporate Law Studies* 151.

<sup>174</sup> See, e.g., D. Cheng, ‘Beiqing Chundu, Yige Guoyou Qiye Chenfu zhi Wanquan Jilu’ [Chundu in Sorrow: A Full Record of An State-Owned Enterprise’ Ups and Downs], 21 *Shiji JIngi Baodao* [21<sup>st</sup> Century Business Herald], 17 April 2004.



and socialise the risks”,<sup>175</sup> although apparently it is minority shareholders who must ultimately pay for this.

For private listed companies,<sup>176</sup> agency costs normally arise among corporate or business groups. Private enterprises have developed significantly in the past decades under the policy that “non-public economy will be encouraged, supported and guided”.<sup>177</sup> In order to improve competitiveness and achieve greater profits, many enterprises are inclined to expand their business empires by establishing more companies or other entities to form corporate groups. This can indeed enhance their benefits by increasing their bargaining power and allowing them to occupy a greater market share, though it may also bring more troubles and burdens, as larger corporations do not always generate more profits. Indeed, it is highly possible that the failure of one corporation may put the whole group at risk. This is particularly true in China as related-party transactions, illegal guarantees and other kinds of financial manipulations are widespread within the groups. Nearly 40 corporate groups relating to more than 200 listed companies have been investigated by market regulators; most have been found to be involved in illegal loans and/or undisclosed related party-transactions between members of the corporate group.<sup>178</sup> These manipulations within a group may help some members overcome their difficulties though it is not the best means of solving problems. On the contrary, it may worsen a situation bringing more risks to the group and causing more losses to other members as the failure of one member may jeopardise the lenders (other members of the group). Obviously, this problematic phenomenon makes minority shareholders more

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<sup>175</sup> S. Tenev and C. Zhang, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (World Bank 2002) 20-21.

<sup>176</sup> The term ‘private’ here means non-SOEs .

<sup>177</sup> The new published Regulations of Individual Business has confirmed this policy again. See Geti Gongshang Tiaoli [Regulations of Individual Business], Passed on 16 April 2011. Available at <[http://www.gov.cn/zwgk/2011-04/28/content\\_1853972.htm](http://www.gov.cn/zwgk/2011-04/28/content_1853972.htm)> (last visited 28 June 2013)

<sup>178</sup> R. Cai, ‘You Shangshi Gongsì Zaoxi Yundong Yinfa De Sikao’ [Some Thoughts Concerning Listed Company’s Profit Making System] (2005) 2 *Shenyang Nongye Daxue Xuebao* [Journal of Shenyang Agricultural University] 98, 105.

vulnerable.

### **2.1.5 Summary**

Agency costs, created by the separation of ownership and management, are recognised as a key issue to be addressed in China. It is even acknowledged that the main objective of company law is to reduce agency costs through the establishment of various mechanisms and the development of good corporate governance. Indeed, a company could barely be profitable if its agency costs were too high; ultimately, negatively affecting and seriously hindering the economy. This is particularly true in China. Unlike other countries with only one principal form of agency cost, China suffers both vertical agency costs between shareholders and managers and horizontal agency costs between majority shareholders and minority shareholders. This particular phenomenon is mainly owing to SOE reform, which led to the emergence of insider control. The absence of an owner makes it more convenient for directors or managers to pursue their personal interests at the expense of the company. The concentrated ownership structure also makes minority shareholders vulnerable to exploitation from blockholders. In consequence, minority shareholders in China face double agency problems within the company and thus protective mechanisms should be in place.

## **2. 2 Non-legal protections for minority shareholders in China**

### **2.2.1 Introduction**

Legal protection focuses on how law and regulations organise the internal structure of the company and coordinate the relationship among the constituencies. If legal mechanisms are able to constrain agency costs and provide strong protection for minority shareholders, it seems unnecessary to explore non-legal measures. On the other hand, if market forces can be demonstrated to be an effective way to reduce agency costs and protect minority shareholders, then the necessity to reform the statutory derivative action would be weakened as both of these legal and non-legal mechanisms have a similar function in protecting the interests of the minority shareholders. Although it is controversial whether market forces can substitute for derivative actions,<sup>179</sup> it is recognised that there would be less need for costly litigations if market forces align the interests of managers or majority shareholders and minority shareholders.<sup>180</sup> As a consequence, the question arises whether these market forces can effectively play their role in protecting the interests of shareholders in the context of contemporary Chinese society. This part will discuss the market mechanisms in China and demonstrate that these mechanisms are ineffective owing to many factors and thus legal methods are needed in order to protect minority shareholders. Four types of market forces have been identified in this regard: the product market, the labour market for managers, the capital market and the market for corporate control.

### **2.2.2 The Product Market**

The principal market for a company is that in which it sells its products or services. To compete in today's fiercely competitive market, it is extremely important for companies to provide high quality products. To achieve that goal, a company must

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<sup>179</sup> A. Reisberg, *Derivative Actions and Corporate Governance : Theory and Operation* (Oxford University Press 2007) 36.

<sup>180</sup> S. Deakin, E. Ferran, R. C. Nolan, 'Shareholders' Rights and Remedies: An Overview' (1997) 1 *Company Financial and Insolvency Law Review* 167.

impose rigid controls on all aspects of production and sale to reduce redundant costs. If a company's products cannot be competitively priced, then it can lose its market share and induce the negative consequence that managers are likely to be dismissed. In this respect, there is little room for managers to abuse their powers to pursue personal interests by exploiting the company. For example, self-dealing directors would have greater concern in keeping the company's products competitive. Legal remedies are thereby less important as directors have restricted space to manipulate their positions.

In China, the economic miracle has undoubtedly demonstrated the success of the market economy. The transformation from a planned economy to a market-oriented economy has seen markets becoming increasingly competitive. This is also enhanced by rapid globalisation. It is therefore reasonable to suggest that in practice product markets in China have prevented directors from misusing their powers to some extent and in this sense the interests of minority shareholders might be safeguarded. This assertion is supported by some practical research. Huang has examined the relationship between product markets and corporate governance among 807 listed companies on the Shanghai and Shenzhen Stock Exchange. He concluded that a competitive product market can improve resource allocation and enhance supervision within the company, which together constrain the behaviour of directors, and thus improve corporate governance.<sup>181</sup> Another practical study led by Xiao and Xia investigated the relationship between the product market and Board of Directors using evidence from listed manufacturing corporations in China from 2003 to 2005. This study found that product market competition can effectively increase the efficiency of the company and improve the functions of the corporate governance.<sup>182</sup>

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<sup>181</sup> L. Huang, 'The Practical Analysis of Product Market Competition' (2010) 11 *Journal of Finance and Economy* 72-74.

<sup>182</sup> H. Xiao and X. Xia, 'Chanpin Shichang Jingzheng, Dongshihui Zhili yu Gujia Tongbuxing – Jiyu Zhongguo Zhizaoye Shangshi Gongsi de Shizhengyanjiu' [Product Market Competition, Board of Director and Stock Price Synchronicity- An Empirical Study Based on China's Listed Manufacturing Companies] 2011 (1) *Guizhou Caijing Xueyuan Xuebao* [Journal of Guizhou College of Finance]

This is further supported by Qi and Yan.<sup>183</sup>

Nevertheless, the above studies neglect to address the political factors behind the listed companies under examination. As a Communist country, the Chinese government must own or control some listed companies and these state-owned enterprises or state-controlled corporations might differ in their effectiveness *vis-à-vis* the product market. Research conducted by Fisman and Faccin shows that state-controlled corporations can significantly increase their value because of special political connections<sup>184</sup> while this is not the case in China. SOEs in China have to fulfil a number of functions assumed by the government, such as providing employment, taxation and social stability to build a harmonious society. This policy burden not only hampers the corporation's value, but also affects the efficiency of investment.<sup>185</sup> In return, SOEs receive financial subsidies from the government when their products are not competitive. Here, the product market seems to be less important for some SOEs. Empirical research on China also supports the assertion that government-controlled enterprises are less sensitive to product market competition.<sup>186</sup> Even in some private sectors, local companies do not need to worry about their products because of local protections. The obvious example is the beer industry where many local authorities wish to protect their own beer companies and thus restrict the beer products of other areas. Last, even the product market is

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62-67.

<sup>183</sup> Y. Qi and X. Yan, 'Zibenjiegou yu Chanpinshichang Jingzheng Hudong Guanxi Yanjiu – Laizi Zhongguo Shangshigongsi de Jingyan Zhengju' [Study of the Interactive Relationship between Capital Structure and Product Market Competition—Empirical Evidence from Chinese Listed Companies] (2011) 1 *Guizhou Caijing Xueyuan Xuebao* [Journal of Guizhou College of Financial] 41-45. In which it is argued that the debt ratio and product market competition intensity have notably negative effects on each other.

<sup>184</sup> R. Fisman, 'Estimating the Value of Political Connections' (2001) 91 *American Economic Review* 1095-1102.

<sup>185</sup> Q. Zeng and X. Chen, 'Guojia Konggu, Chaoe Guyuan yu Laodongli Chengben' [State Stockholder, Excess Employees and Labour Cost] (2006) 5 *Jingji yanjiu* [Journal of Economic Study] 74-86.

<sup>186</sup> Y. Xu and Z. Zhang, 'Chanpin Shichang Jingzheng, Zhengfu Kongzhi yu Touzi Xiaolv' [Product Market Competition, Government Control and Investment Efficiency] 2010 (2) *Ruan Kexue* [Soft Science] 19-23.

effective in constraining managers' misconduct; it only reduces the vertical agency costs while the horizontal agency costs remain unaddressed.

### **2.2.3 The Labour Market for Managers**

Reference to the "labour market for managers" denotes the employment marketplace for managerial and director services. Managers and directors, like other employees, must look for work when they are unemployed. Disloyalty or conducts harmful to a previous employer, damages their reputation and reduces their ability to obtain a well-paid job.<sup>187</sup> In this regard, the labour market for managers could act as a mechanism to constrain agency costs and protect the interests of the minority shareholders.

Theoretically it does indeed provide a strong disincentive to incompetence or disloyalty where managers wish to pursue their careers. However, this function might be undermined by real world factors. First, where managers are at the end of their careers, the market for managerial and director services may not operate well to constrain misbehaviour, as senior officers no longer seek to further their careers and their performance may not to some extent matter to them. This is particularly so in China where many senior SOE officers exploit their personal interests through self-dealing or embezzlement when they are close to retirement. This so-called "59 phenomenon"<sup>188</sup> is not uncommon in China because retirement pensions for SOE officers are considerably lower than for government officials operating at the same level. Secondly, where managers have sufficient personal wealth, the labour market might not be an effective method of curbing misbehaviour. Thirdly, even if managers

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<sup>187</sup> D. Kershaw, *Company law in Context: Text and materials* (Oxford University Press 2009) Web Chapter A. 2.

<sup>188</sup> The "59 phenomenon" is described for those persons who are going to retire soon as the retirement age for male is 60 in China.

are sacked for disloyalty or incompetence, the marketplace may not be informed of this as the company may be concerned about damaging its reputation in disclosing this information: thus those managers may continue to serve in other companies as prestigious as in previous employment. Furthermore, in the context of China's Party State, senior SOE managers are unlikely to lose their jobs merely because they are not competent or loyal to their companies. Many SOEs are controlled by the so-called *Taizidang* or offspring of party leaders.<sup>189</sup> Their removal is highly unlikely unless they commit some serious crime that might put the whole company at risk. This can be illustrated by the case of Chen Jiulin, a former head of China Aviation Oil (Singapore) Corp, imprisoned for more than four years for his role in a scandal that drove the company to the brink of bankruptcy. His poor governance led to a significant loss and failure to disclose a \$550 million trading loss. He was also charged with deceiving an adviser, Deutsche Bank AG. That sentence seemed to mark the end of his career as Chen was no longer eligible to work in SOEs under China's Company Law and Enterprise State-owned Assets Law.<sup>190</sup> However, Chen

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<sup>189</sup> See Y. Zheng and F. L. Lye, 'Elite Politics and the fourth generation of Chinese Leadership' (2003) 8 *Journal of Chinese Political Science* 65-86.

<sup>190</sup> Article 147 of Chinese Company Law 2005 states that "A person in any of the following categories may not serve as a director, supervisor, or the general manager of a company:

- (1) without civil capacity or with limited civil capacity;
- (2) having been sentenced to prison for the following crimes, and completion of the sentence being less than five years ago: embezzlement, bribery, conversion of property, misappropriation of property, sabotage of social economic order; or having been deprived of political rights as a result of a criminal conviction, and completion of such sanction being less than five years ago;
- (3) having served as a director, the factory chief, or the general manager of a company or enterprise which underwent bankruptcy liquidation as a result of mismanagement, and being personally responsible for such bankruptcy, and completion of the bankruptcy liquidation being less than three years ago;
- (4) having served as the legal representative of a company or enterprise whose business license was revoked due to its violation of law, and being personally responsible for such revocation, and such revocation occurring less than three years ago;
- (5) in default of personal debt of a significant amount.

Article 73 of Enterprise State-owned Assets Law states: "Where any director, supervisor or senior manager of a wholly state-owned enterprise, wholly state-owned company or company in which the state has a controlling stake is removed from office for a violation of this Law which has caused gross losses of state-owned assets, he shall not serve as a director, supervisor or senior manager of any wholly state-owned enterprise, wholly state-owned company or company in which the state has a controlling stake within 5 years from the day of removal; if the violation has caused especially gross losses of state-owned assets or he has been subject to a criminal punishment for corruption, bribery, encroachment upon property, embezzlement of property or undermining of the socialist market economic order, he shall not serve as a director, supervisor or senior manager of any wholly

was nevertheless appointed vice president of CGGC International Ltd (*zhongguo Gezhouba Jituan Guoji Youxiangongsi*) after his release from prison.<sup>191</sup> It is therefore conceivable that such a person could be reappointed as vice president of an SOE after causing a loss of state assets; the function of labour market for managers is consequently highly questionable in this Party-State. Last, the labour market for managers aims to constrain managers' misbehaviours and thus the potential exploitation by majority shareholders is not addressed by this market mechanism. This means vertical agency costs cannot be reduced even if this market force is effective.

#### **2.2.4 The Capital Market**

Another non-legal protection for minority shareholders is the capital market. This mechanism operates on the principle that high agency costs will lower a company's share price as shareholders will exercise their exit rights by selling their shares. A lower share price has the following minimum consequences: first, it makes it difficult for a company to raise finance on the capital market. Secondly, it can be easily acquired by other companies. In order to avoid this, directors and managers must reduce agency costs, thus disincentivising their exploitation of minority shareholder interests. Nonetheless, the key question is how the capital market reflects the share price.

The rationale behind this assertion is the 'semi-strong efficiency' hypothesis, known

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state-owned enterprise, wholly state-owned company or company in which the state has a controlling stake for life." (translated from Beida Fabao Website with minor amendments)

<sup>191</sup> Although it is argued that his appointment is not against the law because the crime he committed was in Singapore and the penalty execution does not necessarily extend to the mainland of China, it is a duplicitous quibble, wherever this took place, his deeds clearly show Chen to be an inappropriate person to run a state-owned enterprise. See <<http://baike.baidu.com/view/134742.htm>> (last visited 28 June 2013)



as the ‘efficient capital markets hypotheses.’<sup>192</sup> This theory holds that capital markets are efficient and can incorporate all publicly available information into the price of a company’s shares. It does not presume that *everyone* is aware of the information available to the public and makes their decisions according to a proper analysis of this information as it is obviously impossible for every investor to investigate relevant information before buying or selling shares. Instead, it assumes that there are some market participants who are strong and smart enough to alter share prices in the right direction.<sup>193</sup> Such participants might be the highly informed and skilled investors investing their own or other people’s money, or those investors who themselves are not very informed but rely on market professionals such as research analysts or securities.

In theory, it may be correct that publicly available information could inform capital markets which are efficient enough to reflect this information in share prices. However, the extent to which this hypothesis is merely an attractive theoretical idea or empirical reality has been a subject of intense debate. It would take a whole book to discuss this issue which therefore is beyond the scope of this paper. However, recent events in capital markets indicate that this hypothesis has increasingly less support. For example, the technology bubble in the late nineties and the recent subprime mortgage crisis appear to indicate that the market was pricing available information inaccurately. The counter-argument is that this hypothesis has weathered previous crisis such as the 1987 stock market crash.<sup>194</sup> Moreover, some studies demonstrated that investors are paying more attention to the internal regulations of companies, indicating the effectiveness of the capital market hypothesis.<sup>195</sup> This

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<sup>192</sup> See E. Fama, ‘Efficient Capital Markets: A Review of Theory and Empirical Work’ (1970) 25 *Journal of Finance* 383; E. Fama, ‘Efficient Capital Markets II’ (1991) 46 *Journal of Finance* 1575.

<sup>193</sup> R. Gilson and R. Kraakman, ‘The Mechanisms of Market Efficiency’ (1984) 70 *Virginia Law Review* 549.

<sup>194</sup> See R. J. Shiller, *Market Volatility* (MIT Press 1990).

<sup>195</sup> J. Gordon, ‘The Mandatory Structure of Corporate Law’ (1989) 89 *Columbia law review* 1549; R. Romano, ‘Empowering Investors: A market Approach to Securities Regulation’ (1998) 107 *Yale Law Journal* 23, 59.

controversial debate is still ongoing and divides economists. As Lo observes, even after several decades of research and study, the question whether markets are efficient has not yet been solved and there is still no consensus among the economists.<sup>196</sup>

If we assume that the capital market is efficient and the hypothesis of semi-strong efficient is correct, we must acknowledge that information publicly available to the market should also be accurate. Three types of information have been categorized by Kershaw.<sup>197</sup> The first category concerns the company's financial position and includes financial statements; the second is the regulations or legal rules set out in the corporate statute or constitution. The last category encompasses any information about managerial misbehaviour or incompetence. These categories of information must be made accessible to the public to properly reflect a company's share price. However, given the widespread financial fraud occurring in today's China, the price of shares does not actually reflect the value of a company.<sup>198</sup> In addition, it is generally believed that the Chinese capital market is a policy market rather than a real capital market. This so-called policy market has two implications: first, the market is extremely vulnerable to variation in the government's policy; secondly, policies regulating the capital market are changeable.<sup>199</sup> This capital market, which is so characteristic of the market in China, is relevant to the background of the economic reforms started in 1978. The 'cross the river by feeling its stones' paradigm was promoted by Deng Xiaoping, the former leader of China, in order to implement the reform policy and break down resistance to it.<sup>200</sup> This paradigm had a positive influence on almost every aspect of China – a state with little experience and

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<sup>196</sup> A. Lo, 'Efficient Markets Hypothesis' In L. Blume and S. Durlauf (eds.), *The New Palgrave: A Dictionary of Economics* (2<sup>nd</sup> edn, palgrave Mcmillan 2007).

<sup>197</sup> D. Kershaw, *Company law in Context: Text and materials* (Oxford University Press 2009) 5.

<sup>198</sup> S. Pei, 'The Financial False and its Countermeasures in Chinese Listed Companies' (2005) 3 *Journal of Changzhou Institute of Technology* 51-54.

<sup>199</sup> X. Wang, 'The Implications of 'Cross the river by feeling its stones'' *China Institutional Economics Annual Conference Papers*, 2008.

<sup>200</sup> Xiaoping Deng, *Selected Works of Deng Xiaoping (volume 3)* (Renmin Publisher 1993) 174.

knowledge of market economics at that time. However, the paradigm has now become an obstacle for the development of the capital market as the price of shares does not mirror the value of a company owing to unpredictable policies.<sup>201</sup> Wang and Ye have also concluded that the ‘cross the river by feeling its stones’ paradigm unquestionably leads to the policy market, which incurs the ineffectiveness of the capital market.<sup>202</sup>

In light of the above discussion, the capital market could to some extent effectively constrain managerial misbehaviour in general. However, it is strongly doubted that it could minimise agency costs in the context of modern China owing to the prevalence of financial fault and the uncertain policy market.

### **2.2.5 The Market for Corporate Control**

The market for corporate control has been regarded as a central mechanism to constrain the misbehaviour of managers and directors since it was first unveiled by Henry Manne.<sup>203</sup> The basic idea behind this theory is that self-dealing or inefficient management may induce a low company share price, resulting in a corporate takeover threat. If a company is successfully acquired, those self-serving managers may be removed. In light of the risk of being sacked, managers have to try their best to increase company profits and act in the best interests of the company as a whole rather than pursuing their own interests to the detriment of the company. In this sense, the market for corporate control could reduce agency costs and constrain managerial

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<sup>201</sup> Y. Zhou and M. Yuan, ‘Study on Policy Market in Chinese Stock market’ (2011) 4 *Finance and Accounting Monthly* 21-24.

<sup>202</sup> X. Wang and M. Ye, ‘An Expatiation of the Policy Market Phenomenon in China’s Stock Market’ (2011) 1 *Academic Research* 81-90.

<sup>203</sup> H. Manne, ‘Mergers and the Market for Corporate Control’ (1965) 73 *Journal of Political Economy* 110.

misbehaviour.<sup>204</sup> Apparently, this theory is based on the assumption that the market is efficient or at least relatively efficient: incompetence or the abuse of managerial discretion for self-benefit would be reflected in the capital market by lowering the value and share price of the company. Accordingly, an acquirer can seize this opportunity to acquire the company and remove bad managers.

However, several factors need to be considered to assess how this mechanism operates in practice. First, it should be noted that takeovers are not easy to execute. Indeed, they are a very expensive way of changing the management of a company as they involve substantial transaction costs.<sup>205</sup> Accordingly, a prudent bidder must consider the current value of a company and the agency costs incurred by its managers as well as the costs of acquiring the company before making a takeover decision. Generally, only when there is a profit-making opportunity in the value delta,<sup>206</sup> will a bidder offer to buy controlling company shares. Nevertheless, as Kershaw points out, agency costs alone are not normally large enough to activate a bid.<sup>207</sup> Even if they cause a significant reduction in a company's shares, Coffee considers that internal corporate governance mechanisms would be instigated before a bidder arrives on the scene.<sup>208</sup> Moreover, the evidence that corporate governance could be improved or agency costs reduced after takeovers remains ambiguous. Singh and Weisse have found that the main motivation behind a corporate takeover is not to improve an acquired company's competence but to build the business empire.<sup>209</sup> Also, the empirical evidence in the UK has shown that takeover markets

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<sup>204</sup> F. H. Easterbrook and D. R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 112.

<sup>205</sup> A. Peacock and G. Bannock, *Corporate Take-overs and the Public Interest* (Aberdeen University Press 1991).

<sup>206</sup> The share delta is the difference between the traded value of the share and the value of the share without a discount to take account of such costs.

<sup>207</sup> D. Kershaw, *Company law in Context: Text and materials* (Oxford University Press 2009) 10.

<sup>208</sup> J. Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 *Columbia Law Review* 1145.

<sup>209</sup> A. Singh and B. Weisse, 'Corporate Governance, Competition, the New International Financial Architecture and Large Corporations in Emerging Markets' *ESRC Centre for Business Research*, University of Cambridge Working Paper No.250, 28. Available at

are not notably related to poor performance.<sup>210</sup> Furthermore, Koulouridas argues that the threat posed by the market for corporate control could fuel managerial incentives for self-interested acquisitions.<sup>211</sup> Some managers may not wait to become targets if they know they will be ousted following a takeover. Consequently, they may attempt a defensive takeover to protect their own personal interests as the threat of replacing them is enough to make them act in their own interests. In this sense, the market for corporate control may increase agency costs and harm the interests of the minority shareholders.

When it comes to China, the effectiveness of the market for corporate control faces greater challenges. Empirical research conducted by Zhang has found that the extent to which the transfer of corporate control improves a company's performance depends on the status of ownership concentration and its variation during the process of transformation.<sup>212</sup> Here, the function of the market for corporate control in China is not as useful as other countries' might be. Indeed, several factors contribute to this: first, the ongoing reform of share trading has not proved unproblematic. This reform seeks to change split shareholding structures into one single form that could be freely transferred to the general public in order to implement the principle that the same shareholding should have the same right. It was expected that most non-tradable shares owned by central or local governments in listed companies would be reduced to an acceptable level and the modern corporate governance of SOEs could be established. However, the basic ownership structure of companies remains unchanged even after several years' reform,<sup>213</sup> and State investment companies are

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<[www.cbr.cam.ac.uk/pdf/WP250.pdf](http://www.cbr.cam.ac.uk/pdf/WP250.pdf)> (last visited 28 July 2013)

<sup>210</sup> J. Franks and C. Mayer, 'Governance as a Source of Managerial Discipline' *Prepared for the Company Law Review, Committee E on Corporate Governance*, (first draft 14 January 2000; revised 10 April 2000) 18.

<sup>211</sup> A. Koulouridas, *The Law and Economics of Takeovers: An Acquirer's Perspective* (Hart Publishing 2008) 39.

<sup>212</sup> M. Zhang, 'Woguo Shangshi Gongsi Kongzhiquan Shichang Zhili Xiaoli Yanjiu' [The Study on the Effectiveness of the Market for Corporate Control in Chinese Listed Companies] (2007) 11 *Nanjing Shehui Kexue* [Nanjing Social Science] 28-36.

<sup>213</sup> D. Du, 'Houguquan Fenzhi Shidai de Shangshi Gongsi Guquanjiegou Fenxi' [The Exploration on

still the blockholders of those listed companies. This makes it more difficult for the market for corporate control to function. Second, the visible hand of government prevails almost everywhere in the market despite the demise of the planned-economy. It is fair to say that the history of the market for corporate control is the history of government intervention, as the government remains continuously concerned with enterprise ownership partly because the traditional concept that the Communist state should control companies and markets has not completely vanished. In light of government intervention, accurate predictions of whether a takeover would be successful are extremely difficult because decision making power is in the hands of the government. Therefore, the market for corporate control's disciplinary function in deterring bad managers is weakened. Third, the incomplete legal system of mergers and takeovers in China also casts doubt over the efficiency of the market for corporate control. Although several laws and regulations have been published to regulate mergers and takeovers, including the Measures for the Administration of the Takeover of Listed Companies<sup>214</sup> and the Administration of Disclosure of Information on the Change of Shareholdings in Listed Companies,<sup>215</sup> many problems persist because of flaws in these regulations and an absence of other relevant laws. For instance, some of the regulations which were drafted under reforms concerning split shareholding structures are not suitable for addressing problems in capital markets after the reform of share-trading while the corresponding laws and regulations are still deficient. Fourth, it is also argued that the history of capital and stock markets in China is far too short, which inevitably creates some problems. Only in 1990, were two national stock exchanges authorised to be established: the Shanghai Stock Exchange in 1990 and the Shenzhen Stock Exchange

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the Ownership Structure after Share Trading Reform] (2008) 8 *Shangdong Shehui Kexue* [Shandong Social Science] 112-114.

<sup>214</sup> This regulation was adopted at the 180th chairman's executive meeting of China Securities Regulatory Committee on 17 May 2006 and entered into force on 1 September 2006. Then it was revised in 2008 and 2012.

<sup>215</sup> It was promulgated by China Securities Regulatory Committee on 28 September 2002 and effective as of 1 December 2002.

in 1991. It is widely recognised that China's economic miracle could not have been achieved without the establishment of these stock markets, though many problems have emerged over the last twenty years. One of these problems is the extremely strict regulation of Initial Public Offerings (IPO).<sup>216</sup> This means that the motives for acquiring a company do not necessarily include improvement of its performance in corporate governance but can sometimes be merely to obtain listed status. These numerous limitations in China would undoubtedly weaken the effectiveness of the market for corporate control.

### **2.2.6 Summary**

Unlike other countries which have either vertical or horizontal agency cost problems, China has both. This is the result of China's SOE reform and its concentrated ownership structure as discussed in the previous part. In order to reduce these agency costs, legal and non-legal mechanisms must be put in place to constrain the opportunistic behaviour of managers and controlling shareholders. This part examined the non-legal mechanisms and four market methods were identified. Although these market forces may be effective in some other countries, their functions are hampered in the context of modern China owing to the aforementioned reasons discussed above. As a result, it is essential to examine legal methods in order to protect the interests of minority shareholders and company.

## **2.3 Legal Protections for Minority Shareholders in China**

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<sup>216</sup> See Securities Daily News. 27 April 2011. Available at <<http://finance.qq.com/a/20110427/001039.htm>> (last visited 29 April 2014).

### **2.3.1 Introduction**

As demonstrated above, there are currently two agency costs in China: vertical agency costs between minority shareholders and managers; horizontal agency costs between controlling shareholders and minority shareholders. In order to constrain the misbehaviour of managers and controlling shareholders and reduce these agency costs, various mechanisms have been adopted to protect the interests of the minority shareholders. Several defects have been found in non-legal protections in China and it is argued above that these non-legal mechanisms of themselves do not have the capacity to provide a strong shield for minority shareholders. In this regard, the law has a key role to play. This is particularly so when the rule of law has been advocated during the past fifteen years and awareness of safeguarding individual's rights has been strengthened. If the legal protections for minority shareholders and the means for their enforcement are strong enough, then the importance of derivative actions would be weakened and the necessity to reform and rely on this direct form of litigation could be diminished. Otherwise, this protective measure will retain a central role in regulating the misbehaviour of controlling shareholders and managers and deterring them from abusing the powers.

### **2.3.2 The Sources of Legal Protections Conferred in favour of Minority Shareholders**

There are three main legal sources of protection that are available for minority shareholders. The first and most important is statutory law, including the Company Law and the Securities Law. The Company Law basically deals with corporate governance issues and provides protection for shareholders in general. The Securities



law, however, focuses principally on stock companies or listed companies by stipulating provisions for disclosure of information, market transparency and listing qualifications, etc. The two laws were adopted and passed by the Standing Committee of the National People's Congress (SCNPC), which has an enhanced degree of legal force than other regulations. Anything that contradicts these laws in judicial decisions or administrative regulations is treated as invalid.

The second source of minority shareholder protection is judicial interpretation. Judicial interpretations issued by the Supreme People's Court (SPC) can generally be divided into two components. The first one is the explanation of a specific law such as *Decisions on Issues Regarding Application of the PRC Company Law*. In practice, judicial explanations are treated as having statutory authority that is binding on all courts in China.<sup>217</sup> It is recognised that some provisions in law are ambiguous. However, it is impractical to revise them once the defects are found since the amendment of those provisions by formal legislative process would take a long time. The second component is guiding cases. On 26 November 2010, the SPC made a significant change to the Chinese legal system by adopting a rule creating a procedure to recognise a batch of "guiding cases."<sup>218</sup> Although the new rule states only that courts at all levels should "refer to" guiding cases issued by the SPC, it is expected that these cases should be followed, otherwise there may be serious consequences.

The third source of legal protection for shareholders can be found in administrative regulations. While there are numerous administrative regulations governing various matters in China, regulations on legal protection for minority shareholders are

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<sup>217</sup> The power of legal interpretation of the SPC was granted by several regulations as follows: *Decisions on Issues Regarding Interpretation of Law* (1955), *Law of the PRC on Organization of the People's Court* (1979), *Resolution of the SCNPC Providing an Improved Interpretation of the Law* (1981), *Provisions of the Supreme People's Court on the of Judicial Interpretation Work* (1997).

<sup>218</sup> The SPC had published twenty-six guiding cases, available at < <http://cgc.law.stanford.edu/guiding-cases> > (last visited 29 April 2014)

predominantly issued by the China Securities Regulatory Committee (CSRC).<sup>219</sup> Regulations issued by the CSRC play a key role in constraining controlling shareholders and managers of listed companies because the Company Law and Securities Law are ineffective and insufficient to offer redress for minority shareholders. The Company Law 1993 was enacted primarily to regulate state-owned enterprises (SOEs) which accounted for the majority of corporations in China at that time. It basically provided little protection for minority shareholders because the principal purpose of the law was in favour of majority shareholders. Furthermore, there were few provisions policing the conduct of controlling shareholders and directors in listed companies since the securities market was newly established. The Securities Law was first enacted in 1999, which means most of the regulations pertaining to listed companies were largely provided by the CSRC from 1993 to 1999. Even after the enactment of the Securities Law, the CSRC still plays a key role in regulating various forms of management and majority shareholder misconduct.<sup>220</sup>

### **2.3.3 Developments of Legal Protection for Minority Shareholders Prior to the Chinese Company Law 2005**

At the beginning of the 1990s, the main purpose of commercial law was considered as reforming and serving SOEs. From this perspective, the first enactment of the Company Law in 1993 provided a legal basis for SOEs reform, and therefore only a

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<sup>219</sup> The CSRC was first established as the executive branch of the State Council Securities Commission (SCSC) in 1992 and then in 1998 both of them were merged into one body which is now the CSRC. For further information of the CSRC, please visit its official website: < <http://www.csrc.gov.cn/pub/newsite/> > (last visited 29 April 2014)

<sup>220</sup> The primary regulations issued by the CSRC are as follows: Detailed Rules for Implementation Regulations on Information Disclosure by Companies Offering Public Stocks (1993), Provisional Measures on Prohibition of Securities Fraud (1993), Guidelines on Articles of Association of Listed Companies (1997), Rules for the General Assemble of Shareholders of Listed Companies (2000), Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (2001), Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders (2004).

few provisions were designed for the protection of minority shareholders. However, with the rapid development of the capital market in China and increasing occurrences of exploitation of shareholders, interests of minority shareholders received increasing attention in China. The attention to minority shareholders was strengthened by the argument that legal protection of minority shareholders indicated success of a capital market because a country with inadequate protection for minority shareholders would be less attractive to investors and would have significantly smaller debt and equity markets.<sup>221</sup> The research conducted by Johnson *et al.* also revealed that there was a link between legal protection for minority shareholders and conditions of a financial market with the argument that legal mechanisms to constrain controlling shareholders and reduce “tunnelling” activities were vital in furthering capital market development.<sup>222</sup> Acknowledging the insufficient protection provided by the Company Law 1993, CSRC issued many regulations and guidelines to prevent majority shareholders and managers from exploiting the interests of minority shareholders and companies and to discipline those who violate these regulations and rules. Nonetheless, it is argued that these regulations and guidelines are unsystematic and only provide limited and low-level protection.<sup>223</sup> In addition, it seems that the reluctance of courts to hear civil cases involving protection for minority shareholders exacerbated the situation, although this was to change years later.

### **2.3.3.1 Company Law 1993**

The enactment of the Company Law 1993 was regarded as a milestone in Chinese economic reform for the reason that, prior to the date of its adoption, China

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<sup>221</sup> See L. Porta, F. Lopez-de-Silanes, A. Shleifer & R. W. Vishny (“LLSV”), *Law and Finance*, Working Paper 5661, National Bureau of Economic Research 1993; L. Porta, F. Lopez-de-Silanes, A. Shleifer & R. W. Vishny, *Legal Determinants of External Finance*, Working Paper 5879, National Bureau of Economic Research 1997; L. Porta, F. Lopez-de-Silanes & A. Shleifer, *Corporate Ownership around the World*, Working Paper 6625, National Bureau of Economic Research 1998.

<sup>222</sup> S. Johnson *et al.*, ‘Tunnelling’ (2000) 90 *American Economic Review* 22.

<sup>223</sup> X. Li, *A Comparative Study of Shareholders’ Derivative Actions* (Kluwer Law International 2007) 269.

ostensibly did not need a Company Law since it was deemed to be capitalist branch of the law. Someone even suggested that the name of Company Law should be State-Owned Enterprise Law because that Law was intended to serve the formation and management of SOEs.<sup>224</sup> Fortunately, the name was not changed, although the basic structure and the main content of the law was indeed primarily related to regulations of SOEs. The Company Law remained unchanged until the substantial revision in 2005.<sup>225</sup>

Shareholders were given some basic and general rights under the Company Law (1993). Article 4 stated that shareholders “have the right to enjoy the benefits of the assets of the company, make major decisions, choose managers etc., in accordance with the amount of capital they have invested in the company.”<sup>226</sup> In particular, shareholders were given the right to attend and vote at the shareholders’ general meeting,<sup>227</sup> examine the financial reports and accounting records,<sup>228</sup> draw dividends,<sup>229</sup> seek remedies when their interests were infringed<sup>230</sup> and enjoy priority in subscription of newly issued shares.<sup>231</sup> However, some of these rights were ambiguous and limited, and therefore it was reasonable to say that these rights were on the books only without any practical application. For example, the priority in subscription for new shares in the Company Law seems to be a strong protection for minority shareholders, while actually it lacks any specific means of being applied. There is only one sentence stating that “[the] existing shareholders may have priority in subscription for new shares where a company increases its capital.”<sup>232</sup> However, it

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<sup>224</sup> Many provisions of the Company Law 1993 emphasized the interests of the State. For example, article 4(3) stated that the ownership of state-owned assets in a company shall vest in the country.

<sup>225</sup> The Company Law was revised in 1999, but it was a minor amendment with little significance.

<sup>226</sup> Article 4 of Chinese Company Law 1993.

<sup>227</sup> Articles 37,41,102 and 106.

<sup>228</sup> Articles 32 and 110.

<sup>229</sup> Article 33.

<sup>230</sup> Article 111.

<sup>231</sup> Article 33.

<sup>232</sup> Ibid.

provides no procedure for such a shareholder to subscribe.

Besides general rights as above, specific and carefully tailored protection for minority shareholders were scarcely included in the Company Law (1993). MacNeil examined the legal protection for minority shareholders by employing LLSV's "anti-director rights index" and concluded that minority shareholders protection in China's Company Law (1993) was much weaker than those of other countries.<sup>233</sup> Six protective components are identified in LLSV's index and are calculated by adding 1 point when each of them occurs. MacNeil discovered that the total score for China was 2 with a world average of sample countries there of 3 and an average of common law jurisdictions of 4 (see Table 3).

Table 3

| <b>Index of Protective Components in Chinese Company Law<br/>(1993)</b>   |       |
|---|-------|
| Protection  | Score |
| Shareholders can mail their vote to the company.  | 0     |
| Shareholders are not required to deposit their share prior to the Annual Shareholders' General Meeting.   | 1     |
| Cumulative voting or proportional representation of minorities in the board of directors is allowed.  | 0     |
| An oppressed minorities mechanism is in place.  | 0     |
| The minimum percentage of capital that is necessary for shareholders to call an extraordinary shareholders' meeting is less than or equal to ten percent. | 1     |
| Shareholders have pre-emptive rights that can only be waived by a shareholder vote.   | 0     |

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<sup>233</sup> I. MacNeil, 'Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies' (2002) 2 *Journal of Corporate Law Studies* 289.

It is no surprise that the Company Law 1993 failed to provide specific protective rights to minority shareholders since the primary intention to introduce this law was to reform governance of SOEs and to protect state assets. However, the potential for directors to abuse their powers was recognised by the drafters of the Company Law and several modest measures were adopted, such as a supervisory board to supervise acts of the directors<sup>234</sup> and administrative and criminal liabilities they should bear when violating certain laws and regulations.<sup>235</sup> Nevertheless, experience demonstrates that directors were rarely disciplined for their wrongdoings owing to the ineffective and impractical mechanisms of enforcement. For example, as Li pointed out, the supervisory board did not perform the supervising function as expected and thus failed to supervise the directors.<sup>236</sup>

### **2.3.3.2 Administrative Regulations**

The administrative regulations issued by the CSRC took a more robust and progressive approach to protect the interests of minority shareholders. Among many regulations issued by the CSRC, *Guidelines for the Articles of Association of Listed Companies* (hereinafter, the “Guidelines 1997”) and *Code of Corporate Governance for Listed Companies* (hereinafter, the “Code 2002”) are the most fundamental ones, and their provisions seemed to be effective in constraining controlling shareholders and directors.

Prior to the Guidelines 1997, the articles of association of many listed companies were chaotic and controlled by the majority shareholders. In order to prevent majority shareholders from using the articles of association to deprive minority shareholders and the company of interests, CSRC issued the Guidelines 1997 with

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<sup>234</sup> Article 50 of Chinese Company Law 1993.

<sup>235</sup> Chapter X of Chinese Company Law 1993.

<sup>236</sup> X. Li, *A Comparative Study of Shareholders’ Derivative Actions* (Kluwer Law International 2007) 280.

which all companies that demand to become listed should comply or provide reasonable grounds for non-compliance, and failure to do so would result in rejection of its listing application. Under the Guidelines 1997, shareholders enjoy certain rights that did not exist in the Company Law 1993. For example, shareholders with 5% of the voting shares in the company have the right to raise proposals to the company.<sup>237</sup> Secondly, the Guidelines 1997 also addressed problems resulting from when the board of directors disapprove to convene an interim shareholders' assembly meeting requested by eligible shareholders. Guidelines 1997 specified that such a meeting should be convened despite the board of directors' disapproval.<sup>238</sup> Furthermore, the supervisory board has more practical rights to perform its supervising functions.<sup>239</sup>

The Code 2002<sup>240</sup> made substantial improvements to the protection for minority shareholders and achieved an average level of 3 under the LLSV's index owing to the first adoption of cumulative voting right.<sup>241</sup> The Code 2002 provides that listed companies that are owned more than 30% by controlling shareholders shall adopt a cumulative voting system which is expected to provide a strong mechanism for minority shareholders to have a voice in the company by electing their favoured directors.

Besides the two foregoing important Codes, several other regulations issued by the CSRC also deal with particular problems in this field. For example, the Interim Regulations on the Administration of the Issuing and Trading of Stocks (1993) and

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<sup>237</sup> Shangshi Gongsi Zhangcheng Zhiyin 1997 [Guidelines for the Articles of Association of Listed Companies 1997], article 57.

<sup>238</sup> *Ibid.*, articles 44, 54.

<sup>239</sup> *Ibid.*

<sup>240</sup> *Code 2002* is issued based on a previous *Guidelines for Corporate Governance 2000*. *Guidelines 2000* with only 55 articles, however, was not mandatory for listed companies; while *Code 2002* with 95 articles, is mandatory for all listed companies.

<sup>241</sup> A precise explanation of the cumulative voting system is as shown in Chapter III B (2).

the Implementation Rules on Information Disclosure by Companies Offering Public Stocks (1993) were issued to improve shareholders' access to company information. Also, the Provisional Measures on Prohibition of Securities Fraud (1993) was issued to target emerging securities fraudulent activities in the capital market. In collaboration with the CSRC, the Ministry of Finance issued the Accounting Standards for Disclosure of Related Parties and Affiliate Transactions (1997), which sought to enhance the transparency of transactions by disclosing relative information. Although these regulations have been repealed, many rules in these regulations have been incorporated into the Company Law 2005.

### **2.3.3.3 Judicial Interpretation**

The SPC has played a key role in the legal protection of the interests of minority shareholders. On the one hand, the SPC can encourage individual shareholders to bring lawsuits against wrongdoers, on the other it can also limit these lawsuits by issuing judicial interpretations. Specifically, the SPC circulated a notice stating that the high people's courts should not accept civil compensation cases arising from insider trading, securities fraud and market manipulation because the causes of action in these types of cases could not be clearly demonstrated.<sup>242</sup> The SPC later explained that several factors were considered in making this decision. First, the absence of judicial consistency would produce different results to plaintiff-investors with similar facts and causes of actions. Secondly, it was expected that the acceptance of civil compensation arising from securities would encourage more cases and the caseload of courts might exceed what is reasonable, especially given that the exploitation of shareholders in the capital market had been increasing. Thirdly, the professional knowledge and expertise of judges in the securities area is a major concern. At that time, the reality was that many judges were retired military officers during the

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<sup>242</sup> *Notice of the Supreme People's Court on Temporary Refusal to Accept the Civil Compensation Cases Involving Securities* (2001)



military reform. They did not have the professional legal experience to handle these cases. Fourthly, the lack of a standardised rule of evidence was also an obstacle for the acceptance of civil compensation cases involving securities. Lastly, since a majority of listed companies were SOEs at that time, there was concern that some small investors might strip state assets away by filing such a case.<sup>243</sup>

However, this notice provoked a debate about China's commitment to the rule of law and the role of the SPC in the legal protection of shareholders' rights.<sup>244</sup> Many scholars and investors harshly criticised that the functioning of capital markets would be prejudiced by the refusal to accept civil compensation cases involving securities. Facing this intense pressure, the SPC changed its decision several months later by issuing another notice. The second notice provided that investors could assert claims against anyone for losses caused by false representation made by information disclosure in violation of law.<sup>245</sup> However, there was a prerequisite that had to be fulfilled before such a case was filed. A case must be investigated and penalised by the CSRC or its dispatched institutions before it is accepted by a court and the investigation result should be used as basis by the investor in filing.<sup>246</sup> The provision actually means shareholders cannot initiate a lawsuit unless it has been investigated by the CSRC and the violator of the information disclosure obligations has been punished by an administrative decision or/and the criminal law. Although this provision was criticised for its limitations on access to justice, there is no doubt that the SPC did make some progress in protecting minority shareholders with it.

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<sup>243</sup> News Report available at < <http://finance.sina.com.cn/y/20011011/114918.html> > (last visited 29 April 2014)

<sup>244</sup> J. Wang, 'Rule of Law and Rule of Officials: Shareholder Litigation and Anti-Dumping Investigation in China' (2008) 4 *Rule of Law in China Series Policy Brief*.

<sup>245</sup> *Notice of the Supreme People's Court on Issues Concerning Acceptance of Civil Compensation Arising from False Statement in Securities Market* (2002), article 1.

<sup>246</sup> *Ibid.*, article 2.

### **2.3.4 General Protections for Minority Shareholders under the Company Law 2005**

Since the SPC started to embrace the significance of private securities litigation, the recognition that legal protections for minority shareholders are insufficient has also increased. Along with the continual issuance of regulations by the CSRC, support has been growing for a revision of China's Company Law to strengthen minority shareholders' rights. Widely reported cases concerning the exploitation of shareholders in capital markets also pushed legislators into reforming the Company Law. As a key piece of legislation regulating commercial business and capital markets, it was recognised that Company Law should not fall behind other regulations and interpretations in terms of protection for minority shareholders. Instead, the Company Law legislation should have been in a leading position in providing an investor-friendly environment. Based on this recognition and common view, the Company Law was revised in 2005. The revision was considered the most comprehensive and significant reform in the legislative history of Chinese company law. One of the distinctive characteristics of this revision was to meet the increasing demands for rules that provide better protection for minority shareholders.

#### **2.3.4.1 Improvements in Protection for Minority Shareholders**

First of all, shareholders are given more rights to protect themselves and are encouraged to participate in the management of the company. For example, shareholders have the right to examine and view corporate documents such as the stubs of corporate bonds and the minutes of shareholders' general meetings.<sup>247</sup> Besides, directors and senior managers are subject to questions from the shareholders

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<sup>247</sup> Articles 34 and 98 of Chinese Company Law 2005.

during the shareholders' general meeting.<sup>248</sup> Furthermore, in order to encourage shareholders to engage in management, the Company Law 2005 provides that in a limited liability company, shareholders representing 10% or more of the voting rights may convene and preside over the shareholders' meeting where the executives and the board of supervisors both fail to do so.<sup>249</sup> In a company limited by shares (i.e., stock company), shareholders who individually or jointly hold more than 3% of the shares of the company may also submit proposals to the shareholders' general meeting.<sup>250</sup> Additionally, shareholders representing more than one-tenth of the voting rights may propose to convene an interim meeting of the board of directors.<sup>251</sup> Last but not least, given the fact that the "one share one vote" doctrine may undermine the willingness of minority shareholders to exercise their rights in company management, the Company Law 2005 for the first time allows shareholders in a limited liability company not to exercise their voting rights in proportion to their respective capital contributions where the articles of association provides another approach.<sup>252</sup> In a stock company, the cumulative voting system was introduced<sup>253</sup> for the minority shareholders to have a louder voice in the election of directors and supervisors at the shareholders' general meeting.<sup>254</sup>

Where the interests of minority shareholders are infringed, shareholders can be awarded a wider range of remedies under the Company Law 2005. First, individual shareholders may bring a derivative action against the wrongdoers for compensatory

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<sup>248</sup> Article 151.

<sup>249</sup> Article 41. For a company limited by shares, there is one additional requirement that shareholders have to hold more than 10% of the company's shares for 90 or more consecutive days. See Company Law 2005, article 152.

<sup>250</sup> Article 103.

<sup>251</sup> Article 111.

<sup>252</sup> Article 43.

<sup>253</sup> A precise explanation of the cumulative voting system is discussed in paragraph 4.2.1.2 in this paper.

<sup>254</sup> Article 106 of Chinese Company Law 2005.

damages in the interests of the company.<sup>255</sup> Secondly, a shareholder may request the company to buy his shares at a reasonable price under certain circumstances.<sup>256</sup> Thirdly, when a company is facing serious difficulties confronted in its operation and management, and its continued existence may cause grievous losses and the difficulties cannot be surmounted by other channels, the minority shareholders may file a request to court to dissolve the company.<sup>257</sup>

Owing to the emerging ‘insider controls’ problem and the increasing vertical agency costs, duties of loyalty and diligence are imposed upon directors and senior managers (including supervisors) under the Company Law 2005 while the Company Law 1993 only provided that directors should perform their duties faithfully.<sup>258</sup> Article 148 of the Company law 2005 requires directors, supervisors and senior managers to assume the duties of loyalty and diligence to the company,<sup>259</sup> and they will be liable for any breach of duties that causes loss to the company or shareholders. For instance, directors are liable for resolutions of the board of directors. Where a resolution of the board violates laws, administrative regulations, or the company’s articles of association and thus causes serious losses to the company, the directors who participate in adoption of such a resolution may be liable for compensation to the company.<sup>260</sup> Furthermore, the Company Law 2005 itemized several activities that directors and senior managers should not commit, such as misappropriating the company’s funds. All earnings derived by a violation of these rules must be returned to the company.<sup>261</sup>

A great emphasis on the functions of the supervisory board in a company is another

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<sup>255</sup> Article 152.

<sup>256</sup> Article 75.

<sup>257</sup> Article 183.

<sup>258</sup> Article 159(1).

<sup>259</sup> Article 148.

<sup>260</sup> Article 113.

<sup>261</sup> Article 149.

approach resorted to in the Company Law 2005 to constrain directors and senior managers. The supervisory board was criticised for its inability to perform task of holding directors to account, and for its excessive dependence to exercise its monitoring function.<sup>262</sup> The first argument is that the Company Law 1993 did not confer sufficient power to the supervisory board to supervise the internal management, correct managerial misconduct and discipline the wrongdoers. The second argument is that supervisors were not independent enough to exercise their rights. Supervisors elected by shareholders were normally controlled by the majority shareholders and supervisors elected by employees were reluctant to challenge the directors and senior managers for fear of being dismissed. The Company Law 2005 responds to these criticisms by conferring more powers and functions on the supervisory board, including the powers to remove directors and senior managers who violate laws, administrative regulations or the articles of association of the company, or the resolutions adopted by the shareholders' meetings.<sup>263</sup> The supervisory board even may take legal proceedings against the directors or senior managers under certain circumstances.<sup>264</sup> Besides the additional supervisory board's functions, independent director system is also adopted to reduce vertical agency costs of companies. However, the Company Law 2005 does not provide specific rules regarding responsibilities of independent directors in corporate governance. Instead, it simply states that a listed company should have independent directors and the specific measures in this regard will be formulated by the State Council.<sup>265</sup>

The prevalence of horizontal agency costs between controlling shareholders and minority shareholders is also addressed. As a result, certain duties are imposed on the controlling shareholders and *de facto* controllers of a company under the Company

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<sup>262</sup> X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 262.

<sup>263</sup> Articles 44, 54(2) and 119 of Chinese Company Law 2005.

<sup>264</sup> Articles 54(6) and 119.

<sup>265</sup> Article 123.

Law 2005 to prevent them from taking advantages from the company.<sup>266</sup> Article 21 states that controlling shareholders or *de facto* controllers of a company should not take advantage of their affiliated relations to damage the interests of the company. A person who violates this rule and causes losses to the company should be liable in compensation.<sup>267</sup> The new Guidelines for the Articles of Association of Listed Companies which have been revised in accordance with the Company Law 2005 and the Securities Law goes further. The new Guidelines provide that controlling shareholders and *de facto* controllers of the company owe a duty to act *bona fide* to the company and other shareholders. Controlling shareholders should not impair the legal rights of the company and other shareholders by profits distribution, assets reorganization, external investments, appropriation of funds, borrowing and loan guarantee, nor should they use their controlling status to damage the interests of the company and individual shareholder.<sup>268</sup> It is expected that these legal duties will effectively reduce horizontal agency costs of corporate governance.

#### **2.3.4.2 Deficiencies of the Protection**

Notwithstanding that protection for minority shareholders has been improved significantly and substantially by the Company Law 2005, these mechanisms do have some drawbacks and some of them even do not have sufficient and effective implementing details. This part is dedicated to explore defects of these general protections and demonstrates why the derivative action is necessary in China.

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<sup>266</sup> The definition of controlling shareholders and *de facto* controllers are clearly stated in article 217 of the Company Law 2005. A controlling shareholder refers to a shareholder whose capital contribution accounts for more than 50% or of the total capital of a limited liability company, or a shareholder who holds accounts for more than 50% of the total amount of shares in a stock company, or a shareholder, although the amount of his capital contribution or the proportion of the shares he holds is less than 50%, whose voting right enjoyed on the basis of the amount of capital contribution made or the number of shares held are enough to have a vital bearing on the resolutions of a shareholders' meeting or a shareholders' general meeting. A *de facto* controller means a person who is able practically to govern the behaviour of a company through investment relations, agreements or other arrangements, although the person is not a shareholder of the company.

<sup>267</sup> Articles 21 and 44 of Chinese Company Law 2005.

<sup>268</sup> Guidelines for the Articles of Association of Listed Companies (2006), article 39.

### **2.3.4.2.1 Rights Conferred on Shareholders**

#### **2.3.4.2.1.1 Right to know**

It can be presumed that shareholders will be unable to protect their rights and interests without information about the company in which they invest. Therefore, the ‘right to know’ is a fundamental and extremely important right which is restated and improved under the Company Law 2005. Article 34 states that shareholders have the right to consult the articles of association, the minutes of the shareholders’ meetings, the resolutions of the board of directors and the board of supervisors, and the financial and accounting reports of the company. However, if a shareholder asks to consult accounting books of the company, he will need to submit a written request with an explanation of his purpose. The request may be refused by the company in a written reply where the company reasonably deems the request is for an illegitimate purpose that may damage the lawful interests of the company. Shareholders with the refusal from the company can request the court to demand the company to provide such information.<sup>269</sup>

There is no doubt that the right to know provides fundamental protection for minority shareholders by furnishing information such as whether the interests of the company, especially interests of minority shareholders, have been damaged. However, in order to prevent abuse of this right, the company can refuse the request if it has reasonable grounds to believe that the subjective purpose behind the request is illegitimate or may harm the interests of the company. Whilst it might seem that this provision strikes the balance between protection of the minority shareholders and trade secrets of the company, several problems have arisen. The first seemingly obvious issue is

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<sup>269</sup> See Article 34 of Chinese Company Law 2005.

who can enjoy the right to know. According to the legislation, the answer should be very straightforward: the shareholders. However, the next question would be whether former shareholders, dormant partners and shareholders who have defective capital subscription should also enjoy the right. Although it is extensively recognised in the legal profession that former shareholders can also exercise the right to know,<sup>270</sup> companies or the courts are very likely to refuse their requests if the law is strictly interpreted. The second issue is that there is no prerequisite for shareholders to exercise this right in either a limited liability company or a stock company.<sup>271</sup> In a limited liability company, owing to its private nature, it is certain that every shareholder can exercise the right to know and consult the company documents. However, in a stock company, the rules should be adjusted because of its different nature. Because stock companies are companies that offer shares to the public, they should be kept under more strict supervision than a private company, and therefore, the rules applied to it should not be identical. Since shares of a stock company can be purchased by anyone on stock exchange markets, a person with a malicious purpose can easily become a shareholder holding a small amount of shares and request to consult information of the company, which may damage the interests of the company. Although the company can refuse his request with reasonable ground that to fulfil his demand may harm the interests of the company, it is unrealistic for the company to discover the true motivation of each request and to screen the background of each applicant. Hence, certain restrictions should be placed. For instance, shareholders of a stock company cannot enjoy the right to know without holding a certain percentage of shares of the company.

Another vexed issue is how to evaluate the existence of an “illegitimate purpose”. Given that the company can refuse to meet the request on the ground of illegitimate

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<sup>270</sup> J. Liu, *Xiandai Gongsifa* [Modern Corporate Law] (Falv Chubanshe [Law Press] 2008) 242.

<sup>271</sup> Generally, a limited liability company is a private company and a stock company is comparable to a public company.



purpose, it is essential to give a clear definition of such a purpose. However, such a definition is absent from the current Company Law. Additionally, it is unclear that who should bear the burden of proof. Article 34 provides clearly the company should state the reasons why the request is refused. However, it remains unclear that whether it is the shareholder who should show the reasonableness of the request. Another question up in the air is whether the shareholders can consult the original accounting books, such as the company's invoices. It is argued that shareholders do not have right to examine the original accounting books and reports because the Company Law does not states so. However, it is too difficult for shareholders to inspect the accuracy of accounting books without comparing to the original records. Therefore, it should be clarified in the future revisions.

#### **2.3.4.2.1.2 Cumulative Voting System**

One of the strongest protections for the minority shareholders is the right to participate in the management of the company by electing directors and supervisors. Under the traditional “one-share, one-vote” doctrine,<sup>272</sup> majority shareholders can control the company by electing their favourite directors and it is highly unlikely for the minority shareholders to elect their directors because they represent minority shares of the company. However, the situation might be changed after the system of cumulative voting introduced to the current Company Law.<sup>273</sup> This system will give all shareholders the opportunity to have a voice in corporate governance and protect their own interests to some extent. It is widely accepted that this voting system has several advantages. It encourages minority shareholders to participate in

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<sup>272</sup> The “one share, one vote” doctrine is still the general principle under the Company Law 2005. Article 43 states that shareholders shall exercise their voting rights at the shareholders' meetings in proportion to their respective capital contributions, except where provided for by the company's articles of association. Article 44 further explains, “in addition to what is provided for in this Law, the modes and voting procedures of the shareholders' meetings shall be stipulated by the company's articles of association.” (translated from Beida Fabao Website with minor amendments)

<sup>273</sup> Article 106 of the Company Law 2005.

management of the company and contribute their perspectives to maximize the company's interests.<sup>274</sup> It is a true reflection of the inherent concept of "check and balance" in corporate governance to prevent directors from abusing powers.<sup>275</sup> It can reduce conflicts of interests and moral risks and minimize the risk of investments.<sup>276</sup> In a word, the system of cumulative voting can effectively protect minority shareholders and improve the structure of the corporate governance system.

Although the adoption of the cumulative voting system received a warm welcome, some doubts have been raised about the design of this rule and its functions. First of all, this voting system is not mandatory and it is ultimately decided by the company's articles of association. In other words, shareholders that come in after the company is incorporated will not be able to use this voting system unless it is stipulated in the company's articles of association. Although it is true that the articles of association can provide the system of cumulative voting by a later amendment, it will be impractical to be achieved since requirements for an amendment of the articles of association are much higher and the minority shareholders alone will generally be unable to meet the requirements.<sup>277</sup> Secondly, the success of this system depends on the agreements between the minority shareholders. The cumulative voting system requires minority shareholders to vote unanimously. However, it is hard to ask minority shareholders to align with each other and vote for the same directors or supervisors, especially in a stock company where minority shareholders normally have diverse interests. Thirdly, minority shareholders may be reluctant to vote and elect their directors because they may believe that their votes are of little influence

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<sup>274</sup> J. Liu, *Xiandai Gongsifa* [Modern Corporate Law] (Falv Chubanshe [Law Press] 2008) 284.

<sup>275</sup> J. Wang, 'Woguo Gufen Youxian Gongsì Leijitoupiao Zhidu Falv Lilun yu Shiwu Wenti Yanjiu' [Study on the Legal Theory and Practical Problems on the Cumulative Voting System in China] (2009) 27 *Guizhou Daxue Xuebao* [Journal of Guizhou University] 30, 34.

<sup>276</sup> J. Liu, *Xiandai Gongsifa* [Modern Corporate Law] (Falv Chubanshe [Law Press] 2008) 244.

<sup>277</sup> According to article 44 of the Company Law 2005, resolution made at a shareholders' meeting on amendment to the company's articles of association shall be subject to the adoption of shareholders representing 2/3 or more of the voting rights.

under the special ownership structure in China. As is well known, China is one of the few communist countries with many SOEs. Therefore, many listed companies are solely or particularly controlled by the government. Additionally, many institutional investors prefer to hold shares of these SOEs because of their economic privileges. Hence, even in a case where the minority shareholders vote for the same director or supervisor, it is highly likely that their efforts turn out to be in vain. The directors who are preferred by the minority shareholders and successfully get elected still are subject to removal by the controlling shareholders or marginalised through other legal channels. In practice, there is evidence to show that the shareholders' general meeting is often simply a "rubber stamp" for the controlling shareholders' wishes in China and thus the attendance and voting level of minority shareholders is considerably low.<sup>278</sup> As a result, the cumulative voting system cannot be expected to be a practical means of monitoring the management of a company.

#### **2.3.4.2.1.3 Restriction and Proxy Voting System**

In terms of the voting rights, there are some other systems under the Company Law 2005 that provide protection for minority shareholders besides the system of cumulative voting. The current Company Law provides two more instruments to improve the corporate governance of companies. The first one is a restriction of shareholders' voting rights on matters that they are involved in and subject to a resolution adopted by the shareholders' meetings.<sup>279</sup> The other one is the proxy

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<sup>278</sup> J. Yang, 'Shareholder Meetings and Voting Rights in China: Some Empirical Evidence' (2007) 18 *International Company and Commercial Law Review* 4–16.

<sup>279</sup> Article 16 of the Company Law 2006 states that where a company intends to invest in other entities, the matter shall, in accordance with the provisions of the company's articles of association, be subject to a resolution adopted by the board of directors or the shareholders' meeting or the shareholders' general meeting; and where norms for the gross amount of investments or guarantees and for the amount of a single investment or guarantee are specified in the company's articles of association, such norm should not be exceeded. Where a company intends to provide a guarantee for its shareholders or its actual controller, the matter shall be subject to a resolution adopted by its shareholders' meeting or the shareholders' general meeting. (translated from Beida Fabao Website with minor amendments)

voting system, which creates a user-friendly environment for shareholders to participate in the management of the company.<sup>280</sup> The restriction on voting precluding shareholders from voting for matters they are involved in, which is designed to resolve conflicts of interests between the company and its controlling shareholders, and the company's interests should be prioritized when such conflict occurs. It is argued that the best protection for interests of the minority shareholders is to restrict or invalidate voting rights of the controlling shareholders.<sup>281</sup> Indeed, if the majority shareholders can vote without any restriction, the interests of minority shareholders or even the company will be under potential expropriation, according to the fundamental presumption of rational-economic man (*homo economicus*). The presumption reveals that any person who is rational will act in a self-interested way to maximise his own benefits. This presumption justifies the introduction of the voting restriction and has been heavily relied upon in the revision of Chinese Company Law.

Another reform of voting rights that aims to protect minority shareholders is the proxy voting system. Along with the exponential development of capital markets in China, investments are getting more diversified. As a result, shareholders may need to put additional time and energy to learn about and follow up each company he invests in and personally attend each general meeting of shareholders to exercise his voting rights. Ideally, shareholders should be able to do so and his interests would be protected adequately, but in the real business world, it is very impractical. This is one of the reasons why the system of proxy voting was designed and adopted under Chinese Company Law. Second, according to the Company Law or the company's articles of association, some resolutions have to be adopted by a certain number of

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<sup>280</sup> Article 107 of the Company Law 2005 states, a shareholder may entrust a proxy to attend a shareholders' general meeting. The proxy shall present the shareholder's power of attorney to the company, and shall exercise the voting rights within the scope of authorization. (translated from Beida Fabao Website with minor amendments)

<sup>281</sup> M. He, *Gongzhong Gongsi jiqi Guquan Zhengquan* [Company and Equity Securities] (Beijing Daxue Chubanshe [Peking University Press] 1999) 828.

attending shareholders or percentage of representing voting rights to become effective.<sup>282</sup> This means some of the resolutions cannot be made without adequate number of attending shareholders, where proxy may be an efficient solution to the problem. Last but not least, proxy voting provides a platform for every shareholder to express himself and to vote when he cannot personally attend the shareholders' general meetings.<sup>283</sup>

Meanwhile, there are some arguments over effectiveness of these two methods under current Company Law. Three issues have been brought up regarding the voting restriction. First, the scope of application of the restrictions is too narrow. The Company Law 2005 suspends a shareholder's voting rights only where the company intends to provide a guarantee to him.<sup>284</sup> Other related-party transactions are not mentioned under the current Law. Therefore, it is obvious that the scope of applicable transactions is extremely narrow, which needs to be extended. The second issue is the definition of voting restriction is ambiguous. Under the current Company Law, only the shareholders dominated by the actual controller are subject to the restriction. However, it remains unclear if these mentioned shareholders should be excluded from voting when they represent other shareholders as well. Additionally, it is ambiguous whether the proxy should be subject to the voting restrict if he is a related party to the voting matters while his principal-shareholder is not. Another loophole is the legal consequences of the violation of this rule need improvements. The Law should identify means that can be resorted to by the minority shareholders to protect their rights where the voting restriction is not being followed. The current Law stipulates that shareholders can take legal proceedings and request rescission of

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<sup>282</sup> For example, article 44 stipulates that “resolutions made at the shareholders' meeting on the increase or reduction of the registered capital, or on the merger, division, dissolution, or transformation of the company shall be subject to adoption by the shareholders representing 2/3 or more of the voting rights.(translated from Beida Fabao Website with minor amendments)

<sup>283</sup> X. Wang, ‘Lun Gudong Biaojuquan Daili Zhengji Zhidu’ [Study on Chinese Proxy Voting System] (2008) 9 *Fazhi yu Shehui* [Legal System and Society] 130–132.

<sup>284</sup> See article 16 of Chinese Company Law 2005.

a violating resolution where the resolution in its content or its voting formula is against laws, administrative regulations or the articles of association of the company.<sup>285</sup> Apparently, the Law provides that shareholders can request the court to rescind the resolution, but it is unclear whether shareholders related to the voting matters are still qualified to be plaintiffs. Further, it is argued that legal consequences of violation here is not reasonably severe, which may result in insufficient deterrence.<sup>286</sup> As to the system of proxy voting, current Company Law only spares one basic provision providing a shareholder may entrust a proxy to attend a shareholders' general meeting without any detailed implementing rules.<sup>287</sup> Second, it can be hard for a shareholder to find a reliable proxy, especially when the shareholder lives far away from headquarter of the company. Third, there is no specific restriction imposed on the proxy's exercising of the voting rights under the current Law. Under the theory of agency, the agent should act for the interests of and instructions from his principal. Therefore, under the Company Law, some mechanism should be provided to make sure the proxy would vote based upon the true intents of his principal. Nevertheless, the current Law does not contain such provisions and therefore several questions are still up in air. For instance, is it necessary for the principal-shareholder to state clearly in the power of lawyer whether he would vote for or against a certain resolution? What if the proxy votes against the true intents of his principal-shareholder? These questions need to be

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<sup>285</sup> Article 22 of Chinese Company Law 2005 states that the resolution adopted by the shareholders' meeting or shareholders' general meeting or the board of directors of a company, which in content violates laws or administrative regulations, shall be invalid. Where the procedure for convening the shareholders' meetings, or the shareholders' general meeting, or board of directors, or the voting formulas are against laws, administrative regulations or the articles of association of a company, or the content of the resolution adopted is against the company's articles of association, the shareholders may, within sixty (60) days from the date that the resolution is adopted, request the court to rescind the resolution. Where shareholders take legal proceedings in accordance with the provisions of the preceding paragraph, the court may, upon request of the company, demand the shareholders to provide appropriate guarantees. (translated from Beida Fabao Website with minor amendments)

<sup>286</sup> J. Song and Z. Xu, 'Lun Woguo Gudong Biaojuquan Paichu Zhidu de Wanshan – Cong Zhongxiaogudong Liyibaohu de Jiaodu' [Improvements of Voting Restrictions in China — A Perspective from the Protection of Minority Shareholders] (2007) 10 *Shangchang Xiandaihua* [Market Modernization] 279–280.

<sup>287</sup> See article 107 of Chinese Company Law 2005.

answered eventually to provide more effective protection to the minority shareholders.

### **2.3.4.2.2 Measures to Constrain Directors and Controlling Shareholders.**

#### **2.3.4.2.2.1 The Supervisory Board (“SB”)**

The supervisory board (the *Aufsichtsrat*) was adopted in the early version of Chinese Company Law to supervise the internal management of company; however, it was regarded as a complete failure due to its dysfunction in practice. The revised company law acknowledged the problem and under the new law, the SB may exercise more rights, including: (i) to put forward proposals for removal of the directors or senior managers who violates laws, the company’s article of association, or the resolutions adopted by the shareholders’ meeting; (ii) to propose, convene and preside over shareholders’ interim meeting as provided for by the Law when the board of directors fails to perform the duty of convening; (iii) to put for the motions at the shareholders’ meeting; and (iv) to take legal proceedings against directors and senior managers.<sup>288</sup>

Although the SB was given more rights to strengthen its supervising function, its inefficiency is still criticised on several grounds.

First, the SB’s rights are still not strong enough for it to play the role under the new Company Law. The SB system was transplanted from Germany with fundamental alterations. In Germany, a SB enjoys much stronger powers, including appointing

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<sup>288</sup> Article 54 of Chinese Company Law 2005 states that the board of supervisors shall exercise the following functions and powers: (i) to examine the financial affairs of the company; (ii) to demand directors or senior managers rectify when their acts damage the interests of the company; and (iii) to convene and preside over interim shareholders’ meetings. (translated from Beida Fabao Website with minor amendments)

and removing directors. Additionally, important business decisions are subject to advice or/and consent of the SB.<sup>289</sup> However, SBs in China have no right to appoint or remove directors, nor the authority to control the process of business decision-making in the company. Absence of the right and power will inevitably impair a SB's deterrence and make it impossible for a SB to act as a supervisory organ.

Second, the composition of the SB further undermines its function. According to the Company Law 2005, a SB should be composed by three types of supervisors: (i) representatives of the shareholders, (ii) representatives of the staff and workers of the company, and (iii) external supervisors.<sup>290</sup> It seems such a composition of supervisors will ensure the independence of a SB to supervise the directors, however, the evidence shows to the contrary. Supervisors who are democratically elected by the shareholders normally only represent the preference of the controlling shareholders instead of the minority shareholders. The practical research conducted by Xu and Wang confirmed that among all Chinese listed companies' supervisors that examined in their research, very few of them were representing individual shareholders.<sup>291</sup> Leaders of the dysfunctional labour union are always also the supervisors representing employees.<sup>292</sup> In fear of being fired by the directors, these

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<sup>289</sup> According to the German Stock Corporation Act, the supervisory board is responsible for appointing and dismissing members of the management board (§84(1)) and representing the corporation in its dealings with such board (§90), including entering into employment agreements with its members (§112). The management board reports to the supervisory board, though the latter is independently entitled to inspect the books, records and properties of the corporation (§111(2)). The supervisory board must consent to certain business decisions of the management board if required by the articles or the supervisory board's rules. The supervisory board may not, however, encumber the management board's ability to manage the corporation with excessive consent requirements. If the supervisory board withholds consent, the management board may nevertheless act if it can obtain a three quarters majority of votes cast at the shareholders meeting. (§111(4)). See J. Wang, 'The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies' (2007) 3 *Compliance & Regulatory Journal* 47–55.

<sup>290</sup> See article 52 of Chinese Company Law 2005.

<sup>291</sup> X. Xu and Y. Wang, 'Ownership Structure, Corporate Governance, and Corporate Performance: The Case of Chinese Stock Companies' (1997) No. 1794 Policy Research Working Paper, World Bank.

<sup>292</sup> S. Tenev and C. Zhang, *Corporate Governance and Enterprise Reform in China: Building the*



types of supervisors are little more than puppets of the directors or senior managers and are extremely reluctant to challenge the directors. The external supervisors are expected to be more efficient in exercising their powers and rights since they have fewer conflicts of interests within the company. Indeed, Tam and Hu discovered that performance of external supervisors are more effective than internal supervisors, although generally the latter actually dominant the SB.<sup>293</sup> However, some research shows that many external supervisors are close friends or acquaintances of the senior managers, which significantly limits their role in supervising the board of directors and senior managers.<sup>294</sup> Besides the forgoing arguments, two more factors may also affect the independence of the SB. The first one is that the remuneration of the supervisors is decided by the executives of the company. The second one is the level of education of the supervisors. Research on education backgrounds among supervisors in companies listed in Shanghai Stock Exchange reveals that the average level of professional knowledge of supervisors is lower than that of the directors.<sup>295</sup>

Overall, it is commonly accepted that the SB is unlikely to be effective in supervising the board of directors and the senior managers. A senior official from the CSRC even candidly admitted that the system of supervisory board failed to provide checks and balances into the managements of companies.<sup>296</sup>

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*Institutions of Modern Markets* (World Bank 2002) 20-21.

<sup>293</sup> O. K. Tam and H. W. Hu, 'Supervisory Boards in Chinese Corporate Governance' In L. S. Ho & R. Ash (eds.), *China, Hong Kong and the World Economy: A Study of Globalization* (Macmillan Press 2006) 327-347.

<sup>294</sup> J. Dahya et al., 'The Usefulness of the Supervisory Board Report in China' (2003) 11 *Corporate Governance* 308, 321

<sup>295</sup> Shanghai Stock Exchange Research Centre (SSE), *Zhongguo Gongsi Zhili Baogao* [Report of Chinese Corporate Governance] (Fudan University Press 2003) 160.

<sup>296</sup> Laura M. Cha, the former Vice Chairman of the China Securities Regulatory Commission, said in a speech she gave at the China Business Summit, "It is sometimes argued that the supervisory boards should enjoy more rights and powers to sit on top of the boards of our listed companies. However, experience shows that this system is not effective because it is often unclear whose interest the supervisory board should represent. In many cases, the supervisory boards duplicate the authority of the board without corresponding responsibilities. In fact, the existence of supervisory boards may create an illusion that there are certain checks and balance in the listed company, while in fact, there is none. Available at < <http://www.people.com.cn/GB/jinji/35/159/20010419/446294.html> > (last visited 29 April 2014)

### 2.3.4.2.2 Independent Directors.

By acknowledging the ineffectiveness of the supervisory boards supervise the acts of the directors and senior managers, the independent director system was borrowed from common law jurisdictions, particularly from the U.S. law, to improve the corporate governance and protects the interests of individual shareholders. The system was first introduced by the Guiding Opinions on the Establishment of Independent Director System in Listed Companies in 2001<sup>297</sup> and later confirmed by the Company Law in 2006 stating that a listed company should have independent directors and the specific measures in this regard should be formulated by the State Council.<sup>298</sup> The detailed rules are known as Independent Director Guidelines.

The independent director system was designed to supplement the supervising function of the SB and was expected to be more effective than the SB in providing checks and balances into the management of listed companies. However, research indicates that the effects of this system on the corporate governance are disappointing. Ma and Gao conducted empirical research on effectiveness of the independent director system selected by the listed companies on Shanghai Stock Exchange from 2006 to 2008. Their research discovered that independent directors were having very limited effects on constraining the majority shareholders.<sup>299</sup>

Although this research may not necessarily tell the whole story, there is no doubt that to date, the independent director system has not been performed as effectively as

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<sup>297</sup> Guanyu zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de Zhidao Yijian [Guiding Opinions on the Establishing Independent Director System in Listed Companies] was issued by the CSRC on August 16, 2001 and revised on December 22, 2006.

<sup>298</sup> Article 123 of Chinese Company Law 2005.

<sup>299</sup> L. Ma and N. Gao, 'Guquanjiegou, Jingwai Beijing Duli Dongshi yu Gongsi Jixiao', [Ownership Structure, Independent Directors with Overseas Background and Corporate Performance — Evidence from Listed Companies in Shanghai Stock Exchange] (2011) 33 *Shanxi Caijing Daxue Xuebao* [Journal of Shanxi Finance and Economics University] 74, 82.

expected. The outcome may be explained by several reasons as follows.

First of all, it is argued that independent directors are reluctant to challenge decisions made by the board of directors or senior managers.<sup>300</sup> In a survey conducted by *China Securities Daily*, sixty five percent of the independent directors admitted they never raised a challenge when attending meetings of the board of directors and all of them did, at least “occasionally,” vote for a proposal where they should not based on its content.<sup>301</sup> This problem was brought up by various reasons. First, the independent director’s remuneration is not competitive and thus the economic motivation for them to exercise their rights is not strong enough.<sup>302</sup> However, even independent directors can receive much higher annual compensation may lose their independence if their remuneration is decided by the senior managers or controlling shareholders. Second, the supervising function of independent directors may be further undermined by the traditional Chinese business culture of *guanxi* (关系). *Guanxi* signifies the inclination to compromise one’s own interests in order to show respect to others, particularly to friends. In this sense, independent directors would be reluctant to offend their friends, for example, the CEO or senior managers the company, even where the latter have committed some misconduct to the company.<sup>303</sup> Third, the absence of legal liability also contributes to the ineffectiveness of this system. The Guidelines did not specify any legal consequence that independent directors may bear if they fail to perform their duties, with one exception that if an independent director fails to attend in person three consecutive meetings of the board of directors, he may be replaced upon request of the board of directors.<sup>304</sup> Without

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<sup>300</sup> D. C. Clarke, ‘The Independent Director in Chinese Corporate Governance’ (2006) 31 *Delaware Journal of Corporate Law* 125.

<sup>301</sup> Zhongguo Dudong Diaocha ji Zhidu Fansi [Survey and Reflections on China’s Independent Directors] *Zhongguo Zhengquan Bao* [China Securities Daily], July 28, 2005.

<sup>302</sup> Recent empirical research based on annual reports from 81 listed companies in 2002 reveals that independent director’s average annual remuneration is less than RMB 30,000. See Luo, fn. 112 at 22.

<sup>303</sup> C. Xie, *Duli Dongshi Falv Zhidu yanjiu* [Study on the Independent Director System] (Falv Chubanshe [Law Press] 2002) 320.

<sup>304</sup> Guiding Opinions on the Establishing Independent Director System in Listed Companies, article

actual legal consequences, independent directors will act little more than “ornamental vases” and it will be hard to encourage them to fulfil their duties.<sup>305</sup>

Limitation to access of company information is another obstacle for independent directors. According to the Independent Director Guidelines, a listed company should provide sufficient materials and working conditions to the independent directors.<sup>306</sup> Furthermore, when an independent director exercises his powers, the relevant personnel of the listed company should actively co-operate with him, and may not refuse to do so.<sup>307</sup> However, to exercise these rights mainly relies on the management of the company. In other words, the executive directors or senior managers control the access to corporate information and limit the independent director to get access to relevant information. A survey regarding this issue demonstrates by that ninety percent of independent directors, to a great extent, have to rely upon the management of the company to get necessary information. The key point here is that the rights to knowledge of independent directors are almost unenforceable since there is no provision providing legal consequences where the management of the listed company fails to provide such information. As a result of the absence of legal enforcement, it can be imagined that the effectiveness of independent director system in supervising the controlling shareholders and the senior management is diminished.

#### **2.3.4.2.2.3 Duties of the directors**

The Company Law 2005 provides, first, that directors assume the duties of loyalty and diligence to the company, it also itemised that the following conduct should not

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IV (5).

<sup>305</sup> S. Shen and J. Jia, ‘Will the Independent Director Institution Work in China?’ (2005) 27 *Loyola of Los Angeles International and Comparative Law Review* 223.

<sup>306</sup> Guiding Opinions on the Establishing Independent Director System in Listed Companies, article VII (2).

<sup>307</sup> *Ibid.*, article VII (3).

be committed:

- (i) misappropriating the funds of the company;*
- (ii) opening an account in his own name or in the name of another person to deposit the funds of the company;*
- (iii) in violation of the stipulations of the company's articles of association or without the consent of the shareholder's meeting or general meeting, lending the funds of the company to another person or using the property of the company to provide guarantee for another person;*
- (iv) in violation of the stipulations of the company's articles of association or without the consent of the shareholders' meeting or general meeting, entering into a contract or conducting transactions with the company;*
- (v) without consent of the shareholders' meeting or general meeting, taking advantage of his position to seek commercial opportunities, which belong to the company, for himself or for another person, or operating for himself or for another person the same kind of business as that of the company where he is holding a post;*
- (vi) taking into his own possession the commissions from transactions conducted by another person with the company;*
- (vii) disclosing secrets of the company without authorization; or*
- (viii) other acts committed in violation of the duty of loyalty to the company.*<sup>308</sup>

It is also provided that all earnings derived by the director or senior managers in violation of the restrictions above should be returned to the company. It was expected that these duties of directors and senior managers would incentivise them to act in compliance with the duties for the interests of the company, and would prevent them from pursuing their own benefits. However, several problems have emerged in the meantime.

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<sup>308</sup> Article 149 of Chinese Company Law 2005.(translated from Beida Fabao Website with minor amendments)

First, the scope of directors' duties is narrow. It is recognised that the duty of loyalty in China is similar to the fiduciary duty in the United Kingdom since both are mainly aim to eliminate the potential conflicts of interests. However, the ambit of the fiduciary duties of directors in the UK is much wider. There are three types of duties under UK law, however, is absent from China law. The first type is that directors must exercise their power within the scope of authorisation. The second one is the good faith requirement, which requires directors to act in good faith for the commercial success of the company. The last one is that the directors should use independent judgment during exercising their powers and right.<sup>309</sup> Among these three types of duty, the good faith requirement is regarded as the important tool for preventing management misconducts. Therefore, it is argued that the scope of directors' duties in China should be extended and the good faith requirement should be adopted. One reason for such an extension is that the duty of loyalty and diligence cannot prevent all types of misconducts that may be committed by the management, and thus the good faith requirement will be a necessary complement based on research conducted by Eisenberg. The research reveals that the good faith requirement would cover most of the cases in which the duty of loyalty is inapplicable.<sup>310</sup>

Another defect is that shareholders can only bring a derivative action to the court against a director who fails to perform his duties and cause losses to the company. Under the current Company Law, shareholders cannot bring lawsuits against the wrongdoers unless the board of directors or supervisors fails or refuses to take legal proceedings.<sup>311</sup> This means that the derivative action is still needed even if the directors' duties *per se* are effectively designed by the legislators.

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<sup>309</sup> P. L. Davies, *Principles of Modern Company Law* (9<sup>th</sup> edn, Sweet & Maxwell 2012) 497.

<sup>310</sup> M. A. Eisenberg, 'The Duty of Good Faith in Corporate Law' (2005) 31 *Delaware Journal of Corporate Law* 1.

<sup>311</sup> Article 152.

#### 2.3.4.2.2.4 Duties of the Controlling Shareholders

Although the new Company Law does not state explicitly that the duties of controlling shareholders to the company and other shareholders, it is widely accepted that the duties were imposed upon the controlling shareholders based on two provisions in the new Company Law requires controlling shareholders not to abuse their rights and should be held liable for damages caused by their violations. Article 20 provides a general rule by stating that the shareholders of a company shall observe laws, administrative regulations and the company's articles of association, exercise the rights of a shareholder according to the law, and shall not abuse his right to damage the interests of the company and other shareholders.”<sup>312</sup> Article 21 focuses on the controlling shareholders or *de facto* controllers of a company, stating that they should not take advantage of their affiliated relations to damage the interests of the company, and otherwise they would be liable for compensation.<sup>313</sup>

However, it is argued that the duties of controlling shareholders may not effectively constrain their conducts and thus are only “paper tigers.”<sup>314</sup> First of all, provisions regarding duties of the controlling shareholders are unsystematic and therefore, it more like a scattergun approach. As discussed before, there are couples of provisions regarding the duties of the controlling shareholder under the Company Law and some other relative rules can be found occasionally in regulations issued by the CSRC, such as Guidelines for the Articles of Association of Listed Companies. These dispersed provisions are obviously not conducive to either the minority shareholders or the controlling shareholders. Second, these provisions are criticized for being too general to claim in practice without details of content or applicable

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<sup>312</sup> Article 20.

<sup>313</sup> Article 21.

<sup>314</sup> X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 256.

standards.<sup>315</sup> It can be revealed by the fact that to date, there has been no case filed to court claiming the controlling shareholders breach their duties. Third, there is no provision explicit stating a shareholder can bring lawsuits against controlling shareholders where they fail to perform their duties and cause damages to other shareholders. This is different from the situation covered under the current Company Law where directors fail to fulfil their duties since the Law clearly provides that shareholders, whose interest is damaged when a director violates his duties to shareholders, may bring a lawsuit to the court.<sup>316</sup> This may further prove that the duties of controlling shareholders are potentially ineffective in constraining their conducts. Fourth, remedies for shareholder are very limited. According to the Company Law 2005, the controlling shareholders should be liable in compensation to the company or other shareholders for their breach of duties. Therefore, it can be inferred that the only available remedy for the injured shareholders is compensatory damages. For a listed company, this seems to be no problem since a shareholder can leave the company by selling out his shares after receiving the compensation. However, for the shareholders of a limited liability company, it is not easy for the injured shareholders to leave the company. For example, they may want to leave the company after its controlling shareholders fail to perform their duties, while the only available remedy is pecuniary compensation. Therefore, it is suggested that a right to exit should be provided to the injured shareholders along with compensatory damages.

### **2.3.5 Conclusion**

It cannot be denied that the Company Law 2005 made significant progress in

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<sup>315</sup> Li, *ibid.*, 256.

<sup>316</sup> Article 153 of Chinese Company Law 2005.



constraining misconducts of majority shareholders and management in several ways. Nevertheless, there still exist many defects and thus, functions of these improvements are inevitably affected in protecting the interests of minority shareholders. In view of the growing severe exploitation of minority shareholders and the deteriorative double agency costs in Chinese companies, it is essential and significant that the interests of minority shareholders should be well protected. Without an investor-friendly legal system, the interests of shareholders and the companies would ultimately be injured and the development of capital markets would be severely impeded. As a consequence, in the future many protection mechanisms, such as derivative actions, should be further improved and clarified to prevent misconducts and to promote the standards of corporate governance in China.

## Chapter 3 Derivative Actions in China

### 3.1 Shareholders' Direct Actions in China

#### 3.1.1 Introduction

In China, when the interests of a company are prejudiced by the decisions or actions of directors or senior managers, in certain circumstances, an individual shareholder will be entitled to bring a derivative action against the wrongdoers for the benefit of the company. However, if a shareholder's personal rights are breached by a director or senior manager - that shareholder will be entitled to bring a direct action to the People's Court. This is because the infringed rights are not vested in the company and therefore a derivative action would be an inappropriate means of enforcement for personal claims. Here, an individual shareholder can bring a direct action without abiding by the special requirements of derivative actions and such a case would naturally be treated as a normal litigation. Direct action was formally established in Chinese Company Law 2005 by article 153 which provides as follows:

*If any director or senior manager damages the shareholders' interests by violating any law, administrative regulation or articles of association, the shareholders may lodge a lawsuit in the people's court.*<sup>317</sup>

As such, shareholders are allowed to bring direct actions against directors or seniors

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<sup>317</sup> Article 153 of Chinese Company Law 2005.(translated from Beida Fabao Website with minor amendments)

managers if their rights and interests are violated. However, this article does not specify the circumstances in which shareholders are entitled to do so. Unlike common law jurisdictions where it is possible to classify the grounds for raising personal claims by reference to a series of cases, the basis for a Chinese shareholder's personal action can only be found in statute. Since the above provision does not offer a comprehensive definition of what constitutes a shareholder's interests or rights, it is necessary and important to classify the precise basis upon which such an individual may initiate a direct suit by examining company law.

### **3.1.2 The Grounds for Raising Direct Actions**

#### **3.1.2.1 Defects in Resolutions**

Irrespective of whether a resolution is passed by a general meeting or the board of directors, such a resolution has a direct and strong effect on the interests of individual shareholders, particularly when it is passed to the prejudice of minority shareholders. Company Law recognises this danger and thus grants shareholders the right to bring a direct suit if a resolution is defective in some way. There are two types of defects under Company Law and the legal consequence of each differs.<sup>318</sup>

##### **3.1.2.1.1 Illegal Content**

If the contents of a resolution adopted by a shareholders meeting, a general meeting or the board of directors of a company is in violation of any law or administrative regulation, then such a resolution is null and void. This is because such a resolution normally infringes upon the interests of shareholders. As Company Law and other

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<sup>318</sup> Article 22.

relevant laws and regulations are principally designed to protect the interests of shareholders and the company as a whole, a breach of these laws and regulations would put individual shareholders at risk and must therefore be treated as null and void.

In practice, this type of resolution is not uncommon and can be easily determined. For example, in *Shumin Zhou v Chongqing Jinhong Company*, the shareholders meeting of the Jinhong Company passed a resolution that forty percent of the company's assets would be distributed according to the shareholdings, and the remaining assets would be distributed equally among the employees. However, Shumin Zhou was dissatisfied with this resolution and so brought a direct action claiming that the contents of this resolution violated the law. The Court agreed with this claim and decided that the resolution was null and void for the reason that legal liquidation procedures should be required in advance of distribution.<sup>319</sup> In the case of *Hong Zhang v Shanghai Shenhua Company*, the court ruled that a resolution appointing directors to the board of directors was null and void as the company law stipulates that the directors should be elected by the general meeting rather than the board of directors.<sup>320</sup>

### **3.1.2.1.2 Illegal Procedures**

Even if the content of a resolution does not violate laws and regulations, the resolution may be revocable where the convening of a shareholders' meeting, the board of directors of a company or the voting method used violates laws, administrative regulations or the articles of association of the company.<sup>321</sup> The rationale behind this rule is to protect shareholders' interests to some extent by

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<sup>319</sup> *Shumin Zhou v Chongqing Jinhong Company* (2006).

<sup>320</sup> *Hong Zhang v Shanghai Shenhua Compan* (2006)

<sup>321</sup> Article 22 of Chinese Company Law 2005.

ensuring that the laws regarding the procedure for passing resolutions are fully complied with. One can imagine that the value of the general meeting or the board of directors would be weakened or even diminished if the procedure for calling such a meeting violated relevant laws and regulations, and shareholders could not obtain a remedy. In order to address this problem, the Company Law stipulates that shareholders are entitled to apply to the court for revocation within sixty days of the date when the resolution is passed.

In reality, the above two types of defect in resolutions can cover most cases. In fact, if the interests of shareholders are infringed by a resolution, this is normally because either the content or procedures behind the resolution violate relevant laws and regulations. It is thus obvious that an application for null and void or revocation of a resolution should be founded on the precondition that the resolution has not been passed or adopted in accordance with the company's constitution. However, one situation is neglected by the law. When a resolution does not actually exist or is passed only by the controlling shareholders, other shareholders cannot apply to the court for it to be declared null and void or revoked as this kind of "resolution" is not actually passed or adopted by the general meeting or the board of directors. This is not rare in practice in light of increasing reports of rights abuses by controlling shareholders. Indeed, various courts have different ways of dealing with such cases owing to lack of legislation.<sup>322</sup>

### **3.1.2.2 Infringement of the Right to Know**

Access to information is recognised as a basic condition for shareholders to participate in the management of a company. The Company Law provides that a shareholder shall have the right to view the articles of association, the minutes of

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<sup>322</sup> J. Wu, 'Gongsi Jueyi Xugou de Falv Mangqu' [The Legal Blind Spot of the Non-existence of Resolutions] (2011) 3 *Dongshihui* [Journal of the Board of Directors] 88.

shareholders meetings, resolutions of the board of directors and board of supervisors and the financial and accounting reports of the company.<sup>323</sup> Beside the above information, shareholders are also entitled to view the accounting books and reports of the company. However, considering the importance of these accounting books and reports, the company could refuse such a request if it has reason to believe that the shareholders has an unjust purpose. Here, shareholders are allowed to apply to the court for an order under which the company must provide the shareholder with such material.<sup>324</sup>

After such personal rights were conferred onto individual shareholders, many actions were initiated in the following few years. According to incomplete statistics in Jiangsu province, 1,060 cases of corporate litigation took place during the first year and a half after the new Company Law entered into force. Among these were 137 cases relating to the infringement of the right to know, which was ranked first of a dozen of types of corporate actions.<sup>325</sup> The defects of this right have been examined in the previous chapter. However, two more points regarding the procedural aspect of this right need to be clarified. First, it is not clear whether a common or summary procedure should be applied to litigation on the right to know according to this provision.<sup>326</sup> In practice, such litigation is generally commenced as a common procedure, which has been criticised by many scholars.<sup>327</sup> They argue that it would take at least nine months to conclude a case if it is conducted as a common procedure.

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<sup>323</sup> Article 34(1) of Chinese Company Law 2005.

<sup>324</sup> Article 34(2). For the details on this right, please refer to Chapter 2 part 3.

<sup>325</sup> J. Li, *Gongsi Susong Zhuanti Yanjiu* [Thematic Studies on Corporate Litigations] (Chinese University of Political Science and Law Publishing House 2008) 294.

<sup>326</sup> There are currently two types of procedure in Civil Procedure in China: a common procedure and a summary procedure. The common procedure, as its name shows, is the very common process and applies to most civil cases. The drawback of this procedure is that it normally takes a long time to complete the procedure and its cost is quite high. On the other hand, the summary procedure applies to civil cases in which the facts are evident, the rights and obligations are clear and the disputes are trivial. Cases in which the summary procedure is followed shall be concluded within three months after placing the case on the docket. See Chapter 13 of Civil Procedure law of the People's Republic of China.

<sup>327</sup> J. Li, *Gongsi Susong Zhuanti Yanjiu* [Thematic Studies on Corporate Litigations] (Chinese University of Political Science and Law Publishing House 2008) 317.

This is obviously not favoured by shareholders as justice delayed is justice denied. Therefore, it is strongly urged that litigation regarding infringement of the right to know should be conducted as a summary procedure where the action could be completed within three months of after placing the case on the docket. Second, it is also argued that shareholders should provide relevant security if they wish to bring a suit to protect their right to know.<sup>328</sup> This is intended to balance the interests of the company with that of the shareholders as they could abuse their rights. However, Li believes that the requirement of providing security would put more burdens on vulnerable shareholders and thus hinder shareholders from exercising their rights.<sup>329</sup> In light of the adverse circumstances in which minority shareholders can find themselves, it would be sensible that shareholders are not required to provide security.

### **3.1.2.3 Actions to Withdraw from the Company**

In listed companies, shareholders are free to buy and sell shares in the capital market and thus conferring a legal right in favour of shareholders of public stock companies to be bought out would seem to be pointless.<sup>330</sup> For limited liability companies, there are some restrictions which shareholders have to comply with if they want to leave a company.<sup>331</sup> Shareholders in limited liability companies cannot sell their shares and

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<sup>328</sup> X. Zhou and Y. Mao, 'Qianxi Youxian Zerengongsi Gudong Zhiqingquan de Falv Baohu' [The Legal Protections on the Right to Know in Limited Liability Company] (2004) 4 *Zhejiang Social Science* 87.

<sup>329</sup> J. Li, *Gongsi Susong Zhuanti Yanjiu* [Thematic Studies on Corporate Litigations] (Chinese University of Political Science and Law Publishing House 2008) 318.

<sup>330</sup> Only under one circumstance, can a shareholder require a company to buy his shares. According to the article 143 of Company Law, if shareholders of the company oppose the decision to merge or divide a company made at a general meeting of shareholders, then they are entitled to request the company to purchase their shares.

<sup>331</sup> According to the article 72 of the Company Law, shareholders are free to transfer their shares to other shareholders in a limited liability company. However, if a shareholder wants to transfer his shares to a person other than a shareholder, he must obtain the consent of more than half of all shareholders. The shareholder who intends to transfer his shares shall notify the other shareholder in writing and seek their approval. If those shareholders fail to make any response within thirty days of the receipt of the written notice, then they are deemed to consent to such transfer. Where more than half of the other shareholders do not consent to the transfer, such shareholders should purchase the

leave the company without restriction. Furthermore, it would be difficult for a shareholder to transfer their shares when their interests are damaged by the acts of the company as no one would buy such shares. Therefore, the new Company Law confers certain rights on shareholders entitling them to force the company to buy them out in any one of the following situations:<sup>332</sup> (1) where the company fails to distribute dividends for five consecutive years notwithstanding that the company has generated profits over these years and has satisfied the distribution requirements prescribed by law; (2) in the event of a merger, division or assignment of the company's major assets; (3) when the business term as specified in the bylaw expires or other reasons for dissolution as prescribed in the bylaw occur, and the shareholders' meeting makes the company exist continuously by adopting a resolution to modify the bylaw. Dissident shareholders may raise proceedings in the court if they cannot conclude a share purchase agreement with the company.<sup>333</sup>

Any one of the above three circumstances could be cause for a shareholder to bring a direct action to withdraw from the company. However, the first situation is the most common as shareholders can fall into dispute with the company if each has different ideas about how to manage profits.<sup>334</sup> Under the new statutory rules, if a company does not distribute its profits when it meets the compulsory requirements, dissident shareholders are given the right to raise proceedings forcing the company to buy out

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shares to be transferred. Failure to do so would be deemed to be consent to such transfer. Where the shareholders consent to the share transfer, other shareholders shall have the preemptive right to purchase the shares on equal terms and conditions. However, the Company Law also stipulates that these above rules could be changed if the articles of association have some contrary rules regarding to shares transfers. Considering the nature of limited liability companies, it is reasonable to believe that a transfer would have greater restrictions if the articles of association stipulate otherwise.

<sup>332</sup> This is unlike the UK where there is no equivalent automatic right to be bought out by the company or other shareholders under the UK Companies Act 2006. Instead, the shareholder would have to show that the directors and/or controlling shareholders had run the company in a manner that is unfairly prejudicial to his/her interests under section 994 of the UK Companies Act 2006.

<sup>333</sup> Article 75 of Chinese Company Law 2005. For more details on this, please refer to Chapter 2 part 3 (Protections for Minority Shareholders).

<sup>334</sup> For controlling shareholders, they may wish to retain the profits to expand the scale of operations and broaden the field of investment or simply for their own benefits. Minority shareholders prefer to receive the profits once they are distributable.



their shares. This undoubtedly provides a precious opportunity for shareholders to exit the company if they are not satisfied with its decisions regarding distribution. However, if a shareholder wishes to continue to be a member of the company, he would not be willing to exercise this right as it would result in his loss of status as a shareholder. For that reason, it is strongly recommended that the right of a shareholder to bring an action to compel distribution of dividends should be introduced.<sup>335</sup> With this right, shareholders could receive distributable dividends as well as continuing to be members of the company. In addition, this right could also produce another benefit in preventing controlling shareholders from using the failure to distribute dividends as a means of forcing other shareholders out of the company.

#### **3.1.2.4 Actions to Dissolve a Company**

If a company encounters serious difficulties and continuing to operate will definitely cause heavy losses to shareholder interests, shareholders representing 10% or more of all votes may request a court to dissolve the company if such difficulties cannot be solved by any other means.<sup>336</sup> According to the legislation, four requirements must be met in order to commence such litigation: (1) a company must face serious difficulties during the operation of the business; (2) its continuance must inevitably bring considerable damage to the interests of the shareholders; (3) there must be no alternative method of resolving these difficulties and the dissolution of the company must be the only way to protect the shareholders; and (4) not every individual shareholder is entitled to bring such litigation as only shareholders who hold ten percent or more of the voting rights of all the shareholders of the company may do so.

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<sup>335</sup> J. Li, *Gongsi Susong Zhuanti Yanjiu* [Thematic Studies on Corporate Litigations] (Chinese University of Political Science and Law Publishing House 2008) 351.

<sup>336</sup> Article 183 of Chinese Company Law 2005.

Generally, there are two circumstances in which eligible shareholders are allowed to bring direct actions to dissolve a company. First, where a company is in a deadlock situation, shareholders may apply to the court to dissolve the company. During the operation of a business, a company may face numerous difficult situations. Some of these situations can be resolved while others cannot be dealt with owing to dissent among shareholders. If the dissension leads to the dysfunctioning of directors or officers, the company may fall into a deadlock situation. Here, its continuance would more or less damage the shareholders and dissolution of the company would be a preferable choice. Second, a direct action to dissolve a company can be brought if the interests of the company or its shareholders have been significantly damaged and its continuance has become unnecessary. If controlling shareholders or directors have done something harmful to a company and their behaviour has threatened the fundamental interests of other shareholders, then eligible shareholders can bring an action to dissolve the company. In practice, however, courts are not willing to support plaintiff shareholders' claims for the following reasons: firstly, the dissolution of a company signifies that the life of a company expires and its termination would inevitably affect not only shareholders but also other stakeholders, like employees, suppliers, customers and others. These stakeholders' interests cannot be neglected or at least cannot be the cost for protecting shareholders. Second, one of the purposes of the Company Law is to encourage business: article 1 of the Company Law 2005 points out that the law is enacted in order to promote the development of the socialist economy.<sup>337</sup> The decision to dissolve a company is obviously not an appropriate way of promoting the economic development and thus courts are not inclined to accept a plaintiff's request unless it is necessary to do so. Third, even if the application for dissolving a company fully meets the aforementioned four

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<sup>337</sup> The complete article 1 of the Company law is "this law is enacted for the purposes of regulating the organization and operation of companies, protecting the legitimate rights and interests of companies, shareholders and creditors, maintaining the socialist economic order, and promoting the development of the socialist market economy." (translated from Beida Fabao Website with minor amendments)

requirements, courts would normally attempt to mediate such a case initially and try to encourage the parties to reach a settlement avoiding dissolution. On the whole, as Shu maintains, the institution of dissolving a company is not the best way to tackle deadlock problems because it challenges the principle of corporate autonomy, creating new unfairness to other stakeholders and generating a high cost in its implementation.<sup>338</sup> Thus, courts should be extremely cautious in deciding whether a company should be dissolved.

### **3.1.2.5 False Statements in Listed Companies**

If shareholders suffer losses owing to false statements made in securities trading, they are allowed to bring a direct action to compensate any damage. Thus, where a prospectus, measures for financing through issuance of corporate bonds, financial statement, listing report, annual report, midterm report, temporary report or any other information disclosed by an issuer or a listed company has any false record, misleading statement or major omission, creating losses for investors, the issuer or the listed company shall be liable to pay compensation. Any director, supervisor, senior manager or any other person of the issuer or the listed company directly responsible is subject to joint and several liability, unless they are able to prove exemption from any fault. Where any shareholder or actual controller of an issuer or a listed company is at fault, they are subject to joint and several liability for compensation together with the relevant issuer or listed company.<sup>339</sup>

It should be noted that the above subjects with potential liability for investors' losses have different ways of assuming their liabilities. Issuers or listed companies assume no-fault liability which means that they have to compensate the investors' losses

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<sup>338</sup> J. Shu, 'The dissolution of the company should be carefully decided' (2011) 36 *Lilun Yanjiu* [The Journal of Theory Research].

<sup>339</sup> Article 69 of Chinese Securities Law.

regardless of whether they are at fault as long as the losses are incurred by false statements. Directors, supervisors and senior managers of a company assume presumed-fault liability which means that they are presumed to be at fault unless they can prove otherwise; they are thus liable for losses. Third, shareholders or actual controllers of the issuer or listed company are not considered to be liable for compensating investors unless they can be proven to be at fault for the losses.

### **3.1.3 Distinctions between Direct Actions and Derivative Actions**

Direct actions have some features or forms in common with derivative actions: first, plaintiffs are shareholders and defendants are normally directors or senior managers; second, directors or senior managers have done something wrong during the operation of the business; third, the interests of individual shareholders are damaged by these wrongful acts directly or indirectly. In spite of these common features, the differences between these two actions are considerable and it is of great significance to understand these distinctions. First, Direct actions and derivative actions have their own respective distinctive features. This means that the fact that derivative actions cannot be replaced by direct actions even if the latter could provide a strong protective mechanism for shareholders. Second, it is helpful for shareholders to protect their interests in a better way by choosing the correct form of action.

#### **3.1.3.1 Different Purpose**

The purpose of a direct action is to safeguard an individual shareholder's interests while the intention of a derivative action is to protect the interests of a company. This is a fundamental distinction between these two actions as a direct action is designed to protect the particular interests of a particular shareholder while a derivative action

is enacted to provide a fair opportunity for minority shareholders to protect the company as a whole. Although the side effect of a derivative action produces benefits for shareholders, its direct target is not to safeguard the shareholders themselves but the company.

### **3.1.3.2 Different Qualifications of Plaintiffs**

Any shareholder is entitled to bring a direct action against wrongdoers as a result of the infringement of his personal interests. On the other hand, not every individual shareholder is allowed to raise a derivative action because of the duality of the right to bring such action. The first aspect is that shareholders are the members of the company and the second aspect is that they raise the proceedings on behalf of the company. From this point of the view, it is reasonable that not every individual shareholder can commence litigation as all can act on behalf of the company. Therefore, shareholders have to meet certain qualifications in order to be plaintiffs in derivative actions.<sup>340</sup>

### **3.1.3.3 Different Beneficiaries**

For a direct action, any damages recovered will go to a plaintiff shareholder instead of the company as it is the plaintiff shareholder himself who suffered the damage. By contrast, the benefits from a derivative action will accrue to a company if the litigation is successful. A plaintiff shareholder can only receive a *pro rata* share of the gains achieved by this action. The rationale behind this is that the right of an individual shareholder to bring a derivative action is derived from the company as it is the company itself who suffers the damage rather than the shareholders. Theoretically or practically, the company is the real claimant in interest while the

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<sup>340</sup> In China, shareholders in stock companies must separately or aggregately hold 1% or more of the total shares of the company for 180 consecutive days or more in order to bring derivative actions.

plaintiff shareholder is only the nominal claimant and thus any compensation or relief obtained will flow directly to the company.

#### **3.1.3.4 Different Requirements for Raising Proceedings**

In order to prevent shareholders from abusing their right to commence derivative actions, the Company Law has set out some preconditions for exercising this right. Without meeting these requirements, a shareholder's application would not be accepted by the courts. For example, In China eligible shareholders have to make a request in writing to the board of supervisors to initiate a lawsuit if a director or senior manager has done something wrong to the company. Alternatively, the shareholders can demand that the board of directors raise such lawsuit if a supervisor's behaviour is harmful to the company. If the request or demand is refused or they fail to commence such a lawsuit, shareholders are then entitled to exercise this right.<sup>341</sup> This demand requirement is designed to balance the interests of the company and the shareholders. It is expected that shareholders should first make every effort to resolve the issues at hand within the company. By contrast, there is basically no precondition before an individual shareholder can bring a direct action against wrongdoers. As long as the personal interests of the shareholder are infringed, they are entitled to bring direct actions without meeting any special requirements.

#### **3.1.3.5 Different Requirements of Settlement**

It is not unusually for plaintiffs and defendants to reach a settlement during litigation. Under the background policy of maintaining a harmonised society in China, settlement is strongly encouraged, particularly in commercial and marital cases. In direct actions, both parties are free to make a settlement and courts will not interfere

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<sup>341</sup> Article 152 of Chinese Company Law 2005.

with such a settlement as it is treated as a contract. However, settlements in derivative actions are not that simple. Generally, their effectiveness needs to be approved by the court because an action is brought by the shareholder acting on behalf of the company. The settlement, if reached, would affect not only the plaintiff shareholder himself but also other shareholders in the company. Therefore, the court has to step in to have a say on the settlement in order to protect other shareholders and the company as a whole. It is also argued that the contents of the settlement should be disclosed to other shareholders so that the court can hear more views before making any decision.

### **3.1.3.6 Different Scope of Claim Preclusion**

Claim preclusion, also known as *res judicata*, means that a case which has been judged as a final decision cannot be appealed or raised again, either in the same court or in a different court. This legal concept is mostly intended to avoid the unnecessary waste of court resources and ensure an efficient judicial system.<sup>342</sup> In a direct action, neither the plaintiff nor the defendant can raise the proceeding again on the basis of the same facts and causes because of the *res judicata* principle. However, other shareholders whose interests have been damaged by the same defendant can disregard this principle and bring a direct action against that defendant without violating this principle. On the other hand, the *res judicata* in a derivative action could be extended to other shareholders who have not participated in the litigation. Here, other shareholders are not allowed to bring another derivative action if that

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<sup>342</sup> Judge Stewart explained the rationale of this legal concept that “Federal courts have traditionally adhered to the related doctrines of *res judicata* (claim preclusion) and collateral estoppels (issue preclusion). Under RJ, a final judgment on the merits of an action precludes the parties . . . from re-litigating issues that were or could have been raised in that action. Under collateral estoppel, once a court has decided an issue of fact or law necessary to its judgment, that decision may preclude re-litigation of the issue in a suit on a different cause of action involving a party to the first cause. As this court and other courts have often recognized, *res judicata* and collateral estoppel relieve parties of the costs and vexation of multiple lawsuits, conserve judicial resources, and by preventing inconsistent decisions, encourage reliance on a adjudication. See *Allen v McCurry* 499 U.S.90.94,101 S.Ct.411 (1980).

action had been previously raised regardless of the result of the suit. The reason behind this is that a derivative action is brought on behalf of the company and thus other members of the company cannot initiate such proceedings again even if the litigation is unsuccessful. For a direct action, the principle of *res judicata* is only confined to the parties themselves and thus it will not affect other shareholders' rights to bring a personal action.

### **3.1.4 The Connection between Direct Actions and Derivative Actions**

It is not difficult to conclude from the above that the most fundamental distinction between direct actions and derivative actions is the difference in their purpose. The derivative action aims to protect the interests of the company while the direct action is intended to safeguard the personal interests of individual shareholders. This difference results from the issue of who got hurt first. The consideration is that if the company suffers the injury first, then shareholders have to use a derivative action in order to protect the company. They are not entitled to bring direct actions because the shareholders' loss in value is a consequence of a prior injury sustained by the company, regardless of how real and substantial the loss is.

Normally the line between these two actions is not difficult to draw, but sometimes they can be mingled in practice. Consider the following example: Company A was planning to sell a property below the market price to its controlling shareholder and has signed the contract. According to the Company Law 2005, this transaction has to be approved in the general meeting in order to be effective. Thus the company convenes a general meeting and passes a resolution to authorise that transaction. However, the controlling shareholder also participated in the meeting and voted in this matter which violates the articles of association. Under this circumstance,



shareholders are entitled to bring a derivative action as the transaction apparently injures the interests of the company. At the same time, shareholders are also allowed to bring a direct action because the procedure for convening the general meeting has violated the articles of association. In such a situation, the Company Law does not provide a solution. Theoretically, shareholders might choose either a direct action or a derivative action to safeguard their interests while in practice they would prefer direct actions considering the unfeasibility of rules regarding derivative actions in China.

In the US, direct actions and derivative actions can also overlap. A typical example is where a plaintiff shareholder alleges that his voting rights were contravened and that the underlying transaction on which the shareholder voted was harmful to the company. Here, the shareholder is allowed to seek an injunction in a direct action or raise a derivative suit for seeking monetary recovery. The American Law Institute adopted the majority rule that a shareholder can commence and maintain both actions simultaneously.<sup>343</sup> This means that a shareholder is not forced to choose either action and the dismissal of the derivative action would therefore not bar the continued direct action. Unfortunately, the issue of whether compensation in one action should be offset in any way against the other is not addressed by the ALI.

A derivative action could also be characterised as a direct action in closely held corporations in the US. This policy originated from the *Donahue* case in which the court decided that a closely held corporation can be treated as essentially an incorporated partnership and thus a minority shareholder could sue individually even when the action alleges a corporate injury.<sup>344</sup> The rationale behind this is that both

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<sup>343</sup> Section 7.01(c) of Principles of Corporate Governance: Analysis and Recommendations (ALI) states that “if a transaction gives rise to both direct and derivative claims, a holder may commence and maintain direct and derivative actions simultaneously, and any special restrictions or defenses pertaining to the maintenance, settlement, or dismissal of either action should not apply to the other.

<sup>344</sup> *Donahue v Rodd Electrottype Company of New England*, 367 Mass. 578, 328 N.E. 2d 505 (1975).

closely held corporations and partnerships are virtually interchangeable business forms which make the difference of their legal treatment unnecessary. Furthermore, the procedural requirements of derivative actions, such as the demand requirement, are pointless for the persons who are effectively incorporated partners. Last but not least, injury to the corporation cannot be distinguished from injury to the shareholders in the context of a closely held corporation with only a handful of shareholders. On the other hand, there is a counter-argument that the consequence of characterizing an action as direct will be unfair to corporate creditors as the compensation recovered from the derivative action goes to the company which would benefit the creditors. The ALI recognized these two arguments and thus took a compromise position that the court has discretion to treat a derivative action as a direct action if it finds that to do so will not (1) unfairly expose the corporation or the defendants to a multiplicity of actions, (2) materially prejudice the interests of creditors of the corporation, or (3) interfere with a fair distribution of the recovery among all interested persons. Although this approach is criticized for not providing sufficient guidance for the courts about when to override the direct/derivative distinction and not being sufficiently sensitive to the way the distinction protects the deal among shareholders,<sup>345</sup> it is widely accepted that the ALI approach is a better way to deal with the relation between derivative and direct actions in the context of the closely held corporations.

In the UK, a personal claim can be joined in the same proceedings as a derivative claim.<sup>346</sup> The CPR 7.3 permits that a claimant to use a single form to start all claims which can be conveniently disposed of in the same proceedings.<sup>347</sup> However,

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<sup>345</sup> For details, see D. S. Kleinberger, 'Direct versus Derivative and the law of Limited Liability Companies' (2006) 58 *Baylor Law Review* 63-138.

<sup>346</sup> It used to be thought that it was not possible to combine a personal and a derivative claim in the same litigation, but Vinelott J. permitted in the case of *Prudential Assurance Co Ltd v Newman Industries Ltd (No.2)* Ch.257, 303-304. The court of Appeal [1982] did not dissent from this view. See P. L. Davies, *Principles of Modern Company Law* (9<sup>th</sup> edn, Sweet & Maxwell 2012) 624.

<sup>347</sup> The previous formulation of the rule (RSC Ord 15, r 1(1)(c)) was very restrictive. It required a leave to join the causes of action and the granting of that leave was uncertainty depending on the facts.

plaintiff shareholder damages cannot be recovered from the defendants if such losses merely reflect losses suffered by the company. This so-called no reflective loss is exemplified by the case of *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) in which the Court of Appeal stated:

*[A Shareholder] cannot . . . recover damages merely because the company in which he is interested has suffered damages. He cannot recover a sum equal to the diminution in the market value of his shares, or equal to the likely diminution in dividend, because such a 'loss' is merely a reflection of the loss suffered by the company. The shareholder does not suffer any personal loss. His only loss is through the company, in the diminution in the value of the net assets of the company, in which he has (say) a 3% shareholding.*<sup>348</sup>

A shareholder cannot recover a loss which is simply a reflection of the company's loss even if the shareholder's cause of action is independent of the company's.<sup>349</sup> This principle is justified for several reasons. First, it can prevent the defendant from paying double compensation. It would be unfair for the defendant to pay both the company and the plaintiff if he fails to win the litigation without this principle. Secondly, the compensation that must go to the company first would not prejudice the interests of the company's creditors. Thirdly, the right to distribute a company's assets is normally entrusted by the articles to the board and not to individual shareholders. This principle can be supported by the no reflective loss principle as both of these principles reflect the centralised management of the company through the board.<sup>350</sup> On the other hand, some argue that preventing double pay could be avoided simply by paying the shareholder first instead of the company. The company's creditors would not be prejudiced if the company has distributable assets. Furthermore, it is not fair for shareholders if the company may not recover its loss and thus their own loss is not made good through the company.<sup>351</sup> It is highly unfair

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See, *Cooke v Cooke* [1997] 2 BCLC 28.

<sup>348</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1982] Ch 204, 22g-223b.

<sup>349</sup> See *Johnson v Gore* [2002] 2 A.C. 1, HL.

<sup>350</sup> See P. L. Davies, *Principles of Modern Company Law* (9<sup>th</sup> edn, Sweet & Maxwell 2012) 625.

<sup>351</sup> *Ibid.*

for individual shareholders if the defendant's act rendered the company incapable of enforcing its claim. This point has been recognized in *Giles v Rhind* in which the Court of Appeal refused to apply the no reflective loss principle because the wrongful act of the defendant had put the company in a position where it could not bring the action.<sup>352</sup>

From the above discussion, it seems that China's rule in addressing the relation between direct action and derivative action is similar to the no reflective loss principle in the UK. As mentioned above, a Chinese shareholder has to choose either a direct action or a derivative action in the situation where both of these actions are mingled. In this sense, the law supports the idea that defendants do not need to make double compensation as a result of their wrongful acts. In view of the current unfeasible rules of derivative action system, shareholders would prefer to bring direct actions to safeguard their interests. However, this might harm a company's creditors as the recovery could go to a company if a derivative action is initiated by shareholders. This is particularly so when a company is in financial difficulty and its asset may not sufficient enough to pay creditors. As a consequence, the compromised approach which ALI adopted in treating a derivative action as a direct action can be borrowed. For example, the law can stipulates that the court has discretion to treat a direct action as a derivative action if it finds that not to do so will (1) unfairly expose the company or the defendants to a multiplicity of actions, (2) materially prejudice the interests of creditors of the company, or (3) interfere with a fair distribution of the recovery among all interested persons. However, this rule undoubtedly needs to be examined in practice and the detailed guidance of this rule could be provided during the application of this rule.

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<sup>352</sup> *Giles v Rhind* [2003] Ch. 618, CA.

### **3.1.5 Summary**

An individual shareholder is entitled to bring a direct action under certain circumstances, for example, when there are some defects in resolution. This right vested in shareholders is one of the means to safeguard the interests of minority shareholders. From this perspective, it seems that derivative action may play a less important role in protecting minority shareholders if a direct action system is effective. However, these two mechanisms have their own distinctive aspects. For example, the purpose is different as a direct action aims to safeguard individual shareholders' interests while the intention of a derivative action is to protect the interests of a company. As such, even if direct action institution is effective in protecting shareholders' interests, it does not mean that derivative action could be replaced as it still has a key role to play. Last, although direct action and derivative action have differences in many aspects, they may be mingled in certain situations.

## **3.2 Derivative Actions in China I**

### **3.2.1 The Background to the Chinese Company Law**

Before examining the detailed rule of derivative action, it is necessary to briefly introduce the background of the Chinese company law. The current incarnation of China's Company Law was first enacted in 1993 and revised in 2005. The history of China's Company Law is much shorter than the history of China as a country and it is therefore unavoidable that this legislation has many drawbacks. However, the first

company law to be introduced in China traces its origins back to the Qing government (the Qing Dynasty). Although these old company laws were completely abolished after the Communist Party took power and established a new China (the People's Republic of China), they are nonetheless useful in considering the background to China's legislation as the past might tell the future.

### **3.2.1.1 The History of Chinese Company Law before the Establishment of the PRC**

At the beginning of the twentieth century, the Qing Dynasty faced many pressures from within and without China: the people under the Dynasty's rule demanded rights and opportunities to forge a better life and western countries were demanding that the government open up the market. Within this context, the first Company Law (*Gongsi Lv*) was drafted by the Imperial Law Codification Commission in 1904 and entered into force the same year. This legislation aimed to create a better environment for businesses to flourish and was based on Japanese and English company law, though in much abbreviated form.<sup>353</sup> The rationales behind this legislation were various but three main objectives have been identified. The first is that the Qing Dynasty wanted to use commercial law, particularly company law, as a tool to promote the competitive edge of its domestic enterprises and economic development.<sup>354</sup> The second objective was to cater for the needs of the western countries as China's lack of commercial law had become a concern and even an obstacle for westerners seeking to conduct business in China.<sup>355</sup> The third aim was to strengthen the power

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<sup>353</sup> W. N. Goetzmann and E. Koll, 'The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control' In R. K. Morck (eds.), *A history of Corporate Governance around the world: Family Business Groups to Professional Managers* (University of Chicago Press 2005) 181-184. Some also argue that this law was mainly inspired by German and Japanese laws. However, it is actually not contradiction since many aspects of Japanese law were borrowed from Germany. See X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 241.

<sup>354</sup> C. Li, 'The Kung-ssu-lu of 1904 and the Modernization of Chinese Company Law' (1974) 10 *Chengchi University Legal Review* 171-221.

<sup>355</sup> In the Sino-British Treaty of Commerce of 1902, Great Britain had proclaimed its willingness to

of central government to control local authorities. These three objectives were never achieved as the new law was not given enough time to be implemented owing to the collapse of the Qing dynasty in 1911.

The fall of the Qing and the rise of the early-republic (*Beiyang*) government afforded a great opportunity to revise China's company law substantially and significantly. However, its company law was only partly revised, and entered into force in 1914. This so-called Ordinance Concerning Commercial Associations (*Gongsi Tiaoli*) has more articles than the first Law and has thus been regarded as laying the foundations for future company law with regard to structure, content and values.<sup>356</sup>

In 1927, the central government of the Republic of China was established and the legislative process was accelerated in order to control the whole country effectively. Under this background, the codification of previous legislation was promoted and promulgated. The Company Law, as one of the particularly important commercial laws, was included in this process and codified in 1929. Although this new Company Law (*Gongsi Fa*) was also based on the previous Ordinance Concerning Commercial Associations (*Gongsi Tiaoli*), 90 of its 233 provisions were modified from its predecessor and the concept of 'restricting private capital' (*Jiezhi Ziben*) so as to protect the interests of minority shareholders was introduced for the first time.<sup>357</sup> This new Company Law was widely accepted as a true modern form of company law in Chinese history.

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relinquish its extraterritorial privileges "when she is satisfied that the state of Chinese laws, the arrangement for their administration, warrant her doing so" ( T. Chien, *The Government and Politics of China* (Harvard University Press 1950); See also W. C. Kirby, 'China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China' (1995) 54 *The Journal of Asian Studies* 43-63.

<sup>356</sup> S. Wei, 'Gongsifa zai Zhongguo de Bainian Licheng' [The Historical Development of Chinese Company Law' (2005) 2 *Huadong Zhengfa Xueyuan Xuebao* [The Journal of Southeast University of Political Science and Law] 72-78.

<sup>357</sup> For instance, article 129 provides that "the voting power of any shareholder could not exceed one-fifth of the votes of all shares, no matter what his ownership".

After the War of Resistance against Japan (1937-1945), China witnessed a significant change not only politically but also in its economic structure. Accordingly, many laws had to be amended or abolished to serve the government of these times. The Company Law (*Gongsi Fa*) was substantially revised in 1946 in order to encourage private corporations and attract foreign investments. It was in this Company Law that limited liability companies (*Youxian Zeren Gongsi*) were introduced for the first time and foreign companies were regulated and legislated for in a separate chapter. It was perceived that this Company Law was influenced significantly by the United States and thus many rules and regulations were borrowed from the US partly owing to the close relationship between the Chinese government (*Nanjing Guomin Zhengfu*) and the US.

### 3.2.1.2 The Absence of Chinese Company Law before 1993

The victory of the Communist Party and the new establishment of the People's Republic of China led to the declaration that all laws be eliminated because "the legal premise of the establishment of the People's Republic of China is that all the laws which were enacted by the Nationalist Party (Kuomintang) should be smashed completely without any hesitation".<sup>358</sup> As a consequence, the Company Law was entirely abolished and other forms of regulation were formulated in order to fill the gap, as many private companies were still registered at that time.<sup>359</sup> The Interim Regulations on Private Enterprises (*Siying qiye zhanxing tiaoli*) were formulated and implemented to nationalize those private enterprises. After the socialist transformation, the economy was mainly occupied by national and collective

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<sup>358</sup> D. Cai, *Lishi yu Biange: Xinzhongguo Fazhi jianshe de Licheng* [History and Reform: The Development of New Chinese Legal System (Chinese University of Political Science and Law Press 1999) 2

<sup>359</sup> After the establishment of People's Republic of China, 11,298 private corporations were registered. See Z. Zhang, *Jiannan de Bianqian: Jindai Zhongguo Gongsi Zhidu Yanjiu* [The Difficult Transplantation: Study on Modern Chinese Company] (Shanghai Academy of Social Sciences Press 2002) 266.



companies which left no room for private enterprise. Thereafter, the planned economy was established and private enterprises or foreign companies were basically eliminated. The death of Chairman Mao, however, caused a significant change in China's political and economic system. The economic reform and open policy were initiated leading to many private and foreign companies being revived and gradually established which called for regulation and legislation. The absence of commercial law in China obviously constituted a significant obstacle to promoting economic development and therefore efforts were made to put trade and commercial transactions within the framework of legislation. The first attempt in this regard was to regulate foreign companies owing to increasing foreign investment. The Law of the People's Republic of China on Chinese-Foreign Joint Ventures (*Zhonghua renmin gongheguo zhongwai hezi jingying qiyefa*) was first enacted in 1979 and the process to regulate Chinese private companies was followed by the General Principles of Civil Law (*Minfa tongze*). Another two important legislative documents regarding foreign investment were published, occasioning the establishment of new types of company: the Law of the People's Republic of China on Foreign-Capital Enterprises (*zhonghuarenmingongheguo Waizi Qiyefa*) in 1986 and the Sino-foreign Cooperative Joint Venture Law (*zhongwai hezuojingying qiyefa*) in 1988, respectively. These three laws, which generally governed foreign companies, laid the essential foundations for the enactment of the Company Law of the People's Republic of China (*Zhonghua renmin gongheguo gongsifa*) in 1993.

### **3.2.1.3 The Adoption of the Chinese Company Law**

A decade after the implementation of the reform and opening policy, the disparate documents, designed to regulate business and companies could not meet the new requirements of economic and social development.<sup>360</sup> Therefore, the Company Law

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<sup>360</sup> In addition to the above three legislative documents regulating the foreign companies, the regulations governing the domestic companies were so scattered and unsystematic. Since there is no

was adopted on 29 December 1993 and entered into force on 1 July 1994 for the first time since the establishment of People's Republic of China (hereinafter referred to as the Company Law 1993). However, the primary purpose of the Company law 1993 was to serve the reform of SOEs, not to promote all the different types of Company.<sup>361</sup> Many articles were enacted embodying the characteristics of a socialist economy, which today seem absurd.<sup>362</sup> Although it cannot be denied that the law played an important role in reforming SOEs,<sup>363</sup> the Company Law 1993 has been criticised for becoming an obstacle to accelerating economic development. This is for the following reasons: first of all, it was criticised that many provisions were outdated and thus fell behind practice as private companies were increasingly emerging and the path of SOE reform was changed.<sup>364</sup> Furthermore, the provisions stipulated in the Company Law 1993 barely provided protections for minority shareholders and thus the majority shareholders and directors had strong incentives and the ability to abuse their powers. Third, it was very difficult to establish and operate a company as there were many restrictions under this law.<sup>365</sup> It is argued

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unify law, different state departments and local authorities had issued various ordinances and regulations. For example, "Zhonghua Renmin Gongheguo Siying Qiye Zanxing Tiaoli" [The PRC's Provisional Regulations on Privately Owned Enterprise] was promulgated in 1988 aiming to regulate the privately owned limited liability companies. In 1992, Shenzhen which is one of the five special economic zones issued "Shenzhen Shi Gufen Youxian Gongsi Zanxing Guiding" [the Provisional Regulations on Stock Companies of Shenzhen] regulating the stock companies. In 1992, the State Commission for Economic System Reform published two important regulations concerning to the two types of companies: Gufen "Youxian Gongsi Guifan Yijian" [Standard Opinions on Companies Limited by Shares] and the "Youxian Zeren Gongsi Guifan Yijian" [Standard Opinions on Limited Liability Companies].

<sup>361</sup> See X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 243.

<sup>362</sup> For example, article 4 stipulated that "ownership of the State-owned assets in a company belongs to the state." Article 5 further stipulated that "under the state's macro regulation and control adjustment, a company organizes its production and operations autonomously according to market demand with the objective of raising economic efficiency and labour productivity and preserving and increasing the value of assets"

<sup>363</sup> See X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 244.

<sup>364</sup> For example, article 20 stipulated that a limited liability company should be established through joint investment by not fewer than 2 but not more than 50 shareholders. This provision clearly prohibited the possibility of forming one man company while in reality, many one man companies were established in a real sense. Undoubtedly this gap between law and practice would increase the moral risk of nominal shareholders and thus it is detrimental to the business environment.

<sup>365</sup> For example, if a company is established primarily to engage in production, the minimum capital should not be less than 500,000 Yuan which was huge money in 1990s See article 23(1). Shareholder

factors such as insufficient experience and changeable circumstances during the transitional period contributed to the above problem.<sup>366</sup>

Recognising that the law was poorly drafted, the Company Law 1993 was revised in 1999 and 2004, respectively. However, these two amendments were very minor and thus some major issues were left unresolved. In 2005, the Company Law was again amended, and this time its contents were significantly and substantially changed (hereinafter referred to as the Company Law 2005). Although there are still many defects in this legislation, it is generally believed that Company Law 2005 has made some progress in the following respects: first, it makes it much easier and more convenient to set up a company as the requirements of establishing a company are much relaxed.<sup>367</sup> Secondly, it provides stronger protections for minority shareholders as the rights conferred onto shareholders have been strengthened and made more actionable and the duties directors owe to the company are also established.<sup>368</sup> Thirdly, it reduces government intervention and encourages a company's autonomy.<sup>369</sup> Fourthly, it stipulates for the very first time that a company should bear some social responsibility during business operations.<sup>370</sup> Fifth, the interests of creditors or third parties with whom a company contracts are also emphasized and the corporate veil can now be pierced under given conditions.<sup>371</sup>

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may contribute their capital in the form of case, as well as in the forms of tangible goods, industrial property, non-patented technology and land use rights, however, the latter should not exceed 20 percent of the total registered capital. See article 24.

<sup>366</sup> M. Gu, *Understanding Chinese Company Law* (2<sup>nd</sup> edn, Hong kong University Press 2010) 3.

<sup>367</sup> For example, the minimum capital to set up a limited liability company has lowered down to 30,000 Yuan and the amount of the capital contributions in cash is also lowered to no less than 30% of the registered capital. In addition, one person is now allowed to establish a limited liability company.

<sup>368</sup> For the details on this, please see Chapter 2 part 3.

<sup>369</sup> The Company Law 2005 confers more rights on company and the articles of association could make any provision as long as it does not violate the mandatory norm. For example, shareholders normally shall be distributed with the dividends based on the percentages of the capital that they actually contributed, but this would not be applied if shareholders have different agreements in the articles of association. See article 35 of Company Law 2005.

<sup>370</sup> Article 5 stipulates that "When conducting business operations, a company shall comply with the laws and administrative regulations, social morality and business morality. It shall act in good faith, accept the supervision of the government and general public, and bear social responsibilities.(translated from Beida Fabao Website with minor amendments)

<sup>371</sup> Article 20 stipulates that "where any of the shareholders of a company evades the payment of its

### 3.2.1.4 Implications of the legislative process of Chinese Company Law

It may initially seem useless to give an introduction about the history of Chinese Company Law since such outdated legislation has no impact on modern society. However, there are some implications associated with this legislative process, which are still valuable for corporate law reformers.

#### 3.2.1.4.1 How Company Law Lies at the Frontier of Reforms at Different Stages

The substantial alteration of the legal system in the late Qing Dynasty began after the enactment of the Company Law (*Gongsi Lv*) in order to accommodate the increasing pressures of that time. The establishment of company law made the Qing Dynasty aware that the only way to save and revive the nation was to develop the economy and enter the path of industrialization. Company law, as one of the main commercial laws regulating various transactions, is extremely important in promoting economic development and thus ought to be at the frontline of reforms. Even after the establishment of the People's Republic of China, company law still played a key role in enhancing economic reform. For instance, the Law of the People's Republic of China on Chinese-Foreign Joint Ventures (*Zhonghuarenmingongheguo Zhongwaihezijingying Qiyefa*) was enacted to attract foreign investment, introduce foreign advanced technology and attempted to break the ice of the planned-market. After the *Tiananmen Square*, the left wing in the Communist Party was strongly against the economic reform and declared that the planned-market should be maintained and private enterprises be controlled by the government. It was against

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debts by abusing the independent status of legal person or the shareholder's limited liabilities, if it seriously injures the interests of any creditor, it shall bear several and joint liabilities for the debts of the company. (translated from Beida Fabao Website with minor amendments)

this background that the real sense of Company Law 1993 was endowed to encourage private enterprises and boost the confidence of those doubtful about the market economy. Furthermore, China's entry into WTO in 2001 also required significant legal alteration in almost every aspect of economics and Company Law 2005 was thus necessary in order to cater for this reform.

#### **3.2.1.4.2 Most Rules of Chinese Company Law Transplanted from Western Countries**

It is widely accepted that the traditional China did not have a mature commercial law until the late Qing Dynasty. The collapse of the old legal system and the establishment of brand new legal institutions undoubtedly required transplants from other jurisdictions. The first Company Law (*Gongsi Lv*) was basically borrowed from English and Japanese law as noted above, though its implementation was not successful partly owing to the deteriorating social and economic environment. Subsequent company laws were revised on the basis of this document and thus many rules have western characteristics, particularly from the US, UK and Germany. It is argued that the reason behind the failure of the old company laws (1904-1946) could be that China has blindly adopted many rules from western countries without paying attention to Chinese traditional culture.<sup>372</sup> It is undeniable that the implementation of those old company laws was unsatisfactory. However, one cannot expect that the company law would have a great positive impact on economic development in light of the changeable social conditions during that period. Many reasons, such as the social instability, corruption, the privilege of bureaucratic corporations and war might well account for this unsatisfactory development.<sup>373</sup> Even when it was possible for China to create its own systems by using local resources during the

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<sup>372</sup> X. Li, 'Guanyu Jiuzhongguo Gongsi Lifa de Ruogan Sikao' [Reflections on Old Chinese Company Law] (1997) 3 *Faxue* [The Journal of Law Science] 26-29.

<sup>373</sup> See Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 241.

revision of Chinese Company Law in 2005, this did not mean that it was unnecessary to introduce and adopt rules and institutions from other countries.<sup>374</sup> In fact, legal transplant remains necessary and inevitable in China. One of the rationales for this is that it is much easier to borrow rules that have been used for a long time in other countries than create rules without having tested them first. The increasing development of globalisation which requires the convergence of corporate law also accounts for such transplantation.<sup>375</sup>

#### **3.2.1.4.3 Innovation was never absent**

Admittedly, most of the rules in the different stages of China's company law were transplanted from other jurisdictions because of a lack of mature commercial law and transaction practices in China. However, innovation was never absent each time company law was amended. The first Company Law (*Gongsi Lv* 1904) mixed Japanese and English law, though this was not as successful as expected. The Company Law in 1929 (*Gongsi Fa*) entered into force as a slip law rather than as part of commercial law.<sup>376</sup> The subsequent Company Law (*Gongsi Fa* 1946), based on the previous law, made several innovations: the terms company and foreign company were clearly defined for the first time; penal provisions were classified into related provisions so that the consequences of violation could be clearly understood; and the direct intervention of government in corporations was decreased and thus companies had more power to conduct business. Although this kind of innovation was quite common in western countries, it marked significant progress for China considering the historical limitations during that period. Even now, innovation on the basis of transplantations continues.

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<sup>374</sup> For example, the introduction of independent directors and appraisal right from the US and the two-tier system from Germany. See Company Law 2005 articles 52, 74 and 123.

<sup>375</sup> For the details on legal transplant theory, please refer to Chapter 1.

<sup>376</sup> This is a progress in the sense that China, as a civil law jurisdiction, seeks to codify every law.

### **3.2.2 The Development of Derivative Actions in China**

Having introduced the historical development of Chinese company law, it is now necessary to examine derivative actions in China. As mentioned above, the first Chinese Company Law was enacted in 1904; though derivative actions were not introduced at that time. This is understandable considering China's insufficient experience of legislating company law and the changeable social environment. The absence of derivative actions continued as all laws and regulations were completely eradicated after the establishment of People's Republic of China. The Communist government did not enact any commercial law to fill the gap as the target of the economy was to eliminate private ownership and implement the policy of state ownership. The market-oriented economy was deemed to be a capitalist economy and should thus be replaced by the planned economy. In light of this, it was impossible to confer upon shareholders the right to bring derivative actions against directors as there was only one shareholder in the company (the State). Although the implementation of the reform and opening policy in 1978 revived the private economy, derivative actions remained beyond the sight of legislators. Only after the enactment of Company Law 1993 did derivative actions and relevant cases in practice attract the attention of legislators and scholars. Hereafter, the development of derivative action in China can be divided into two stages: development prior to Company Law 2005 and development after this legislation.

#### **3.2.2.1 The Development of Derivative Actions prior to Company Law 2005**

##### **3.2.2.1.1 Company Law 1993**

Company Law 1993 contained several protective mechanisms for shareholders.<sup>377</sup> For example, Article 63 stipulates that directors, supervisors or managers are liable to pay compensation for damage resulting from their violation of provisions under the law, administrative regulations and the company's articles of association. Although these provisions provided a legal basis for shareholders to commence litigation against wrongdoers, it failed to clearly establish whether shareholders are allowed to bring derivative actions if a company is not willing to sue or is prevented from bringing such litigation. It is even argued that these mechanisms have never been exercised as derivative actions in practice.<sup>378</sup>

In addition to the above, one article is regarded as the “single most important” legal provision for shareholders in the Company Law 1993.<sup>379</sup> Thus, article 111 provides:

*If the resolutions of a meeting of shareholders or the board of directors have violated the law, administrative regulations or infringed shareholders' legal rights and interests, the shareholders concerned have the right to sue at the people's courts, to demand that such acts of violation or infringement be stopped.*<sup>380</sup>

Although this article clearly establishes that an individual shareholder has the right to bring an action against wrongdoers in certain circumstances, it does not indicate that these actions could be brought as derivative actions. This has created contention. Some maintain that this article provides a legal basis for shareholders to bring a derivative action. Kong, presently a senior judge of the Supreme People's Court, argues that article 111 confers upon shareholders a right to bring a derivative action,

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<sup>377</sup> These protective mechanisms were incorporated in articles 59-63 and 123. For the details of these provisions, please see: Y. Fu-Tomlinson and F. D. Chu, 'Duties and Responsibilities of Directors and Managers' In M. J. Moser & F. Yu (eds.), *Doing Business in China* (Juris Publishing 2012).

<sup>378</sup> See G. Feng, 'Gongsifa Xiugai Ying Jiaqiang Minshi Zeren Zhidu' [Civil Liability System Should Be Enhanced in the Amendment of the Company Law], *Fazhi Tibao* [Legal Daily] 28 June 2000.

<sup>379</sup> W. Xuan, 'Gudong Daibiao Susong Chutan' [A Preliminary Study on Shareholder Representative Lawsuits], (1999) 36 *Faxue* [Law Science monthly] 211.

<sup>380</sup> Article 111 of Chinese Company Law 1993. (translated from Beida Fabao Website with minor amendments)



stating that this was the intention of this article when it was enacted.<sup>381</sup> Zhao shares this view, though justifies it using the different reasoning that this provision can be broadly interpreted and can thus be read to include derivative actions.<sup>382</sup>

However, these arguments cannot be sustained for the following reasons:

First, according to the strict meaning of this article, shareholders can only raise an action when resolutions infringe upon their legal rights and interests. This is clearly different from derivative action which is founded on an infringement of company interests. A broad interpretation is not consistent with the spirit and the principle of Company Law 1993 and it would also cause confusion as derivative suits are still in the embryonic stages in China.

Secondly, the remedy available to shareholders under this article is to stop such acts, similar in western systems to an injunction. It thus seems that plaintiff shareholders could not be compensated even if they are successful in the litigation. Without such proper incentive, shareholders would be strongly discouraged to bring such actions owing to the collective action problem.<sup>383</sup>

Third, it is not clear whether the action brought under this provision should be based on the conditions of both a violation of laws or regulations and an infringement upon shareholders' right. Zhang suggests that two meanings could be possible and reasonable as these two phrases (violation and infringement) are separated only by a comma: violation and infringement are two requirements that need to be satisfied at

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<sup>381</sup> X. Kong, *Mingshangfa Redian nandian Ji Qianyan Wenti* [Heated, Difficult, and Forefront Issues in Civil and Commercial Law] (People's Court Publishing House 1996) 248.

<sup>382</sup> S. Zhao, 'Zhongri Gongsifa Shang Gudong Susong Zhidu Bijiao Yanjiu' [A Comparative Study of Shareholder Suits in Chinese and Japanese Corporate laws] In L. Li (eds.), *Zhongri Qiye Falu Zhidu Bijiao* [The Comparison of Chinese and Japanese Enterprise Legal Systems] (China Law Press 1998) 258.

<sup>383</sup> See W. T. Allen and R. Kraakman, *Commentaries and Cases on the Law of Business Organization* (Aspen Publishers 2003) 351.

the same time to justify a shareholder's action; or they are two independent and separate conditions of which each one may be sufficient to bring such an action.<sup>384</sup> The prevailing view, however, is that both requirements should be met. According to this view, shareholders are not entitled to bring an action if their interests are not harmed while the resolutions violate the laws or regulations. For the same reason, they are still not allowed to apply for injunctions even if their rights are infringed by the resolutions while such resolutions are legally not against the laws or regulations.<sup>385</sup>

Last, even if this article did provide a legal basis for derivative action, it does not specify any detailed procedure or guidance for how to bring such an action. For example, it fails to set out the rules of *locus standi*, demand requirement or security for expenses. Even if article 111 could be interpreted in a variety of ways – one of them being that it confers the right to raise derivative actions on shareholders - it is rendered impractical and meaningless in its failure to provide clear guidance and procedures. Consequently, it can only be characterized as “a cryptic and potentially powerful way to protect shareholders”.<sup>386</sup>

### 3.2.2.1.2 Rules and Judicial Interpretation

A lack of clear legislation on shareholder derivative actions obviously failed to accommodate practical needs as cases of derivative actions occurred from time to time in practice. In consequence, various departments and the courts have had to issue relevant regulations or judicial interpretations in order to resolve resultant

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<sup>384</sup> X. Zhang, 'Practical Demands to Update the Company Law' (1998) 28 *Hong Kong Law Review* 252.

<sup>385</sup> The US adopted a different rule under this situation. It has been long established that an inequitable action infringing upon shareholder franchises, though legally permissible, will not be tolerated by the Courts. See *Schnell v Chris-Craft Indus., Inc.*, 285 A.2d 437. (Del.1971)

<sup>386</sup> L. S. Liu, 'Chinese Characteristics Compared: A Legal and Policy Perspective of Corporate Finance and Governance in Taiwan and China' Working Paper 2001, available at <<http://ssrn.com/abstract=273174>> (last visited 10 August 2013).

disputes.

The first document of this kind was issued by the Supreme People's Court (hereafter SPC) on 4 November 1994. In the judicial interpretation relating to the *Reply of the Supreme People's Court concerning in whose name the Chinese party of a Sino-Foreign equity joint-venture company should file a suit with the People's court where the joint-venture company has external economic contract disputes, and the controlling foreign party of the joint-venture company has interests with the seller*,<sup>387</sup> the SPC for the first time recognised that shareholders were entitled to bring an action where a company was not able to do so. Although the terminology of "derivative action" was not used in that document, it can be inferred from this judicial interpretation that the SPC accepted the idea of derivative actions.<sup>388</sup> Unfortunately, this judicial interpretation had only a limited impact on legislation and practice owing to the following factors: first, it was regarded that the right conferred on shareholders to file a suit only applied to the same situation as the above case, namely, those situations where the interests of Sino-foreign joint-venture enterprise and the Chinese Party had been injured.<sup>389</sup> In other situations, shareholders were prevented from bringing such litigations.<sup>390</sup> Secondly, it failed to specify the

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<sup>387</sup> This judicial interpretation was based on a case heard by the High People's Court of Jiangsu province. In this case, Zhangjiagang Dacron Factory (the Chinese Party) and Hong Kong Jixiong Co., Ltd., (Hong Kong Party) jointly established Zhangjiagang Jixiong Chemical Fiber Co. Ltd which is a equity joint venture.(EJV). The EJV entered into a sales contract with the seller Hong Kong Daxing engineering Co., Ltd, which was controlled by the Hong Kong Party. When the seller breached the contract, the EJV was prevented by the Hong Kong Party from convening a meeting of the board of directors in order to decide to sue the seller. As a consequence, the Chinese Party brought an action to the court. However, the High People's Court was uncertain whether the Chinese Party could sue derivatively as there was no rule or case of derivative actions at that time. Therefore, the High People's Court of Jiangsu reported this case to the SPC.

Available at <[http://www.law-lib.com/law/law\\_view.asp?id=10830](http://www.law-lib.com/law/law_view.asp?id=10830)> (last visited 10 August 2013).

<sup>388</sup> In its reply, the SPC acknowledged that the Chinese Party would have been entitled to bring an action when the board of the JVC was not able to do so and the court should have accepted it where there had been no arbitration clauses in the joint-venture contract and the sales contract.

<sup>389</sup> X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 269.

<sup>390</sup> That can explain why the case of *Zhongtian v. Bichun*, which happened after the *Zhangjiagang* case, was rejected as it was the interests of the joint-venture enterprise and the foreign party rather than the Chinese party that had been injured in this case. See X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 269.

necessary substantive and procedural requirements or conditions of such an action.<sup>391</sup> Without the detailed rules, it was no wonder that the subsequent cases were dealt with in various ways. Thirdly, this case was not actually resolved within the court due to the existence of arbitrary clauses in the contract as the Reply clearly pointed out that the dispute should be submitted to the arbitrators rather than the court.

The next step attempting to furnish shareholders with the ability to bring a derivative action was article 4 of the Code of Corporate Governance for Listed Corporations (the “Code”), promulgated in January 2002.<sup>392</sup> This article states that shareholders have the right to protect their interests by means of litigation and are also entitled to demand a company to bring an action for damages occasioned by directors, or supervisors if they have violated laws, administrative regulations or company’s articles of association. Some therefore argue that article 4 expressly confers on shareholders the right to initiate derivative actions for the first time in China.<sup>393</sup> Nevertheless, the Code has weak authority and its enforcement was limited as it was neither a formal law nor a judicial interpretation.<sup>394</sup> In addition, the Code failed to provide details pursuant to which individual shareholders could enforce their rights to file suits in the courts. This lack of detailed rules, as Xuan and Li indicate, may

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<sup>391</sup> S. Zhao, ‘Zhongri Gongsifa Shang Gudong Susong Zhidu Bijiao Yanjiu’ [A Comparative Study of Shareholder Suits in Chinese and Japanese Corporate laws] In L. Li (eds.), *Zhongri Qiye Falu Zhidu Bijiao* [The Comparison of Chinese and Japanese Enterprise Legal Systems] (China Law Press 1998) 253.

<sup>392</sup> The full text of article 4 reads: Shareholders shall have the right to protect their interests and rights through civil litigation or other legal means in accordance with the laws and administrative regulations. In the event the resolution of shareholders’ meetings or the resolutions of the board of directors are in breach of laws and administrative regulations or infringe on shareholders’ legal interests and rights, the shareholder shall have the right to initiate litigation to stop such breach of infringement. The directors, supervisors and managers of the company shall bear the liability of compensation in cases where they violate laws, administrative regulations or articles of association and cause damages to the company during the performance of their duties. Shareholders shall have the right to request the company to sue for such compensation in accordance with law.(translated from Beida Fabao Website with minor amendments)

<sup>393</sup> W. Xuan and C. Li, ‘Shangshi Gongsi Zhili Zhunze Ruogan Wenti Pingxi’ [Comments on Several Issues in the Code of Corporate Governance for Listed Corporations] (2002) 7 *Shangshi Gongsi* [Listed Company].

<sup>394</sup> Clarke concluded in his article that the Code is not mandatory for listed companies in China. See D. C. Clarke, ‘Duli Dongshi yu Zhongguo Gongsi Zhili’ [The Independent Director and Chinese Corporate Governance] (2003) 2 *Fada Pinglun* [Chinese University of Politics and Law Review] 110

result in the courts' reluctance or even hostility to accept shareholder derivative lawsuits despite the permission given under the Code.<sup>395</sup>

During the National Court's Civil and Commercial Trials Working Conference held in Shanghai in 2002, Guoguang Li, the vice-president of the Supreme People's Court, stated that derivative actions should be accepted and that a draft judicial interpretation of Company Law 1993 would confer such a right on shareholders to bring actions against managers or controlling shareholders on behalf of the company. Nevertheless, the courts have found that these remarks were inadequate in providing a legal basis for accepting derivative action as they were called only "for references".<sup>396</sup> In light of this, several high-level People's Courts issued their respective opinions describing the detailed implementation of derivative actions under their own jurisdictions, such as Zhejiang,<sup>397</sup> Jiangsu,<sup>398</sup> Shanghai<sup>399</sup> and Beijing.<sup>400</sup> Of these opinions, the Shanghai Opinion was regarded as a very specific and operational one. For example, it confirms that controlling shareholders and third parties could be potential defendants as well as the directors and managers; it authorises the courts to determine whether a company has been harmed or whether any good faith is available to the defendants; the settlement would be prohibited if it is against the interests of minority shareholders in the company; it also empowers the

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<sup>395</sup> W. Xuan & C. Li, 'Shangshi Gongsì Zhili Zhunze Ruogan Wenti Pingxi' [Comments on Several Issues in the Code of Corporate Governance for Listed Corporations] (2002) 7 *Shangshi Gongsì* [Listed Company].

<sup>396</sup> L. Wang, 'Shouli Gudong daibiaosusong Bubei Shouli [First Shareholder Derivative Action is not Accepted] Shanghai Zhengquan Bao [Shanghai Securities New], April 22, 2003.

<sup>397</sup> Zhejiang Sheng Gaoji Renmin Fayuan Minshi Shenpan Di'er Ting [No.2 Civil Division of the High People's Court of Zhejiang Province] Guanyu Gongsifa Shiyong Ruogan Yinan Wenti de Lijie [Understanding on Several Difficult Issues Regarding the Application of Company Law] (December 2002), article 15.

<sup>398</sup> Jiangsu Sheng Gaoji Renmin Fayuan (the High People's Court of Zhejiang Province) Guanyu Shenli Shiyong Gongsifa Anjian Ruogan Wenti de Yijian(shixing)[Opinions on Several Issues on Adjudicating Cases Applying Company Law(Trial Implementation)(June 2003), art.17.

<sup>399</sup> Shanghai Shi Gaoji Renmin Fayuan Minshi Shenpan Di'er Ting(No.e Civile Division of the Hight People's Court of Shanghai) Guanyu Shenli Sheji Gongsì Susong Anjian Ruogan Wenti de Chuli Yijian(Yi)[Opinions on Adjudicating Cases Regarding Company Suits(No.1)] (June 2003), art5.

<sup>400</sup> Beijing Shi Gaoji Renmin Fayuan (the High People's Court of Beijing), guanyu Shenli Gongsì Jiufen Anjian Ruogan Wenti de Zhidao Yijian(shixing)[Guidance on Several Issues on Adjudicating Company Dispute Cases (Trial Implementation)] (February 2004), article 1(8).

courts to annul offending transactions.<sup>401</sup> These various opinions undoubtedly demonstrated the fact that the local-level courts were willing to accept, or were at least not against, derivative actions.<sup>402</sup>

In November 2003, the SPC published the Draft Regulations on Certain Issues Relating to Trial of Corporate Dispute Cases (Part I ) to solicit public comments.<sup>403</sup> There were five articles in this Draft which are relevant to derivative actions. Article 43 clearly states the nature of derivative actions and two types of defendants have also been identified. Article 44 sets out some standing requirements for commencing derivative actions. Article 45 provides that the demand requirements should be satisfied before initiating the lawsuits. Article 46 outlines the role of other participants in derivative actions, such as the injured company and other shareholders who also filed the suits. Article 47 touched upon the possibility of abusing this litigation right. However, as it was expected that Chinese Company Law would soon be substantially amended, the Draft has never become effective.

### **3.2.2.1.3 Summary**

The absent legislation of derivative actions before the Company Law 2005 indicated that the protective mechanisms for shareholders were very weak. Hence, shareholders would encounter many difficulties in pursuing to safeguard their rights and interests. Nevertheless, this phenomenon may be explained if we trace back to the purpose of the enactment of the Company Law 1993. It was recognised that the Company Law 1993 was adopted to advance the reform of SOEs instead of providing better environment for the investors. Therefore, the protections for the

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<sup>401</sup> See above.

<sup>402</sup> D. C. Clarke and N. C. Howson, 'Pathway to Minority Shareholder Protection: Derivative Actions in the People's republic of China' In D. Puchniak et al.(eds.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012) 243.

<sup>403</sup> Guanyu Shenli Gongsi Jiufen Anjian Ruogan Wenti de Guiding (Yi) [Regulations on Certain Issues Relating to Trial of Corporate Disputes Cases (Part I )], S.P.C. 2003

shareholders have to be subordinated to this purpose, and the absence of many effective measures - including derivative actions, were not a surprise. The latter legislation of Securities Law 1998 also had a similar purpose and thus it has insufficient protective measures for the shareholders, too. Besides these two statutory rules, some other rules and judicial interpretations still did not provide legal basis for derivative actions, partly due to their restrictive applications, and partly owing to their weak enforcements or non-compulsory legal force. Although derivative actions were clearly expressed in the Opinions published by various High-Level People's Courts, they were somewhat the causes of different results of the similar derivative actions cases because of their inconsistent and unsystematic rules.

### **3.2.2.2 Judicial Application of Derivative Actions in Practice: Case Studies**

#### **3.2.2.2.1 Research Methodology**

It is essential to explain how the cases that form the basis for this study were collected. This is because it is not a mandatory requirement for Chinese courts to publish all the cases they regularly handle. However, in order to ensure accurate and uniform implementation, judges must check online case summaries or news reports. As such, a court may select and publish some of its decisions.

This research was conducted using an authoritative electronic database of Chinese law, namely Beida Fabao, which provides published verdicts. In order to collect all possible cases, this research also located derivative actions on some other websites, for example, news websites reporting derivative actions that were not included in the database (Beida Fabao). The cases that this research has collected may not represent all the cases that have arisen in the past years. This is owing to the following reasons:

first, some cases may never be publicly reported in newspapers or included in the database for a variety of reasons. They are therefore impossible to collect. Second, although this database is the best available database to conduct this empirical research, it cannot be denied its accuracy is affected by the fact that some cases are not included and others are slow to be updated. Third, many cases may be resolved privately without going to the courts and thus such cases would not be known to others.

### 3.2.2.2 Overview of Derivative Actions Cases prior to the Company Law 2005

Despite the absence of a clear statutory basis for derivative actions, such cases have nevertheless proceeded in the courts from time to time before the entry into force of Company Law 2005. Some of these cases were accepted; some were refused. This part aims to summarise and evaluate these cases. After a comprehensive search of the available websites on which cases and news reports of derivative actions are published, 23 cases were collected. Of these, 4 cases were not accepted by the courts for the reason that the plaintiff shareholders were not eligible to bring an action against the wrongdoers on behalf of the companies; 16 cases were accepted with various different reasons for their acceptance; 2 cases were finally settled and at the time of writing it is unclear whether one case will be accepted or rejected as the result has not yet been published.<sup>404</sup>

Table 4

| <b>Derivative action cases prior to Company Law 2005</b> |               |                   |
|--|---------------|-------------------|
| <b>Results</b>   | <b>Number</b> | <b>Percentage</b> |
| <i>Refuse</i>  | 4             | 17%               |
| <i>Accept</i>  | 16            | 70%               |

<sup>404</sup> The result of this case has not yet been published online. This is not unusual as the publication of court judgements is not compulsory in China.



|                |   |    |
|----------------|---|----|
| <i>Settle</i>  | 2 | 9% |
| <i>Unknown</i> | 1 | 4% |

### **3.2.2.2.3 Analysis of the Refused Cases**

Considering the absence of a legal basis for derivative actions, it seems surprising at first glance that only 4 cases were refused, compared to 16 accepted cases. Several factors might account for this phenomenon: first, shareholders were not familiar with the protective mechanism of derivative action at the beginning of 1990s, and thus they would not attempt to use it to protect their interests. Second, even if they had gained some knowledge of derivative actions owing to the increasing awareness of rights and protection, they would be advised not to bring such litigation because of the unclear result and the absence of statutory derivative actions. Third, many shareholders would prefer to bring direct actions rather than derivative actions where the interests of individual shareholders and the corporations are both infringed. Fourth, those cases accepted by the courts mostly occurred after the issuance of various high-level People's Court' Opinions. Lastly, it is believed that many unaccepted cases were not posted online by the courts partly because the publication of those cases might embarrass the courts. That this latter point is true is indicated by the fact that four denied cases were found in news reports rather than on the judicial authority's website. However, it is both unnecessary and impossible for news agencies to report every unaccepted derivative action. On the other hand, given the importance of protecting shareholder and investor interests, it is conceivable that successful derivative actions would attract public attention. In consequence, it is un-surprising to see that only a few reported cases appear to have been rejected by the courts while seventy percent of reported cases seem to have been accepted.

It is also notable that all four unsuccessful cases were rejected for essentially the same reason: that the plaintiff shareholders were not eligible or entitled to bring derivative actions. The *Yueqin* case was rejected because the Haile Company itself was able to bring an action against the wrongdoers and thus the plaintiff shareholder, Yueqin, lacked standing to bring such litigation.<sup>405</sup> In the *Honguang Shiye* case, the judge ruled that “there is no necessary cause and effect relationship between the losses of the plaintiff shareholder and the misbehaviours of the accused persons”, and that the suit should thus be rejected.<sup>406</sup> In the *Chengdu Lida* case, the plaintiff shareholder was found to be unqualified to bring a derivative action as part of his complaints that sought to claim for his own losses.<sup>407</sup> The court went further in pointing out in the *Sanjiu* case that derivative actions would not be accepted unless plaintiff shareholders obtained the authorization of all the shareholders to bring such a suit. The *Sanjiu* case can be considered typical owing to its high profile and significant influence. It will thus be explored at length as an example of a rejected derivative action case.

### 3.2.2.2.3.1 Refused Case Study: Facts of *Sanjiu*<sup>408</sup>

Sanjiu Medical and Pharmaceutical Co., Ltd. was one of the largest listed companies in China at the time of litigation. In September 2001, it was found that the company had allowed its majority shareholders and other affiliated parties to misappropriate RMB 2.5 billion in corporate funds, in violation of laws and regulations applicable to

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<sup>405</sup> *Yueqin v Rajesh Prabhakar* (Shanghai Municipal Intermediate People’s Court (2003) *Lu erzhong min wu(shang) chuzi* No.100.)

<sup>406</sup> The detail of *Honguang Shiye* case is available at:

<<http://finance.sina.com.cn/t/20010906/104276.html>> (last visited 29 April 2014).

<sup>407</sup> *Chengdu Lida Ltd. Cop v Chunsheng Zhou, Wenzhang Zhou, et al.*(2006). Full detail of this case is available at: <<http://old.chinacourt.org/public/detail.php?id=186427>> (last visited 29 April 2014).

<sup>408</sup> For the full detail of this case, please see Wang Lu, Zhengquan Shichang You Chu Diyi An---Gudong Daibiao Gongsi Zhuanggao Dongshizhang [Another First in Stock Market---Shareholder Sues Chairman on Behalf of the Corporation], *Shanghai Zhengquan Bao* [Shanghai Securities Journal], 19 April 2003.

the company.<sup>409</sup> This unpublished information was discovered by China Securities Regulatory Commission (hereafter CSRC), which consequently fined Sanjiu Company and other related parties for the misappropriation. On 8 April 2003, Shao, an individual shareholder of Sanjiu Company, brought a derivative action against Xinxian Zhan, the chairman at that time. Three claims were lodged: (1) that Zhan should pay RMB 10,000 to Sanjiu Company to compensate it for the damage caused by the misappropriation; (2) that Zhan should also pay RMB 10,000 to Sanjiu Company as a compensation for the mismanagement that resulted in the CSRC fine for disclosure irregularities; and (3) that Zhan should pay the filing fees of the litigation.

On 14 April 2003, the application was moved to the Intermediate People's Court of Shenzhen. Here, Shao's lawyer was informed by the Judge that the case would not be accepted. The Court stated over the telephone that "Shao has to obtain authorization from all the shareholders of Sanjiu before bringing such a lawsuit if he wants to institute an action in the interests of all the shareholders."<sup>410</sup>

### **3.2.2.2.3.2 Comments on *Sanjiu* case**

In this case, the court rejected the application because it considered that the unanimous authorisation of all shareholders should be obtained as a prerequisite to filing a derivative action. It appears reasonable for the court to so impose this prerequisite as the action initiated was in the interests of all the shareholders, and thus their consent should be obtained. However, it was almost impossible for Shao to attain such consent in reality. Before doing so, he first had to call a shareholder's meeting. However, Shao alone was obviously unable to convene such a meeting as

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<sup>409</sup> This misappropriated funds amounted to 96% of the Sanjiu's net assets.

<sup>410</sup> See L. Wang, 'Shouli Gudong daibiaosong Bubei Shouli [First Shareholder Derivative Action is not Accepted] Shanghai Zhengquan Bao [Shanghai Securities New], April 22, 2003.

article 104 of Company Law 1993 stipulates that only shareholders owning ten percent or more of the company can request an extraordinary shareholders' meeting of a listed company.<sup>411</sup> Indeed, even if Shao had been able to convene such a meeting, it would be extremely difficult to obtain authorisation from all shareholders for various reasons: like the fact that some shareholders might not have attended the meeting.

In theory, the request to obtain authorization from all shareholders is largely outdated.<sup>412</sup> The American Law Institute also shares the view that “informed collective [shareholder] consideration of a proposed litigation is not feasible [because the shareholders, as a body], cannot realistically discuss or evaluate the often complex factual and legal issues raised by derivative actions.”<sup>413</sup>

On the whole, since it is almost impossible to obtain the authorisation of all shareholders in practice and it is outdated to have such a requirement in theory, Shenzhen Intermediate People's Court's reasoning in rejecting this case was in fact groundless and absurd. Rather, it reflected the fact that derivative actions were strongly discouraged and that court attitudes towards such litigation were very hostile.

#### **3.2.2.2.4 Analysis of the Accepted Cases**

Although many cases have been accepted by the courts, the reasoning behind such acceptance in these cases is unsystematic and chaotic in light of the existence of various opinions published by the High-level Courts and the absence of a clear legal system. In exploring these published cases, five grounds can be found to have been

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<sup>411</sup> Article 104(3) of Chinese Company Law 1993.

<sup>412</sup> See J. D. Cox and T. L. Hazen, *Corporations* (Aspen Publishers 1997) 408.

<sup>413</sup> See Principles of Corporate Governance: Analysis and recommendations, §7.03© (1992).

used to justify the acceptance of derivative actions.

The first ground is that the Court should support the derivative action on the basis of a fundamental principle of company law. In the *Dalian Shengdao* case, Xiangzhou District Court ruled that the application of the plaintiff shareholder should be supported because “he brought an action to protect his legitimate rights and interests in accordance with the relevant fundamental principles of protecting shareholders’ rights and interests in Company Law.”<sup>414</sup> This reasoning was reaffirmed in another case, *Zhang Baorong v Yugang and Rongma Company*. Here, the Court said:

*Yugang’s behaviour constitutes a tort against the Rongma Company. After the infringement upon the Company, Zhang Baorong, as a shareholder of the Rongma Company, tried every available avenue to seek remedies for the Company, but failed. In order to prevent further infringement to the Company, he filed a lawsuit to this court and its claims should be accepted as it is in line with the legal principles of Company Law.*<sup>415</sup>

The next justification for supporting derivative actions is the protection of the companies and shareholders’ rights. In the case of *Zhang Jianhua v Huang Jiawei*, the Court ruled that the lawsuit brought by the plaintiff shareholders was the proper conduct to safeguard the interests of the corporation and shareholders and is thus not against the law.<sup>416</sup> In *Shunde Guoxin Corporation v Shunde Maocu Corporation* case, the court states that Guoxin Corporation is a qualified plaintiff because its interests as a shareholder were harmed by the defendant and thus Guoxin was entitled to enjoy the right to bring a lawsuit.<sup>417</sup>

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<sup>414</sup> *Dalian Shengdao Group v Zhuhai Huafeng Group* (Zhuhai Municipal Xiangzhou District People’s Court, 2000).

<sup>415</sup> *Zhang Baorong v Yugang and Rongma Company* (Beijing Municipal Zhaoyang District People’s Court (2004) *zhao minchu zi* No 15966). (Originally in Chinese and translated by the author)

<sup>416</sup> *Zhang Jianhua v Huang Jiawei* (Shanghai Municipal Jingan District people’s Court (2002) *jing min er(shang) chu zi* No17).

<sup>417</sup> *Shunde Guoxin Corporation v Shunde Maocu Corporation* (Shunde District people’s Court(2002) *shunfa jingchu zi* No 0234).

The third ground for the courts to accept derivative actions was based on the right of subrogation. Lawsuits founded on the right of subrogation generally applied to cases of contract, where the right was conferred to creditors to raise proceedings to recover their debts.<sup>418</sup> However, there are some differences between lawsuits founded on the right of subrogation and those founded on derivative actions. For example, the direct purpose of derivative actions is to safeguard the interests of the company rather than the plaintiff shareholders themselves; by contrast, the direct intention of the lawsuits founded on subrogation is to recover the plaintiff creditors' debts.<sup>419</sup> Nevertheless, the principle of subrogation was applied to derivative actions in some cases. In the *Dalian Shengdao* case, the Court found that the plaintiff shareholder could bring an action by exercising the right of subrogation in order to protect their legitimate rights and interests.<sup>420</sup> In *Shanghai Zhanwang Corporation and Shanghai Baiyulan Research Institution v Shanghai Jinshan Liangyou Company*, the Court ruled that the plaintiff, as a shareholder of the company who has suffered as a result of the acts of the defendants, was entitled to bring a lawsuit of subrogation on behalf of the company.<sup>421</sup>

Fourth, one case went so far as to indicate that the cause for allowing individual shareholders to bring a derivative action was the abuse of the corporation's right of legal personality. In *Shanghai Zilaishui Company v Shanghai Huihuang Company*, the Court stated that:

*As the defendant controls the management and property of the company, the company,*

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<sup>418</sup> The right of subrogation is stipulated in article 73 of Contract Law of the People's Republic of China in which it states "where the obligor is remiss in exercising its due creditor's right, thereby harming the obligee's interests, the obligee may petition the People's Court for subrogation in its own name, except that the creditor's right exclusively belongs to the obligor."

<sup>419</sup> For more details, please see J. Liu, *Study on Shareholders' Derivative Actions* (2007) PhD Thesis, Chinese University of Political Science and Law 26.

<sup>420</sup> *Dalian Shengdao Group v Zhuhai Huafeng Group* (Zhuhai Municipal Xiangzhou District People's Court, 2000).

<sup>421</sup> *Zhanwang Corporation v Shanghai Jinshan liangyou Company* (Shanghai Municipal First Intermediate People's Court, (2002) *luyizhong min san(shang) chu zi No144*).

*as a factual legal entity, is not able to exercise its right to bring an action. In this situation, the corporate veil should be lifted as the defendant was abusing its legal personality and the interests of the plaintiff shareholders were thus indirectly damaged. Therefore, the claims of these two plaintiff shareholders should be accepted.*<sup>422</sup>

Fifth, although no institution for derivative actions was enacted in Company Law 1993, it was clearly expressed and adopted in several cases. In *Linyi Foreign Trade Company v Shandong Import and Export Company*, the Court simply stated that

*Although derivative action is not adopted currently in Company Law, it is accepted in practice. [...] It is worthwhile emphasising that a derivative action should be commenced under certain circumstances and shareholders cannot abuse this right. In this case, when Linyi Company was prevented from bringing a lawsuit, Linyi Foreign Trade Company was entitled to bring a derivative action on behalf of Linyi Company.*<sup>423</sup>

This view was subsequently reaffirmed in *Hong Kong Youxian Company v Guangzhou Suihang Company* where the court ruled that where the company itself was not able to bring an action, the plaintiff shareholder was entitled to claim rights from the defendant. Therefore, “this litigation is in accordance with the conditions of derivative actions”.<sup>424</sup> In *Shanghai Yaoguo Company v Gaobaoquan*, the Court plainly held that shareholder’ derivative action is an important judicial tool for protecting the legitimate rights and interests of shareholders, and thus individual shareholders are allowed to bring derivative actions where a company is prevented from bringing such litigation.

It is interesting to conclude from the above that the courts had started to use the

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<sup>422</sup> *Shanghai Zilaishui Company & Shanghai Baiyulan International Tourism Culture Research Institute v Shanghai International Rowing Club Company* (Shanghai Municipal Intermediate People’s Court (1999)). (Originally in Chinese and translated by the author)

<sup>423</sup> *Linyi Foreign Trade Company v Shandong Import and Export Company*, (1999) (Shandong Provincial Higher People’s Court (1999) *lujing zhong zi* No719). (Originally in Chinese and translated by the author)

<sup>424</sup> *Guangzhou Suihang Company v Hong Kong Youxiang Company* (Guangdong Provincial Higher People’s Court (2003) *yue gaofa min si zhong zi* No116)

terminology of derivative actions despite the fact that this terminology had not been adopted in Company Law 1993. It is surprising to find that the courts have even stated that derivative actions should only be brought under certain circumstances or conditions, when there seems to be only one condition in which such a claim might be brought: namely, when the company is not able to bring an action against wrongdoers itself. However, one case did not use the terminology of derivative actions, nor did it even cite any regulation relevant to derivative actions.<sup>425</sup> Here, the Court arguably seems to deliberately avoid touching upon the topic of derivative actions, basing its decision directly on the facts of the case. This approach was praised by some lawyers as it was thought to be a “wise way” of dealing with derivative actions.<sup>426</sup>

### **3.2.2.2.5 Other Findings**

Besides the above analysis of successful and unsuccessful derivative actions, several other common findings were revealed by these 23 cases. First, there is almost a complete absence of derivative actions involving listed companies. The only listed company-related case prior to the implementation of Company Law 2005 uncovered by the author is *Sanjiu*, which was rejected by the court. Most of the cases brought to the court concerned limited liability companies.<sup>427</sup> This may be because the courts do not accept listed company-related shareholder litigation for fear that it might lead to numerous securities cases, which could have a negative social impact considering the prevalence of the exploitation of minority shareholder interests in listed companies. Secondly, most cases were occasioned by conflicts between majority shareholders and minority shareholders. As professional managers are unpopular in

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<sup>425</sup> For the full detail of this case, please see: J. Zhao and G. Wu, *Derivative actions* (Series of Cases Recording, Beijing: Law Press 2007).

<sup>426</sup> J. Zhao and G. Wu, *Derivative actions* (Series of Cases Recording, Beijing: Law Press 2007) 274.

<sup>427</sup> Even after Company Law 2005 entered into force, derivative actions involving listed companies are still completely absent. See D. C. Clarke and N. C. Howson, ‘Pathway to Minority Shareholder Protection: Derivative Actions in the People’s republic of China’ In D. Puchniak et al.(eds.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012) 243.



China and managing directors are therefore normally the same persons as majority shareholders, it is not strange that most of the defendants in the cases uncovered were majority shareholders. Thirdly, the courts were willing to accept derivative actions if the plaintiff shareholders' claims were justified, though the reasons for supporting such claims varied.

### **3.2.3 Conclusion**

Although it is argued that Company Law 1993 implicitly conferred a right on shareholders to bring derivative actions, this paper demonstrates that derivative action was not established until Chinese Company Law was revised in 2005. However, derivative actions did exist before 2005. Various departments and courts therefore had to issue several rules and interpretations regulating such derivative litigation as lack of clear legislation meant that the law could not accommodate practical needs. In order to explore these practical cases prior to the implementation of Company Law 2005, this thesis has collected as many cases as possible from various sources, finding 23 cases relating to derivative actions. In examining these cases, this part has revealed several findings. First, the rejected cases were all founded on the same reasoning that plaintiff shareholders were not eligible to bring derivative actions on behalf of companies. Second, although 70% of the cases uncovered were accepted by the courts, the reasons behind this acceptance were various; this is understandable given the absence of any law regulating derivative actions. Last, there was an almost complete absence of derivative actions taken in relation to listed companies, though the courts were not reluctant to accept the actions brought by plaintiff shareholders in limited liability companies if their claims could be justified.

## 3.3 Derivative Actions in China II

### 3.3.1 Introduction

After significant consideration, derivative actions were finally introduced and enacted in China for the very first time in 2005. This was warmly welcomed by many scholars. Krause and Qin describe this introduction as a milestone in Chinese company law reform.<sup>428</sup> Frinerman and Guo also shared the same view that this adoption would significantly improve company law and predicted that it would contribute to good corporate governance.<sup>429</sup> There is no doubt that this enactment was a huge step towards protecting the interests of minority shareholders and reflected the desire of legislators to achieve a balance of power between controlling and minority shareholders. It was expected that this legal framework would not only constrain the opportunistic behaviour of managers and majority shareholders, but also improve the corporate governance structure and thus establish an investor-friendly legal regime.<sup>430</sup> In this sense, the introduction of derivative actions was a big step forward for Chinese company law. However, like other Chinese laws, this new statutory procedure was established by transplanting from other countries and such a mixture from various jurisdictions has many drawbacks upon closer examination. This part will first explore the legal framework of derivative actions in the Chinese Company Law 2005 and then the obstacles for initiating such litigation

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<sup>428</sup> N. Krause and C. Qin, 'An Overview of China's New Company Law' (2007) 28 *Company Lawyer* 316.

<sup>429</sup> J. V. Feinerman, 'New Hope for Corporate Governance in China?' (2007) 191 *The China Quarterly* 590-612; C. Anderson and B. Guo, 'Corporate Governance under the New Company Law(Part2): Shareholder Lawsuits and Enforcement' (2006) 20 *China Law & Practice* 15-22.

<sup>430</sup> R. Dai, 'Gudong Paishengsusong Ruogan Wenti Jiedu' [Analysis on Several Problems of the Shareholder's Derivative Suit] (2008) 21 *Journal of Changchun University of Science and Technology* (Social Sciences Edition) 60-63.

will be identified. This part will conclude that China's mechanism for derivative actions remains inadequate to provide strong protection for minority shareholders and support accountability for managers and majority shareholders, though it ought to play a key role in corporate governance owing to the ineffectiveness of other mechanisms.

### **3.3.2 Legal Framework of Derivative Actions in Chinese Company Law 2005**

Derivative action is now enacted in article 152 of Company Law 2005, which provides as follows:

*Where a director or senior manager has committed a violation as specified in article 150 hereof, the shareholder(s) of a limited liability company or (a) shareholder(s) of a joint stock limited company who separately or aggregately holding at least 1% of the total shares of the company for 180 consecutive days or more may make a request in writing to the board of supervisors, or the supervisor(s) of the limited liability company without the establishment of the board of supervisors to initiate a lawsuit in a people's court. If a supervisor has committed a violation as specified in article 150 hereof, the aforementioned shareholders may make a request in writing to the board of directors, or the executive directors of a limited liability company that has not established a board of directors to institute a legal proceeding in the people's court.*

*If the board of supervisors, or supervisor of a limited liability company without the establishment of the board of supervisors, or board of directors or executive director refuses to institute a lawsuit after receiving a written request as mentioned in the preceding paragraph, or if they fail to initiate a lawsuit within 30 days after receiving the request, or under urgent circumstances where failure to promptly institute lawsuits could cause possibly irreparable damage to the interests of the company, the shareholders mentioned in the preceding paragraph shall have the right, in the interests of the company, to directly lodge a lawsuit in a people's court in their own name.*

*If another person infringes upon the legitimate rights and interests of a company, causing the company to incur a loss, the shareholders mentioned in the first*

*paragraph may initiate a lawsuit in the people's court in accordance with the provisions of the preceding two paragraphs.*<sup>431</sup>

As noted above, all the aspects of derivative actions are included in one provision and thus the provision itself is not easy to understand. The below paragraphs will explore these aspects, including issues of substance and procedure, in detail.

### **3.3.2.1 The Standing Requirement**

The standing requirement plays a key part in striking a balance between the management of a company and the protection of minority shareholders. If a shareholder is entitled to bring a derivative action without any restrictions, malicious suits would arise and the normal management of a company would be affected. However, if the standing requirement is too strict, the goal of derivative actions would not be achieved. The current legislation divides the standing requirement of plaintiffs into two types: there is no special requirement for the shareholders of limited liability companies, while an eligible plaintiff in a joint stock company (JSC) is required to hold one percent or more of the total shares separately or aggregately for at least 180 consecutive days. This differentiated treatment seems to be unique to Chinese derivative actions, as few other countries adopt such approaches.<sup>432</sup> However, there are some justifications that account for this standing rule. First, shareholders in limited liability companies generally bear a much greater risk than in those in JSCs because it is not easy for them to leave the company by selling their shares.<sup>433</sup> Secondly, the risk of abuse in JSCs is relatively higher than in limited liability companies without the standing requirements. This is because investors or outsiders can easily buy shares to become members of a company for the purpose of

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<sup>431</sup> Article 152 of Chinese Company Law 2005. (translated from Beida Fabao Website with minor amendments)

<sup>432</sup> Singapore might be the notable exception. See P. K. M. Choo, 'The Statutory Derivative Action in Singapore - a Critical and Comparative Examination' (2001)13 *Bond Law Review* 81.

<sup>433</sup> Article 72 of Chinese Company Law 2005 states that a shareholder must obtain the consent of at least half of other shareholders in order to sell his or her shares.

obtaining the right to initiate a derivative litigation.<sup>434</sup> Thirdly, it is also argued that listed companies are monitored closely by a variety of regulations which provide various protective mechanisms for minority shareholders while limited liability companies are less regulated and are thus in greater need of the protections provided by derivative actions. This has been proven in an empirical study finding that numerous derivative litigations have been initiated within closely-held corporations.<sup>435</sup>

However, this standing requirement has also been criticised for its high standard, especially the requirement of a one percent holding. It is highly unlikely that an individual shareholder will bring such litigation if he or she is required to hold one percent of the shares because most minority shareholders hold far less than that. Indeed, one percent is equal to RMB 0.3 million, which is still an extremely large amount of money for many Chinese investors.<sup>436</sup> In addition, it is argued that this requirement is unfair for shareholders in the companies of different sizes. In small companies, a one percent holding might represent thousands or hundreds of shares whereas in large corporations, it could represent hundreds of millions of shares – thus making it more difficult for shareholders in large companies to initiate derivative litigation. Thirdly, the idea of such a minimum shareholding requirement for JSCs makes little sense in China considering the current ownership structure in Chinese listed companies. As mentioned above, there are two types of shares in Chinese listed companies: tradable and non-tradable. Non-tradable shares are normally owned by the state and legal entities and cannot be bought or sold in the

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<sup>434</sup> For limited liability companies, article 24 of Company Law 2005 stipulates that the maximum number of shareholders is 50.

<sup>435</sup> See: I. Ramsay and B. Sauners, 'Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action' (2006) 6 *Journal of Corporate Law Studies* 397; Also see P. K. M. Choo, 'The Statutory Derivative Action in Singapore - a Critical and Comparative Examination' (2001) 13 *Bond Law Review* 81.

<sup>436</sup> As the Securities Law stipulates that the minimum capital requirement of a listing company is RMB 30 million, one percent of the shareholding amounts to at least RMB 0.3 million. See F. X. Hong and S. H. Goo, 'Derivative Actions in China: Problems and Prospects' (2009) 4 *Journal of Business Law* 376.

market as they are “non-tradable”. Tradable shares are widely held among numerous investors and the percentage of these is relatively low in the whole market.<sup>437</sup> As a consequence, it would be very difficult to require tradable shareholders to hold 1% of the outstanding shares of a company in order to be qualified to bring derivative actions. Fourthly, it is also argued that this high threshold figure seems to be tied to the notion that a derivative action is in fact a “representative” action and thus requires a minimum shareholding to “represent” the interests of all or most of the other shareholders.<sup>438</sup> This was confirmed by a senior Justice of the SPC, who stated that the minimum shareholder percentage was adopted to “ensure that the plaintiff is sufficiently representative”.<sup>439</sup> Indeed, a derivative action is similar to a representative action to some extent as any compensation from the successful claim will accrue to the company instead of the plaintiff shareholder. Thus all the shareholders would benefit from the litigation. In addition, it is also universally recognized that a derivative action is brought by a plaintiff shareholder who is acting on behalf of the company. However, this notion is a radical misunderstanding of the derivative action as this kind of lawsuit is in essence a corporate claim. The reason why it is initiated by shareholders is merely because the company is unable or unwilling to bring such litigation. Therefore, it is wholly incorrect to make derivative actions reflect representative actions by imposing a high threshold such as the minimum shareholding requirement. Lastly, the minimum shareholding requirement was set to prevent vexatious suits. However, it should also not be high enough to inhibit meritorious suits. Therefore, the critical question is how to strike a balance between preventing frivolous suits and allowing meritorious actions. Indeed, it is

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<sup>437</sup> Even now, this has not been changed significantly despite the fact that the Equity Division Reform has been in effect for some time. See X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 291.

<sup>438</sup> D. C. Clarke and N. C. Howson, ‘Pathway to Minority Shareholder Protection: Derivative Actions in the People’s Republic of China’ In D. Puchniak et al. (eds.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012) 243.

<sup>439</sup> See J. Jin, ‘Gudong Paisheng Susong Zhidu Yanjiu[Study on Shareholders’ Derivative Action System] In Wang Baoshu, Zhu Ciyun, Shi Tiantao and Tang Xin (eds.), *Shijianzhong de Gongsifa* [Company law in practice] (Shehui Kexue Wenxian Chubanshe[Social Sciences Academic Press (China)] 2008) 418.

difficult to find such a balance. Nevertheless, setting a fixed threshold figure seems to be an irrational means of achieving this balance as such a strategy risks either setting a threshold that is too high or too low.<sup>440</sup> In addition, although the 1% shareholding requirement is much lower compared to the 10% requirement adopted in some other countries, this threshold requirement is still too high in light of the above.<sup>441</sup>

The second standing requirement for shareholders in joint stock limited companies is that they must have held their shares for at least 180 consecutive days. This aims to prevent investors from purchasing shares with the purpose of initiating trivial or malicious suits. Nevertheless, this requirement seems to be another barrier for individual shareholders as the average shareholding period is usually shorter than 180 days.<sup>442</sup> This is also supported by Xin's study that the average shareholding period on the securities market is less than 120 days.<sup>443</sup> Therefore it is criticised that the shareholding period prescribed by this standing requirement is too long and thus needs to be shortened to protect minority shareholders. Furthermore, it would be unfair if a shareholder found out that a director of a company had done something wrong the day after they had purchased their shares owing to their inability to meet this standing requirement. It would be ridiculous for a shareholder to have to wait for 179 days during which they can do nothing. Liu recognises this flaw but also points out that during this period the shareholder could appeal to the board of supervisors as a member of the company to investigate the matter or use mass media to put

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<sup>440</sup> Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 160.

<sup>441</sup> In Germany, the minimum shareholding requirement for initiating derivative action is reduced from 10% to 5% and further to 1% or 100,000 euro. In Italy, the latest figure is 2.5%. See German Government Panel on Corporate Governance, paras. 72-73; See A. R. Ulissi, 'Company Law Reform in Italy: An Overview of Current Initiatives' Conference paper (OECD, Stockholm, December 2000).

<sup>442</sup> F. Ma, 'The Deficiencies of Derivative Actions in China' (2010) 5 *Company Lawyer* 150.

<sup>443</sup> J. Xin, *Shangshi Gongsi Jiegou yu Gongsi Zhili* [Shareholding Structure and Corporate Governance in Listed Companies] (Zhongguo Jinrong Chubanshe [China Finance Press] 2005) 143-144.

management under pressure.<sup>444</sup> However, it is highly likely that an appeal to conduct an investigation would simply be neglected by management considering the little influence a new shareholder would have. Also, not every shareholder is able to use public opinion to bring pressure bear on management. If one can exercise this influence on the company, one is probably able to resolve the problem within the company rather than using outside powers.

Besides the above problems, there are several issues that need to be clarified in the future.

Firstly, article 152 does not clearly stipulate that those shareholders who initiate a lawsuit must be the (1) shareholders who make the demand, or (2) the same shareholders for the whole period of the litigation. For the former issue, it is obvious that those shareholders who have met the demand requirement are eligible to bring derivative actions. What is not clear is whether other shareholders could be entitled to initiate a derivative action where those shareholders who have made the demand fail to bring such litigation.<sup>445</sup> From the wording of article 152, it seems that a shareholder must make the demand in order to be qualified to bring derivative actions; but this needs to be clarified. For the latter concern, it is apparent that those initiating a lawsuit must be shareholders when they raise the proceedings according to the article 108 of Civil Procedural law of the People's Republic of China (CPL)<sup>446</sup> and article 4 of Provisions of the Supreme People's Court about Several Issues Concerning the Application of the Company Law of the People's Republic of China

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<sup>444</sup> J. Liu, *Xingongsifa de Zhidu Chuangxin: Lifazhengdian yu Jieshinandian* [Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies] (Law Press China 2006) 259.

<sup>445</sup> For example, they might not raise such proceeding simply because they do not want to spend time and energy on this after they have met the requirement of demand.

<sup>446</sup> Article 108 (1) of CPL states that the plaintiff must have a direct interest with the case, which thereby implies that those persons who are not the members of the company are not eligible to be the plaintiff as they do not have a direct interest in the matter to be litigated.



(1).<sup>447</sup> However, it is unclear whether the litigation should be continued if a plaintiff shareholder transfers his or her shares and thus loses their qualification as a shareholder. Liu argues that the litigation should be terminated in this situation unless other qualified shareholders inherit him or her.<sup>448</sup> However, this approach might be abused by wrongdoers, particularly controlling shareholders, as they may cut the shareholding connection between the plaintiff shareholder and the company by reorganising the company.

Secondly, it is also unclear whether so-called hidden shareholders (*yinmin gudong*)<sup>449</sup> could be eligible to bring derivative actions. To answer this question, it is essential to examine whether Company Law 2005 recognises the hidden shareholders. If hidden shareholders are recognised, then it is beyond question that they are entitled to raise such proceedings. Unfortunately, this is even a more disputed question. Some scholars argue that the concept of hidden shareholders is not legal terminology and is also not mentioned in Company Law 2005, and that it can thereby be concluded that the Law does not recognise hidden shareholders.<sup>450</sup> On the other hand, admitting that hidden shareholders are not explicitly stipulated in the Company Law, some commentaries nevertheless maintain that they are the factual shareholders and are thus entitled to exercise shareholders' rights within the company.<sup>451</sup> The promulgation of the third set of provisions published by the SPC has confirmed the legal status of hidden shareholders to some extent though whether they are eligible to

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<sup>447</sup> Article 4 suggests that the holding period should extend to the date that the lawsuit is initiated, which means those initiating the suits must be the persons who hold the shares in the company (namely shareholders).

<sup>448</sup> J. Liu, *Xingongsifa de Zhidu Chuangxin: Lifazhengdian yu Jieshinandian* [Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies] (Law Press China 2006) 260.

<sup>449</sup> Hidden shareholders are the contributors of capital to the limited liability companies, but not registered as such in public documents. This is similar to the beneficiary share owners in the UK.

<sup>450</sup> D. Liu, *Woguo Gudong Paishengsusong Zhidu Yanjiu* [Study on Shareholders' Derivative Action System in China] (Qunzhong Chubanshe [People Publishing] 2011) 28.

<sup>451</sup> Since they are not registered in public documents, they cannot exercise shareholders' rights against a third party. The detailed of hidden shareholders, please see F. Wang, 'Yinming Touziren Gudong Zige Rending Wenti Yanjiu' [Research about Confirmation of the Qualification of Shareholders of Anonymous Investors] (2012) 1 *Hebei Law Science* 100-107.

initiate derivative lawsuits is still not clearly addressed.<sup>452</sup>

Lastly, there is no requirement that a plaintiff shareholder should have clean hands to raise proceedings. This means that even those shareholders who harbour malicious intentions are not prevented from bringing litigation in this situation. It is said that the absence of such a requirement was probably transplanted from or at least affected by Japanese law, which does not require an eligible plaintiff shareholder to be able to represent fairly and adequately the interests of the shareholders.<sup>453</sup>

### **3.3.2.2 Defendants and the Causes of Action**

#### **3.3.2.2.1 The Scope of Defendants**

The scope of defendants in derivative actions was extended from the beginning of the draft to the final legislation. In 2004, the Amendment of Company Law (manuscript) regulated that the defendants of the derivative actions were limited to directors, supervisors and senior managers.<sup>454</sup> Other persons including majority shareholders were thus excluded from being sued by shareholders for their wrongdoings to the company. This would be unfair and unrealistic in view of the severe horizontal agency cost prevailing in China. Later in 2005, many scholars advocated that the scope of defendants should be enlarged in order to protect the interests of the minority shareholders effectively.<sup>455</sup> In the end, Company Law 2005 extended the scope of potential defendants beyond directors, senior managers and supervisors to

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<sup>452</sup> See article 24-27 of Provisions of the Supreme People's Court about Several Issues Concerning the Application of the Company Law of the People's Republic of China (3).

<sup>453</sup> J. Liu, *Xingongsifa de Zhidu Chuangxin: Lifazhengdian yu Jieshinandian* [Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies] (Law Press China 2006) 261.

<sup>454</sup> Article 70 and article 142 of the Amendment of Company Law (manuscript) 2004

<sup>455</sup> J. Liu, *Xingongsifa de Zhidu Chuangxin: Lifazhengdian yu Jieshinandian* [Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies] (Law Press China 2006) 255.

cover other persons (*taren*).

Some scholars divide potential defendants into two classes: insiders (directors, senior managers, and supervisors) and outsiders (e.g. a related party who injured the company). From this classification, it seems that controlling shareholders are not included. For the first group, if only directors, supervisors and senior managers can be sued then this excludes controlling shareholders. The second group of defendants is very broad and basically contains any person who has done something wrong and causes loss to the company - thus at first glance a controlling shareholder seems to be eligible to be a defendant in this group. However, it is argued that the second group of defendants must be outsiders to the company and controlling shareholders are insiders.<sup>456</sup> As a result, a controlling shareholder cannot be categorized as falling within the second group of defendants. On the other hand, it seems ridiculous that controlling shareholders could not be sued while any other person could be a defendant. To address this issue, the second group should not necessarily be categorized as outsiders. On the face of the law, it is clear that a controlling shareholder who infringes upon the legitimate rights and interests of a company, and causes a loss to the company may be subject to a derivative action.

### **3.3.2.2.2 The Causes of Action**

As mentioned above, potential defendants are divided into two groups. This brings up the question of whether the causes of these two types of potential defendants are the same. According to article 152, the first group defendants may be sued when they have caused losses to the company by breaches of law, administrative regulations or the articles of association in the course of performing company duties. For the second group, “others” may fall into the scope of defendants when they have

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<sup>456</sup> F. X. Hong and S.H.Goo, ‘Derivative Actions in China: Problems and Prospects’ (2009) 4 *Journal of Business Law* 376.

damaged the company by violating its lawful rights and interests. From the wording of the above, it seems that the causes for these two groups are not unified. However, it is difficult to justify this separate approach, particularly where the cause of the second group reaches acts not covered by the cause of the first group. Here, there is a possibility that when the misbehaviour of an “outsider” causes a derivative action, an “insider” can be exempted from being sued regarding the same misbehaviour.

The second issue is that the basis for suing directors, senior managers or supervisors is narrow. According to the article 152, an aforementioned person should not be held liable if he/she violates the law, administrative regulations or the articles of association causing losses to the company while acting under other circumstances than in the course of performing their company duties. However, this restriction is unreasonable as they may engage in misconduct and cause losses to the company even when they are not performing their duties. In order to extend the basis for bringing derivative actions, Li argues that the circumstances under which they committed the wrong is not relevant to whether they could be sued as long as they violate the related laws and damage the interests of the company.<sup>457</sup> Indeed, in view of the other existing procedural obstacles, narrowing the basis for initiating derivative actions does not provide a good mechanism to protect the interests of minority shareholders.

### **3.3.2.3 Demand Requirement**

Another mechanism to strike the balance between preventing frivolous suits and allowing meritorious actions is the demand requirement. The Company Law 2005 requires the qualified shareholders to make a demand in writing to the appropriate body before raising proceedings. To be specific, demand should be made to the board

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<sup>457</sup> X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 286.

of supervisors, or the supervisors of a limited liability company without the board of supervisors in the circumstances where a lawsuit is brought against the directors or senior managers. On the other hand, where an action is taken against the supervisors, the demand should be made upon the board of directors or the executive directors of the limited liability companies without the establishment of the board of directors. Only when the relevant body refuses this demand or fails to respond within 30 days after receiving such a demand, can the shareholders commence a derivative action. This demand requirement actually is a nod to the principle of exhaustion of intra corporate remedies and it is justified by the reason that opportunity should be given to the company before going to the court, as it is the company itself who suffers directly. It would be better if the company could solve it without resorting to the judicial resource.<sup>458</sup> Second, the demand requirement could protect the company from being sued by frivolous shareholders to some extent.<sup>459</sup> Third, the board of directors or the board of supervisors have better resources, such as information and funding to deal with the litigation when it is necessary for a company to bring an action against the wrongdoers.<sup>460</sup>

At the same time, this new procedure is in need of clarification owing to its several loopholes. First, the content of the written demand is not specified under the current provision. In the US, the detailed information such as the factual basis for the accusation and the damage caused to the company should be included in that requirement, as this is very important to the company's process of making the decision.<sup>461</sup> Although there is no need for the law to stipulate the detail requirements of this written demand, it is essential to legislate that the basic facts and demand or

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<sup>458</sup> D. A. Demott, 'Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions' (1988) 11 *Sydney Law Review* 259, 262.

<sup>459</sup> X. Huang, 'Derivative Actions in China: Law and Practice' (2010) 6 *Cambridge Student Law Review* 254.

<sup>460</sup> D. R. Fischel, 'The Demand and Standing Requirements in Stockholder Derivative Actions' (1976) 44 *University of Chicago Law Review* 168, 171.

<sup>461</sup> Federal Rules of Civil Procedure r.23.1.

request should be included. Secondly, it is argued that the 30-day time-limit is unreasonable because the company may need more time to consider the request in some complicated circumstances. Although it is difficult to fix a specific period to accommodate all the situations, it is proposed that the court should be authorised to have the discretion to extend such time-period upon the request of the board of directors or the board of supervisors. Thirdly, it is ambiguous which organ should the demand be made to when the third party was accused for the wrongdoing. Some scholars propose that the board of directors should be the first organ to deal with this request as it is the management institution of the company.<sup>462</sup> There is a counter-argument suggesting that such a demand should be made first upon the Legal representative as he or she is the “representative” of the company.<sup>463</sup> This should be clarified in the future as a failure to do so may give an opportunity for conservative judicial institutions to frustrate meritorious derivative actions on a technicality.<sup>464</sup> This research argues that the demand should be made upon the board of directors for several reasons: first of all, the board represents a company in the daily management and thus the demand made to the board is in line with its legal status. Second, Company Law 2005 clearly stipulates that the board of directors shall be responsible for the shareholders’ meeting while a legal representative of the company does not have such responsibility. This means the board of directors should be in charge of the company including litigation decision. Furthermore, there is no reason not for the board to make the decision since the wrongdoer is a third person rather than the member of the board. Last, the number of the meeting for supervisory board is very low while it is quite often to hold the board meeting. This means additional cost

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<sup>462</sup> J. Liu, *Xingongsifa de Zhidu Chuangxin: Lifazhengdian yu Jiashinandian* [Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies] (Law Press China 2006) 265.

<sup>463</sup> X. Lu, ‘Mantan Woguo Xin ‘Gongsi Fa’ Gudong Daibiao Susong Qianzhi Chengxu’ [Discussion of the Precondition Procedure for the Shareholders’ Representative Lawsuit in China’s New ‘Company Law’] *Caijingjie* [Financial World] July 2007, 231-32.

<sup>464</sup> D. C. Clarke and N. C. Howson, ‘Pathway to Minority Shareholder Protection: Derivative Actions in the People’s Republic of China’ In D. Puchniak et al. (eds.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012) 243.

would be occurred if the demand is made to the supervisory board.

### **3.3.2.3.1 The Effect of the Demand**

When qualified shareholders make a demand to the appropriate body, there are three potential outcomes: the appropriate body may (1) accept, (2) refuse or (3) simply ignore the demand. In the third situation, there is no doubt that an eligible shareholder would be entitled to bring a derivative action. However, this may be problematic in the first and second circumstances.

In situation (1), the company may respond in two ways. First, the company may decide to bring an action against the wrongdoers, in which case there is obviously no need for the shareholders to raise the proceedings. However, the appropriate body may agree to accept the demand in order to block a derivative action and then fail to pursue litigation diligently. In such a case, the losses to the company still cannot be recovered while the shareholders have lost their eligibility to bring derivative actions. In light of this, the law should allow individual shareholders to bring derivative lawsuits despite the fact that the demand has been accepted. However, this should be established with one condition that a plaintiff shareholder could demonstrate that a company was intended to lose the litigation in order to protect defendants. Without satisfying this condition, the courts have to refuse the claim.

The second way for the appropriate body to accept the demand is to address the matter within the company without resorting to the courts. This may happen because legal suits are not generally believed to be in the best interests of the company. In this situation, it is unclear whether an individual shareholder is still entitled to bring derivative actions if he or she is not satisfied with the result of the internal corrective measures. This thesis believes that individual shareholder would not lose the

qualification to sue in this situation. The rationale for this argument is simple and straightforward: since the issue is not brought into the courts and shareholders are not satisfied with the result, why not allow them to commence litigation?

In circumstance (2), where a written demand is refused by the relevant body, minority shareholders can commence derivative litigation. Indeed, it is very important to confer this right on shareholders in this situation as derivative action is normally considered to be a last resort for minority shareholders to protect their rights and interests. Nonetheless, it is possible that the decision to reject a demand is just and reasonable as the body which makes the decision has no conflict interests with regard to the decision, at least theoretically.<sup>465</sup> As a consequence, if a refusal decision is just and reasonable it would be unreasonable for such a decision not to prevent minority shareholders from bringing derivative actions. This would also make the demand requirement meaningless as the shareholder could always raise proceedings if the company refused to do so. Two issues may arise in determining whether a refusal decision is to be respected or deferred to. First, one must ask which standard should be applied to evaluate the effect of the decision made by the appropriate body. It seems impossible that all the decisions of the demand requirement should be deferred to as many of those decisions may discriminate against minority shareholders. Therefore, a standard or guidelines to evaluate whether a decision should be deferred to should be introduced or issued. Second, it must be asked who has a final say on whether the decision should have a binding effect. If it is left for the court to decide, then what if the courts are not capable of doing this? If it is not decided by the court, then should a new independent body be created?

### **3.3.2.3.2 Demand Excused or Waiting Period Waived?**

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<sup>465</sup> Although the independent of supervisory board or supervisors is doubted, it cannot be denied that they may be effective to some extent or in some cases.



According to article 152 of Company Law 2005, eligible shareholders have the right to bring derivative actions in urgent circumstances where failure to bring a lawsuit immediately could result in irreparable damage to the company's interests. This regulation obviously provides more flexible protection for the company and its minority shareholders as the period of waiting for the decision may leave a gap for wrongdoers to gain further. Furthermore, potential irreparable damage requires shareholders or the company to take immediate action to prevent such misbehaviour as such damage is difficult to remedy. Therefore, this exception is essential and important.

Nonetheless, there are mixed views concerning the nature of this exception. Some argue that this is a demand excused and thus the shareholders do not need to make a demand to the appropriate body if it satisfies the conditions specified above.<sup>466</sup> The counter-argument is that this exception only waives the waiting period although the demand requirement is still in place.<sup>467</sup> That means even in an urgent situation, a demand must still be made to an appropriate body; what the rule permits is the waiting period. However, this strict interpretation seems to be groundless as the shareholders can bring an action immediately after making a demand regardless of the decision made by an appropriate body. In order to identify the nature of this exception, the thesis considers that it is first important to explore when the urgent circumstance occurs. There are mainly two possible situations in which this exception may have a role to play: first, if the urgent circumstance happens prior to making the demand, then shareholders can bring derivative actions without making a demand. Second, if the emergency happens after making the demand, then shareholders can ignore the waiting period and commence the derivative lawsuit. As

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<sup>466</sup> X. Qiao, et.al, *Gongsi Jiufen de Sifa Jiuji* [The Judicial Remedies to the Corporate Disputes] (Falv Chubanshe [Law Press] 2007) 93.

<sup>467</sup> D. Liu, *Woguo Gudong Paishengsusong Zhidu Yanjiu* [Study on Shareholders' Derivative Action System in China] (Qunzhong Chubanshe [People Publishing] 2011) 132.

a result, the nature of this exception depends on which situation can be applied. If the legislation can be interpreted and applied in the former situation, then it is a demand excused. Otherwise, it is only a waiting period waived. From the wording of article 152, it is difficult to justify which situation can be applied to this exception. In practice, it seems that the courts are inclined to the former situation as they regularly permit demands to be excused in urgent circumstances.<sup>468</sup>

Besides the above disputes, two concerns have also been raised. First, it seems that the legislative concept is self-contradictory. On the one hand, it requires the shareholders of a JSC to hold shares for at least 180 days consecutively in order to initiate derivative actions. On the other hand, it confers on shareholders a right to raise proceedings without the waiting period where the company would suffer irreparable damage if a suit could not proceed immediately. A contradiction would thus arise if a shareholder had to initiate a lawsuit immediately when an urgent circumstance emerges though is not eligible to bring such an action as their holding period is less than 180 days. In such a case, the purpose or intention of the demand excused or waiting period waived rule cannot be achieved if the holding period requirement has to be obeyed.

The second issue is about the concept of urgent circumstances. The definition of urgent circumstances is not provided in the Company Law 2005. The lack of clarity around the meaning of this concept may lead to various interpretations and create unsystematic practices. Failure to clarify this concept in the future may provide an opportunity for conservative judicial institutions to reject applications as various courts can have different interpretations. Indeed, it undeniably difficult to clarify this concept precisely, though it is possible to set some guidelines for applying this

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<sup>468</sup> D. C. Clarke and N. C. Howson, 'Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China' In D. Puchniak et al. (eds.) *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012) 243.

principle. For example, the law could establish two tests for clarifying this concept: the first test is that if the damage to the company results in the loss of a certain amount of money or a prescribed percentage of the total assets of the company, then it constitutes urgent circumstance. The second test is that if the damage may lead to a malfunction of the management in a company, shareholders could bring derivative actions without making the demand.

### 3.3.2.4 Other issues

Several other aspects of Chinese derivative actions are also worthy of discussion. First of all, considering the special nature of derivative actions, the funding rules for these lawsuits should be different from other types of action. Unfortunately, all litigation in China, including derivative actions, are subject to the same rules. However, it is recommended that plaintiff shareholders be entitled to be rewarded if litigation is successful, as it is unfair for plaintiff shareholders to bear all the costs and risks while the benefits ascribe to the company. A shareholder would be discouraged from bringing a derivative action against wrongdoers without this incentive.<sup>469</sup> Second, the status of the company is uncertain under the current Company Law. Some argue that the company should be treated as a nominal plaintiff, as it is the de facto plaintiff and beneficiary, while others claim that it should be treated as a nominal defendant as in the UK and the US.<sup>470</sup> However, none of these fall within the scope of Chinese derivative actions because the company is treated as a third party without an independent claim under the Civil Procedural Law.<sup>471</sup> This is criticized by Liu who argues that the fundamental basis for a derivative action would be lost without the independent claim of the company because the claims of

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<sup>469</sup> The funding rules of derivative actions will be discussed in detail in Chapter 5.

<sup>470</sup> J. Liu, *Gudong Paishengsusong Yanjiu* [Study on Shareholder's Derivative Actions], PhD thesis (Chinese University of Political Science and Law 2007) 93-96.

<sup>471</sup> Article 56 of Civil Procedural Law.

shareholder plaintiffs stem from the company.<sup>472</sup> Furthermore, any settlement reached by both parties does not need to be published or approved by the courts according to Company Law 2005. However, this might create the issue that both the defendant and plaintiff shareholder can reach a confidential settlement at the cost of the interests of the company and other shareholders. Therefore, it is suggested that any settlement should become effective only after being notified to other shareholders and receiving permission from the courts.

### **3.3.3 The Judicial Application of Derivative Actions under the Company Law 2005**

After Company Law 2005 became effective on 1 January 2006, the new statutory derivative actions system was also implemented. It is essential to examine the judicial application of derivative lawsuits in order to understand how this new system works in practice. Similar to the research methodology used in the previous part,<sup>473</sup> this thesis conducted a comprehensive empirical study collecting all the derivative actions as many as possible and the result of this is examined as follows.

#### **3.3.3.1 Cases concerning Joint Stock Companies**

Strikingly, there are almost no cases involving derivative actions in JSCs, listed or unlisted. This is a tragedy because, as Clarke and Howson point out,<sup>474</sup> the new derivative actions system was adopted in Company Law 2005 to entitle minority shareholders to raise proceedings against directors, senior managers or other persons who have done something harmful to a company. As far as this research can find, the

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<sup>472</sup> J. Liu, *Xiandai Gongisfa* [Modern Corporation Law] (Falv Chubanshe [Law Press] 2008) 277.

<sup>473</sup> For details of this, please refer to Chapter 3 part 2.

<sup>474</sup> D. C. Clarke and N. C. Howson, 'Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China' In D. Puchniak et al. (eds.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012) 243.

*Sanlian Shangshe* case is the only case involving a JSC following the coming into force of the Company Law 2005.<sup>475</sup> In this case the plaintiff shareholders brought an action on behalf of the Sanlian Shangshe Company against the former controlling shareholder, the Sanlian Group. The result of this case is unknown as it is still *sub judice*.

According to Clarke and Howson's research, several factors may account for this unfortunate underutilisation.<sup>476</sup> One explanation is that corporate governance in JSCs on the whole is relatively good and thus managers and majority shareholders rarely have any opportunity to benefit at the cost of the company and its minority shareholders. Here, minority shareholders do not need to bring derivative actions to protect their rights and interests. However, this explanation is weak and hardly plausible given that the severe agency cost in China.<sup>477</sup> Even if it is true that JSC mechanisms constrain managers and majority shareholders extremely effectively, this cannot explain the almost complete absence of derivative actions being brought within JSCs. A second explanation is that there are many obstacles hindering the application of derivative actions in such companies. As described above, the requirements that must be met for shareholders to commence derivative lawsuits are various and depend on company type. For JSCs, the law imposes higher threshold conditions on shareholders to raise proceedings as they are required to individually or jointly hold at least one percent of shares for 180 or more consecutive days.<sup>478</sup> In addition, funding rules may also strongly discourage shareholders from bringing such actions because they lack incentives to do so. These obstacles may contribute to this

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<sup>475</sup> Shuguang Li, who is one of the drafters of the Company Law 2005 and Bankruptcy Law 2006, comments on this case, saying that this is the first shareholders' derivative action to be brought in a listed company after the new Company Law 2005 became effective, and it has landmark significance in the history of Chinese securities. See Qianlong News:

<<http://finance.ifeng.com/stock/ssgs/20091211/1568709.shtml>> (last visited 29 April 2014)

<sup>476</sup> See D. C. Clarke and N. C. Howson, 'Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China' In D. Puchniak et al. (eds.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012) 243

<sup>477</sup> For details of agency costs in China, please refer to Chapter 2.

<sup>478</sup> See article 152 of Chinese Company Law 2005.

near absence of JSC-related cases. Another possible explanation is that minority shareholders may settle with wrongdoers secretly before filing suits in the courts. If the issue is settled within the company, an agreement may be reached to say that the dispute should not be made public. Indeed, if disputes are resolved within the company, potential derivative actions would be avoided and thus no case would be reported. However, this explanation seems unconvincing as it is hard to imagine that almost all cases involving JSCs are settled invisibly in a manner that is so disproportionate when compared with cases involving limited liability companies. Furthermore, even though more disputes are settled within the company than brought to the courts, it is much easier for shareholders in limited liability companies to reach a settlement with wrongdoers as both parties in the company have better information. A fourth explanation may be the attitude of the courts. Prior to Company Law 2005, attitudes towards derivative actions varied as described above. Some courts rejected derivative lawsuits because no derivative action system had been enacted into company law, whilst others accepted derivative lawsuits for a diverse range of reasons. After Company Law 2005 entered into force and with the new derivative action system in place, the attitude of the Chinese courts played a key role in the application of this new institution. In view of the near-total absence of derivative lawsuits in JSCs, it is reasonable to believe that Chinese courts are not willing to accept JSC-related derivative lawsuits. Research conducted by Howson confirms this speculation. Howson examined judicial autonomy in the Shanghai People's Courts from 1992-2008, and found that the Chinese courts will essentially not accept politically or technically complex cases. As JSC-related cases normally involve large numbers of plaintiffs and have a significant impact on listed companies, various local courts are instructed not to accept such cases.<sup>479</sup> This could therefore be the main plausible reason why there are almost no cases involving derivative actions in JSCs.

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<sup>479</sup> N. C. Howson, 'Corporate Law in the Shanghai People's Courts, 1992-2008: Judicial Autonomy in the Contemporary Authoritarian State' (2010) 5 *East Asia Law Review* 303-440. In this article, Howson points out that an *internal* instruction was delivered to local level courts forbidding them to accept all listed JSC-related cases.

### 3.3.3.2 Cases in Limited Liability Companies

#### 3.3.3.2.1 Overview

In contrast to the near absence of JSC-related cases, derivative actions have been found in cases relating to limited liability companies. This research collected all the available cases since the implementation of the Company Law 2005 – covering the dates 1 January 2006 to 30 August 2013 and 77 cases were identified as the table below shows.

Table 5

| Number of Derivative Actions in China from 2006-2013 |       |      |       |       |       |       |       |      |
|--|-------|------|-------|-------|-------|-------|-------|------|
| Year   | 2006  | 2007 | 2008  | 2009  | 2010  | 2011  | 2012  | 2013 |
| Number   | 12    | 6    | 15    | 11    | 14    | 9     | 8     | 2    |
| Percentage   | 15.6% | 7.8% | 19.5% | 14.3% | 18.2% | 11.7% | 10.4% | 2.6% |

It seems that derivative actions have been effectively utilised in China, as 77 cases is a good take-up figure in comparison to other countries. For example, when Japan adopted derivative actions in 1950, this mechanism lay dormant for the first 35 years when not a single derivative action was taken in the five years following its enactment and there was less than one case per year on average from 1950 to 1985.<sup>480</sup> By the end of 1992, there were only 31 derivative actions pending before Japanese courts.<sup>481</sup> In the UK where derivative action was legislated into the Companies Act 2006, there were less than 20 cases brought before courts after its implementation.<sup>482</sup> From this comparative perspective, it appears that derivative

<sup>480</sup> M. Nakahigashi and D. W. Puchniak, 'Land of the Rising Derivative Action: Revisiting Irrationality to Understand Japan's unreluctant Shareholder Litigant', in D. W. Puchniak, H. Baum and M. Ewing-Chow (eds.), *The Derivative Action in Asia* (Cambridge University Press 2012) 133.

<sup>481</sup> M. West, 'The Pricing of Shareholder Derivative Actions in Japan and the United States' (1994) 88 *Northwestern University Law Review* 1439-1440.

<sup>482</sup> *Singh Brothers Contractors (North West) Ltd, Re* [2013] EWHC 2138 (Ch); *Fort Gilkicker Ltd, Re*

action has made a noticeable impact in China.<sup>483</sup>

However, many other factors should be noted as they may affect findings when comparing raw data on the number of cases brought in different countries. Indeed, a closer examination reveals that China's derivative action system is ineffective: first, although there were very few cases in the first 40 years after derivative action was enacted in Japan, one should not neglect the fact that the number of derivative actions skyrocketed from the early 1990s onwards. In 1993, there were 86 cases pending before Japanese courts. This number continued to rise, peaking in 1999 with 95 new cases filed and a total of 222 cases pending.<sup>484</sup> Comparing this figure to the 77 cases over an eight-year period in China, makes the latter seem less impressive. Second, one of the main reasons that few derivative actions have been brought in the UK is that other strong remedies are available for minority shareholders to protect themselves. For example, unfair prejudice has proved to be a very popular mechanism in protecting minority shareholders owing to the wide range of conduct covered by this rule and the flexibility of relief it offers.<sup>485</sup> The dominant role of this remedy means that derivative action plays an insignificant role in disciplining corporate management in the UK. However, no such mechanism like unfair prejudice exists in China and derivative actions therefore ought to play a key role in corporate governance. Third, the exercise of other methods which were enacted to protect

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[2013] EWHC 348 (Ch); *Hughes v Weiss* [2012] EWHC 2363 (Ch); *Phillips v Fryer* [2013] B.C.C. 176 (Ch D); *Certain Limited Partners in Henderson PFI Secondary Fund II LLP v Henderson PFI Secondary Fund II LP* [2013] 3 All R.R. 887; *Bamford v Harvey* [2012] EWHC 2858 (Ch); *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); *Seven Holdings Ltd, Re* [2011] EWHC 1893 (Ch); *Parry v Bartlett* [2011] EWHC 3146 (Ch); *Ritchie v Union Of Construction, Allied Trades and Technicians* [2011] EWHC 3613 (Ch); *Stainer v Lee* [2011] 1 B.C.L.C. 537 (Ch D); *Kiani v Cooper* [2011] 2 B.C.L.C. (Ch D); *Cinematic Finance Ltd v Ryder* [2012] B.C.C. 797 (Ch D); *Wishart, Petitioner* [2010] B.C.C. 162; *Stimpson v Southern Landlords Association* [2010] B.C.C. 387 (Ch D); *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); *Fanmailuk.com Ltd v Cooper* [2008] EWHC 2198 (Ch); *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch).

<sup>483</sup> H. Huang, 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis' (2012) 27 *Banking and Finance Law Review* 628.

<sup>484</sup> M. West, 'Why Shareholders Sue: the Evidence from Japan' (2001) 30 *Journal of Legal Studies* 351-372.

<sup>485</sup> A. Reissberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007) 277.



shareholders is much more than the use of derivative actions. For example, this thesis examined the cases involving the infringement of the right to know and 122 cases were found. Last, considering the severe double agency costs and the huge number of companies in China, 77 cases is not a large figure and Cases involving derivative actions could have been at least double had it had been effectively use. In addition to the above discussion, the procedural and substantial aspects of derivative actions are unclear in practice.

### **3.3.3.2 Procedural Aspect: Demand Requirement**

Several loopholes have been identified above concerning the demand requirement where minority shareholders wish to bring derivative actions. These legislative drawbacks undoubtedly create unsystematic and problematic judicial application in practice. Some courts may use these shortcomings to avoid the implementation of derivative lawsuits, while other courts have taken bold action to welcome these lawsuits regardless of the unclear procedures involved.

In the *Zhaoyu Electronic Hardware* case, the complaining shareholder, who was also the legal representative for the company, brought a derivative lawsuit without making the necessary demand to the appropriate body as they believed that they had the power to act for the company in raising proceedings. The application was permitted at the first-instance court, but it was later rejected by the intermediate-level court on appeal for the reason that it did not strictly follow the demand requirement in accordance with Article 152.<sup>486</sup> In the *Beijing Dingyu Cable* case, the court even refused a claim for failure to make a proper demand while there was no corporate

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<sup>486</sup> *Zhao Yu v Zhou Yuchao re: Shunde Municipal Zhaoyu Electronic Hardware Company Limited* (Guangdong Province Foshan Municipal Shunde District People's Court (2006). *Shun fa miner chuzi* No. 02196; on appeal Guangdong Province Foshan Intermediate People's Court (2007) *fo zhong fa miner zhongzi* No.348)

organ or actor in existence at that time that could have received the demand.<sup>487</sup> This adjudication has been criticised by some scholars for an unforgiving reading of the demand requirement.<sup>488</sup>

Despite the above cases in which the courts have tried to avoid the application of derivative actions by using loopholes in the law, some other courts have taken a positive attitude towards this new system. For example, in the *Beijing Aeronautical* case where the company had already entered into liquidation, the court accepted the derivative action even though the plaintiff shareholder did not make a demand as there was no appropriate body that could receive the demand at that time.<sup>489</sup> This decision which obviously contrasted with the case of *Beijing Dingyu Cable* was followed in some other cases.<sup>490</sup> As prescribed above, it is unclear in the law which company body the demand should be made upon where the defendant is a “third” person, and the courts may use this ambiguous provision to deny a claim if they wish to do so. However, in the *Tonghe Investment* case where the defendant was not an insider, the court allowed the derivative action to continue when the demand was made to the board of directors rather than the supervisory board.<sup>491</sup> In the *Beijing Puren Hospital* case which concerned complex related-party borrowing, the court even stepped further and permitted the lawsuit to proceed where the demand was made to the legal representative.<sup>492</sup> In the *Henan Golden Mango Property* case, the

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<sup>487</sup> *Zhang ke v Zhang Chen re: Beijing Dingyu Special Type Electric Cable Company Limited* (Beijing Municipal Haidian District People’s Court (2008) hai min chuzi No. 23873).

<sup>488</sup> D. C. Clarke and N. C. Howson, ‘Pathway to Minority Shareholder Protection: Derivative Actions in the People’s Republic of China’ In D. Puchniak et al. (eds.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012) 254.

<sup>489</sup> *Lin Yu v Aeronautical New Concept Science and Technology re: Beijing Aeronautical City Tongzhi Nengka Engineering Company Limited* (Beijing Municipal Haidian District People’s Court (2006) hai min chuzi No.08927).

<sup>490</sup> For example: the cases of *Shanghai Ninghui 2008*, *Liaoning Baotong Materials 2006*, and *Huangshan Fenghua Real Estate 2009*.

<sup>491</sup> *Zhejiang Hexin Electric Power Development Company Limited & Jinhua City Daxing materials Company Limited v Tonghe Zhiye Investment Company Limited re: Tonghe Investment Holding Company Limited* (Zhejiang Higher people’s Court and Supreme People’s Court, 2009).

<sup>492</sup> *Wu Yongjian v Xu enxing and Zhu Yuxiang re: Beijing Puren Hospital Administration Company Limited* (Beijing Municipal Shunyi District People’s Court(2009) shun min chu zi No. 1065; on appeal Beijing No. 2 Intermediate People’s Court (2009) er zhong min zhong zi No.11811).

court gave a new explanation of the demand requirement. In this case, the court authorized proceedings to continue even though the plaintiff shareholder did not formally make a demand to the company that he wanted to sue a construction contractor. The demand was “excused” because both the first- and second - instance courts recognised the fact that the company had initially sued the defendant, but later had withdrawn its claim. This was interpreted by the courts as a signal to refuse to bring an action against the wrongdoer.<sup>493</sup> In such circumstances, the complaining shareholder thus does not need to make the demand to the appropriate body.

### 3.3.3.2.3 Substantive Aspects: Unclear Standard

As analysed above, the law stipulates some rules about how to bring a derivative actions against wrongdoers procedurally. However, the standard for the courts to adjudicate the cases in substance is not clear. This absence of clear rules inevitably creates chaos in practice. For example, Article 152 stipulates that the cause of the action against insiders is that they violate the law, administrative regulations or the articles of association in the course of performing company duties, incurring the damage to the company. However, it is not clear whether the violation of fiduciary duty can cause the suits in practice. In the *Beijing Xiaokou Food and Beverage* case, the defendant, who was also a legal representative, had misappropriated corporate revenue and was found to have violated the “duty to properly use the company assets”.<sup>494</sup> The court deemed this violation to be a part of Article 148 and thus supported the shareholder’s claim. However, in the case of *Nanchuan Chemical Industry*, the court denied that a violation of the duty of care could lead to derivative

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<sup>493</sup> The second-instance court noted in the verdict that this “may be seen as a refusal to bring the action”. See *Lu Tong v Henan Longxiang Construction Engineering Company Limited re: Henan Golden Mango Property Company Limited* (Zhengzhou Municipal Guancheng Hui Minority District People’s Court (2007) *guan min er chu zi* No.257; on appeal Henan Provincial Zhengzhou Municipal Intermediate people’s Court (2009) *zheng min er zhong zi* No.718).

<sup>494</sup> *Wen Jianguo v Zhao Limei re: Beijing Xiankou Xiaojing nanjinjia Food and Beverage Company Limited* (Beijing Xuanwu District People’s Court (2009) *xuan min chu zi* No.2625).

actions as “the breach of that duty and resulting liability to the company [for damages] is a separate legal relationship”.<sup>495</sup> This un-unified practice not only makes the law unstable, but also misleads shareholders and management.

In deciding whether a derivative action would be permitted or not, mere internal management is one of the standards to reject a claim in western countries. Although it is not introduced to Company Law 2005, it seems that the courts embrace this principle in practice as one of the criteria to refuse an application. In the *Weihai Yinghai* case, an action was allowed to proceed while it was later rejected for the reason that the dispute “belonged to the issues of the company’s internal administration”.<sup>496</sup> This decision was upheld in another case of *Huangshan Fenghua Real Estate* where an application was permitted at the first-stance, but was then dismissed by the Anhui provincial-level court, which supported the argument of the defendant that the issues “merely pertain to internal shareholder disputes”.<sup>497</sup> Indeed, it is widely accepted that the principle of “merely internal management” could be one of the reasons for rejecting derivative actions in the UK or other western countries. The embracement of this principle can be regarded as a further step in the process of modernisation of company law in China.

### 3.3.4 The Role of Derivative Actions in China

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<sup>495</sup> *Li Xiaozhong and 28 other shareholders v Xiao Wuyong & Zhang Dingzhong re: Nanchuan Municipal Hardware Infrastructure Electric Chemical Industry Company Limited* (Chongqing Nanchuan City [District] People’s Court (2006) *nanchuan fa min chuzi* No.538).

<sup>496</sup> *Qingdao Municipal Chemical Petroleum Supply Company Limited v Zhang Chun re: Weihai Yinghai Zhiye Development Company Limited* (Weihai Municipal Intermediate People’s Court (2007) *wei min er wai chu zi* No.27; on appeal Shandong Provincial Higher People’s Court (2008) *lu min si zhong zi* No.103).

<sup>497</sup> *Shi Jianjun v Qian Guoli and others re: Huangshan Municipal Fenghua Real Estate Development Company Limited* (Huangshan Municipal Intermediate People’s Court (2004) *huang zhong fa min er chu zi* No.21; on appeal Anhui Provincial Higher People’s Court (2009) *wan min er zhong zi* No.0163).

Before exploring the role of derivative actions in China, it is necessary to answer the question of whether derivative actions should play a key role in constraining agency costs in China. If derivative action has a weak function in monitoring management, then it would be meaningless to investigate the role of derivative actions in China. Theoretically, it is generally believed that derivative action is neither the initial nor the primary protection for minority shareholders against the misconduct of management or controlling shareholders. Indeed, if other mechanisms could have an effective role in preventing wrongdoing or punishing wrongdoers, it seems unnecessary to confer the right on shareholders to initiate lawsuits against wrongdoers on behalf of the company. However, it is demonstrated that even though other methods such as market forces can be used to hold managers or controlling shareholders accountable, the role of derivative action cannot be neglected as other mechanisms alone may not constitute an effective functional substitute for litigation. This is particularly true when there are defects affecting the effectiveness of these mechanisms. In China, it is even more urgent and necessary to adopt the derivative action system considering the *status quo* in law and practice. First of all, Chinese minority shareholders are faced with the increasingly severe agency costs. Unlike other countries which either have vertical or horizontal agency cost, Chinese minority shareholders are confronted with double agency costs. Thus, they risk being exploited by both majority shareholders and managers. In order to address these problems, market forces and legal mechanisms are in place. Unfortunately, it has been shown that these non-legal and legal methods cannot effectively constrain agency costs in China. With regard to market forces, it is widely thought that the capital market in China is actually a policy market and thus the function that a capital market ought to have is generally not applicable or at least reduced in China.<sup>498</sup> With respect to laws protecting the interests of minority shareholders, various flaws have been identified in these legal methods which prevent them from reducing agency

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<sup>498</sup> For the detail of this, please refer to Chapter 2.

costs effectively.<sup>499</sup> Overall, increasingly severe double agency costs with the ineffectiveness of market forces and legal mechanisms in China reveals the fact that derivative action is strongly needed to provide protection for Chinese minority shareholders.

Since it is now clear that derivative action should play an important role in constraining managers and controlling shareholders, another question arises as to whether the new statutory derivative action has functionally worked. It cannot be denied that the adoption of a derivative action system is a step forward in the development of China's company law, but the built-in defects in this new institution may discourage shareholders from initiating litigation to protect themselves; they may also provide an excuse for the courts to evade hearing derivative actions. The near absence of cases in JSCs has shown that the system of derivative actions is simply not working, regardless of the reasons behind this absence, speculated on above. Furthermore, various cases in limited liability companies also demonstrate the fact that the vagueness and defects of the law lead to the chaos and unsystematic judicial practice. In sum, China's mechanism for derivative actions, which ought to play a key role in reducing agency costs, remains insufficient to support accountability for managers and controlling shareholders. In view of this, it is necessary to examine derivative actions in the UK and US. Suggestions from these two jurisdictions may possibly be borrowed to improve the system of derivative actions in China.

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<sup>499</sup> For the detail of this, please refer to Chapter 2.

## **Chapter 4 Comparative Analysis**

### **4.1 Why Derivative Actions can be Encouraged**

As discussed in previous chapters, there are double agency costs in China and thus minority shareholders risk exploitation by both majority shareholders and managers. To reduce these agency costs, legal mechanisms and market forces have been examined and found to be ineffective in constraining the misbehaviour of majority shareholders and managers for a number of reasons. Derivative actions, as one legal mechanism for protecting the interests of minority shareholders, should therefore have a key role to play. In light of the inherent defects in the new statutory derivative actions regime in China, it is submitted that restrictions on derivative actions should be relaxed and shareholders are encouraged to raise proceedings. However, the foregoing discussion only addresses why derivative actions should play a significant role in monitoring management; it does not address why shareholders can be encouraged to exercise this right.

In fact, this touches the stone of legal transplant theory. As discussed in Chapter 1, there are basically two arguments for legal transplant: voluntary transplant and contextualist or culturalist theory. The former theory generally believes that legal transplant is socially easy while the latter recognises that the social context of the recipient country should be noted that. In addition to the demonstration of why legal transplant is possible in China which has been discussed in Chapter 1, this thesis argues that the social context is not unimportant for legal transplant. With regard to

derivative action, there are two factors which should be noted when attempting to improve derivative actions. As such, this part will examine why litigation can be developed on Chinese soil, mainly from the perspective of culture and the judiciary.

#### 4.1.1. Culture

It is recognised that culture can deeply affect the means of resolving disputes.<sup>500</sup> Indeed, choice of means for dispute resolution is strongly influenced by the peculiarities of traditional culture. As Chen argues, the means adopted by a society to resolve disputes depends on its available resources, cultural inclinations and philosophic leanings.<sup>501</sup> From this theoretical perspective, it is argued that Chinese culture is not suited to encouraging litigation. It is well-known that Confucian ethics are strongly rooted in Chinese culture and that the core principle of these ethics is the belief that harmony among persons must be achieved.<sup>502</sup> Five cardinal relationships that must be honoured to achieve a stable social order are identified in Confucian ethics: father and son, ruler and subject, husband and wife, elder and younger brother, and friend and friend. Confucianism believes that although such relationships can be achieved by resorting to the law, their stability cannot last for a long time as the law cannot deliver kindness, humanity, compassion and benevolence. In the Analects of Confucius, it is clearly stated that:

*I can hear a court case as well as anyone. But we need to make a world where there is no reason for a court case. If you use government to show them the way and punishment to keep them true, the people will grow evasive and lose all remorse. But if you use integrity to show them the way and ritual to keep them true, they will*

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<sup>500</sup> C. D. Vera, 'Arbitrating Harmony: 'Med-Arb' and the Confluence of Culture and Rule of Law in the Resolution of International Commercial Disputes in China' (2004) 18 *Columbia Journal of Asian Law* 149-194.

<sup>501</sup> G. B. Chen, *Law without Lawyers, Justice without Courts: On traditional Chinese Mediation* (Ashgate Publishing 2002) 1.

<sup>502</sup> U. M. Lauchli, 'Cross-Cultural Negotiations, With A Special Focus on ADR with the Chinese' (2000) 26 *William Mitchell Law Review* 1045, 1062.



*cultivate remorse and always see deeply into things.*<sup>503</sup>

The influence of this Confucian culture means that Chinese people are not willing to resolve their disputes in courts. Instead, they might choose a means of settling disputes privately. In light of this, it is argued that court-based dispute resolution would not be popular in China and thus shareholder litigation would not be aggressively used.

However, this thesis opposes the above arguments for the following reasons:

First, while Confucian culture is widely known in traditional China, another school of Chinese thought, the Legalists, has been intentionally or unintentionally neglected in the debate. This school of thought believes that a nation's cohesion can be secured by the application of strict legislation as well as harsh and draconian punishment.<sup>504</sup> The application of this school of thought was exemplified by the first emperor of unified China, Qin Shi Huang, who organised the construction of the Great Wall and who also emphasized the necessity of using cruel punishment for those who dared to show even the slightest resistance. Throughout the history of China, the Legalist school has been accompanied by the Confucian school. Its main belief of adopting strict laws to secure social stability has undoubtedly had an influence on Chinese dispute resolution. Therefore, Confucianism is not the only traditional culture to affect methods for resolving disputes; another traditional counter-culture has encouraged people to use law to resolve disputes.

Secondly, even though Confucianism has had much more influence than the Legalist school on Chinese culture, its ability to play a significant role in litigation is highly

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<sup>503</sup> Confucius as quoted in U. M. Lauchli, 'Cross-Cultural Negotiations, With A Special Focus on ADR with the Chinese' (2000) 26 *William Mitchell Law Review* 1059.

<sup>504</sup> X. Ren, *Tradition of the Law and Law of the Tradition: Law, State, and Social Control in China* (Praeger Publisher 1997) 21.

doubtful given China's increasing economic and social development. Unlike China's ancient society, the country is now experiencing a fast economic miracle, leading to transformation in almost every aspect of the nation's being. Consequently, a commercial culture is gradually becoming established. One of the core principles in commercial culture is that everyone should be held accountable for his or her behaviour. For example, anyone who fails to perform obligations under a contract should be held responsible for that failure and thus be prepared to be sued if they do not redress the damage caused by their non-compliance. Therefore, in commercial culture it is normal, or at least not unusual, to resolve disputes by bringing litigation. Another factor that encourages litigation as a result of commercial culture is that people are not afraid to do business with strangers. This inevitably leads to the phenomenon that one party would not hesitate to initiate an action against another if they have violated an agreement. This is particularly true in China as Chinese people are not willing to raise actions against those they are familiar with, owing to the need to "face"<sup>505</sup> and "renqing"<sup>506</sup>.

Thirdly, empirical studies have shown that Confucianism may not have any bearing on private shareholder litigation. For example, in Japan, which was and still is dominated by Confucian culture, only twenty derivative lawsuits were raised in the first thirty-five years after the introduction of derivative actions. It was argued that Japanese shareholders would forgo bringing derivative suits for financial gains owing to the cultural obsession with maintaining social harmony.<sup>507</sup> However, this

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<sup>505</sup> "Face" is similar to "honour", which is defined by "one's accumulated moral and social prestige in the eyes of the community". See C. Hutu, *China-Its People, Its Society, Its Culture* (HRAF Press 1960) 493.

<sup>506</sup> "Renqing" is equivalent to "personal goodwill" as it relates to the imperative that one party grant a favour to another party based on the nature of their relationship. The closer the relationship is, the greater the expectation and obligation of fulfilling one's renqing with the other. See C. D. Vera, 'Arbitrating Harmony: 'Med-Arb' and the Confluence of Culture and Rule of Law in the Resolution of International Commercial Disputes in China' (2004) 18 *Columbia Journal of Asian Law* 149-194.

<sup>507</sup> M. West, 'The Pricing of Shareholder Derivative Actions in Japan and the United States' (1994) 4 *Northwestern University Law Review* 1436-507; T. Ginsburgh and G. Hoetker, 'The Unreluctant Litigant? An Empirical Analysis of Japan's Turn to Litigation' (2006) 35 *Journal of Legal Studies* 33.

argument lost its ground as the number of derivative actions being raised started to rise in 1980s. After litigation cost reforms in 1993, the number of derivative actions being brought rose rapidly, peaking in 1999 with ninety-five new actions filed and a total of 222 actions pending.<sup>508</sup> This fact strongly refutes the argument that Japan's culture was solely responsible for low litigation rates. Mark Ramseyer has even claimed that the cultural theory was little more than a tautology.<sup>509</sup> In China, the increasing amount of litigation being engaged in also shows that Confucian culture may have less influence on private litigation than expected. After the Cultural Revolution, litigation actions rose significantly from 613,272 cases in 1979 to 7,462,488 cases in 2009. Civil litigation constituted 51.9% of these actions in 1979, rising to 86.2% in 2009.<sup>510</sup> In the first half of 2012, the number of private lending cases alone was 376,000, an increase of 24.78% compared with the same period for 2011.<sup>511</sup> The boom in commercial suits reveals that the influence of Confucian culture, which discourages litigation, is declining.

The influence of culture on litigation is not unilateral. Instead, there is an interaction between culture and derivative action. As discussed above, commercial culture, which has been promoted by China's economic development, indicates that people would not hesitate to bring an action against others if it is necessary to do so. As such, the establishment of this culture would encourage the use of derivative actions. On the other hand, the strengthening of derivative actions has the capacity to assist in the evolution of commercial culture in China. The main purpose of derivative actions is to protect the interests of minority shareholders and the company from being exploited by directors or controlling shareholders. It can thus be regarded as a means

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<sup>508</sup> D. W. Puchniak and M. Nakahigashi, 'Japan's Love for Derivative Actions: Irrational Behaviour and Non-Economic Motives as Rational Explanations for Shareholder Litigation' (2012) 45 *Vanderbilt Journal of Transnational Law* Volume 1-82.

<sup>509</sup> J. M. Ramseyer, 'The Costs of the Consensual Myth: antitrust enforcement and institutional barriers to litigation in Japan' (1985) 94 *Yale Law Journal* 604-607.

<sup>510</sup> J. Zhu, *Zhongguo Jin 30 nian lai Susong Anjian Shuliang Fenxi* [Quantity Analysis on the Chinese Lawsuits for the Past 30 Years] *Fazhi Ribao* [Legal Daily News] 2012-01-18.

<sup>511</sup> *Ibid.*

of tackling corporate corruption and wrongdoing. From this perspective, derivative actions harbour the transformative potential of fostering a particular conception of a free commercial culture. As a result, the active use of derivative actions can have a positive impact on promoting commercial culture, which would be beneficial to derivative actions themselves in return.

#### **4.1.2. The Judiciary**

Another argument seeks to posit that China's current judiciary may not be able to deal with the increasing volume of litigation, especially derivative actions needing specialist securities knowledge. This is true to some extent as the competence of Chinese judges has been criticised for a long time owing to an earlier policy permitting retired military officers to work as judicial authorities. As a result of this policy, many judges lacked legal knowledge as they had little or no legal education. However, the situation has been changing in recent years making the judiciary capable of dealing with derivative action cases for the reasons outlined below.

First, Chinese judges are becoming increasingly competent. A new Judges Law<sup>512</sup> has replaced the previous policy and stipulates the need for qualifications for becoming a judge. For example, it requires an academic degree and work experience. Furthermore, entry-level judges are to be selected from individuals who not only meet the basic requirements,<sup>513</sup> but have also passed a National Judicial Examination (Bar Exam).<sup>514</sup> The bar exam in China is known to be "the most difficult exam in the

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<sup>512</sup> The Judges Law of the People's Republic of China (hereafter Judges Law) was first enacted in 1995 and then revised in 2001.

<sup>513</sup> For example, a person who wants to be a judge in a High Court must have engaged in the legal work for at least three years in the cases of a law student from colleges or universities or from non-law graduate of colleges or universities but possessing the professional knowledge of law. See article 9 of Judges Law.

<sup>514</sup> See article 12 of the Judges Law.

world” because of its low pass rate. With these strict requirements, it is believed that Chinese judges will become increasingly competent.

Second, it is argued that if shareholders are encouraged to raise litigation, the courts will be heavily burdened in light of the prevailing exploitation of minority shareholder interests. Indeed, derivative actions may rise sharply if unnecessary restrictions are removed and shareholders are given strong incentives to exercise their right to take derivative action. However, there are sufficient judicial resources to deal with this increase in shareholder litigation as judges have risen in number from 130,000 in 1991 to 250,000 in 2010. This has created the availability of approximately one judge to every 48,000 people – a ratio that is much higher than in other jurisdictions. Although it is argued that some judges do not engage in the business of rendering judgment as they are responsible for administrative affairs, one of the tendencies of modern judicial reform in China is a reduction in the number of administrative judges. In addition, every year courts are recruiting increasingly qualified people to engage in judgment business with the retirement of non-competent judges who have no or little legal training. As a consequence, it can be expected that the judiciary would have little difficulty in dealing with the increase in such cases.

Third, the courts are now more willing to accept shareholder litigation. Traditionally, courts have been unfriendly to private securities litigation. As early as 1996, shareholders repeatedly attempted to file suits with the courts, without one case being accepted.<sup>515</sup> One example can vividly illustrate the unfortunate situation at that time. A company shareholder brought an action after the company’s chairman was sentenced to prison for committing financial fraud. However, the shareholder’s application was refused by the court despite the clear evidence of wrongdoing,

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<sup>515</sup> See: W. Hutchens, ‘Private Securities in China: Material Disclosure about China’s Legal System?’ (2003) 24 *University of Pennsylvania Journal of International Economic* 599-689.

demonstrated by the chairman's criminal conviction.<sup>516</sup> This position continued even after the enactment of China's securities law in 1998. In the face of this situation, the SPC surprisingly issued a report in 2001 stating that all lower courts should refuse to hear private securities litigation cases. However, this prohibition was suddenly changed in 2002 as the SPC lifted the restriction on accepting cases, though the only available cause of action was limited to false disclosure. After specific rules for handling private securities cases were issued by the SPC, the courts started to accept such litigations. Although the limited availability of civil remedies continues to be criticised, it is apparent that the attitude of the courts towards shareholder litigation has changed in a direction that is increasingly friendly towards shareholders. With the increasing awareness of the need to protect investors, Chinese courts can be expected to be more open to shareholder litigation.

#### **4.1.3 Summary**

The previous chapters attempt to demonstrate that derivative actions should be actively used and shareholders should be strongly encouraged to bring litigation. However, there is a concern that the traditional culture of unwillingness to raise proceedings and the lack of competent judiciary may hinder the improvement of derivative actions. Indeed, the Confucianism encouraging people to resolve disputes without going to the courts and the old policy permitting retired military officers to work as judicial authorities seem to provide obstacles for establishing effective derivative action system. Nevertheless, this part demonstrates that this worry is groundless owing to the co-existent culture of Legalist school and the enactment of the Judges Law.

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<sup>516</sup> C. E. Walter and F. J. T. Howie, *Privatizing China* (2<sup>nd</sup> edn, John Wiley & Sons (Asia) Pte Ltd 2006) 61.

## **4.2 Improving China' s Derivative Actions**

The previous chapter identified some loopholes in and problems with derivative actions in China. Although some possible solutions were provided in the process of analysis, some issues are not resolved. As such, this part will focus on tackling these unsolved loopholes and thus improve the system by looking to UK and US jurisdictions. In light of the importance of funding rules in providing incentives for shareholders to initiate derivative litigation, the funding issue will be examined separately in the next chapter.

### **4.2.1 Who Can Sue?**

The standing requirement for individual shareholders to bring derivative actions in China is criticised for having too high a standard. This is because as an eligible plaintiff shareholder in joint stock companies (JSC) is required to hold one percent or more of the total shares separately or aggregately for at least 180 consecutive days. It is argued that this standing requirement should be relaxed in order to provide stronger protection for minority shareholders. Moreover, there may be some other factors that could be borrowed from standing requirements in the UK and the US.

#### **4.2.1.1 The Standing Requirement in the UK**

The scope of *locus standi* for shareholders in the UK to bring derivative actions has been widened. According to section 260(5)(C), a derivative action can now be initiated either by a shareholder or by a person who is not a member of the company but to whom shares in the company have been transferred or transmitted by operation

of law.<sup>517</sup> In addition, a shareholder ownership threshold does not need to be met, which means that it is theoretically possible for a claimant to purchase one share with the view to commencing derivative litigation. The new statutory rule also retains the common law position that a shareholder is entitled to initiate litigation even where the cause of litigation arose before he or she became a member of the company. This is different from the standing requirements in the US.

#### **4.2.1.2 The standing Requirement in the US**

Individual shareholders must meet certain requirements in order to initiate derivative actions in the US. There are currently four general standing requirements. First, the plaintiff must be a member of the company when the action is initiated regardless of a record owner of shares or have some beneficial interest in an equity security. Secondly, so-called “contemporaneous ownership” is required. This means that the plaintiff has to have been a shareholder when the alleged conduct took place. They may also meet this requirement if they acquired their shares by operation of law from a former holder who owned the shares at the time that the conduct complained of occurred. Thirdly, “continuing ownership” is also required. This means that the plaintiff must continuously be the member of the company during the period of the action. Lastly, the plaintiff must be able to represent the interests of the shareholders fairly and adequately.

#### **4.2.1.3 Suggestions for China**

Clearly, standing requirements in the UK and the US are quite different from one another. It seems that the scope of plaintiff shareholders in the UK is much wider than in the US, which may create the perception that derivative actions are stronger

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<sup>517</sup> Section 260(5) (c) of the Companies Act 2006.



and more frequently utilised and favoured in the UK as compared to the US. However, this is not the case as there are a number of other factors that affect the function of derivative actions in these two countries. Standing in these two countries is analysed further below.

#### **4.2.1.3.1 Is the Principle of Contemporaneous Ownership Needed?**

In the UK, contemporaneous ownership is not necessary to bring a derivative action as such actions are intended to benefit the corporate entity as opposed to any individual shareholder. It has therefore been found that “it never can be held that the acquiescence of the original holder of stock in illegal acts of the directors of a company will bind a subsequent holder of that stock to submission to all future acts of the same character”.<sup>518</sup> However, this lack of restriction on the standing of plaintiffs may provide opportunities for malicious shareholders to bring frivolous litigation.

In the US the answer to this question differs as contemporaneous ownership is required. It was originally established to prevent collusion in manipulating cases to create federal jurisdiction.<sup>519</sup> The requirement has now been developed to prevent unjust enrichment on the part of those who acquired their shares with knowledge of an alleged wrong to discourage the litigation of purchased grievances. However, the justification for this rule has been strongly contested by scholars as the requirement goes well beyond these legitimate policy objectives. Two problems have been identified with the rule: first, it is argued that preventing the purchase of suits is not the true concern of this rule. Thus, the rule may be relaxed to allow a shareholder

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<sup>518</sup> *Bloxam v Metropolitan Rly Co* (1868) 3 Ch App 337 at 354 *per* Lord Chelmsford LC.

<sup>519</sup> The original purpose behind the contemporaneous ownership rule was that the US courts feared that shareholders who resided in the same state as the corporate defendants would transfer their shareholdings to individuals who resides in other states in an effort to confer diversity jurisdiction upon the federal courts. See R. C. Ferrara, K. T. Abikoff and L. L. Gansler, *Shareholder Derivative Litigation: Besieging the Board* (Law Journal Press 2005) Section 4.02 [2].

who bought shares before discovering an alleged wrongdoing to initiate a derivative action despite not being a member of the company when the wrongdoing occurred. Second, the prevention of unjust enrichment cannot act as a true justification as any recovery will go to the company and thus all current shareholders would benefit no matter when he or she became the member of the company. A windfall for some shareholders is therefore inevitable. In fact, some shareholders who purchased shares after the alleged wrong may sustain injury under the rule as they are highly unlikely to have paid a discounted price for the shares if the wrongdoing was not publicly disclosed.

The above concerns have been recognised resulting in the adoption of a corrective doctrine of “continuing wrong exception” in some jurisdictions. Under this doctrine, a shareholder is entitled to initiate a derivative action if the alleged wrong was still “continuing” at the time when they bought the company’s shares. However, it is argued that this exception makes the contemporaneous ownership requirement more complicated, as the standards to define “continuing wrong” have been applied differently.<sup>520</sup> For example, one court stated that a wrong is a continuing one when “it spans the plaintiff’s ownership, or if new elements in a pattern of wrongful conduct occur after acquisition.”<sup>521</sup> By contrast, another court has framed this continuing wrong exception as occurring when the conduct forming the basis for the cause of action was legally complete.<sup>522</sup> Furthermore, some courts have been very conservative towards this doctrine as it might swallow the contemporaneous ownership rule.

The above discussion suggests that the contemporaneous ownership rule may be

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<sup>520</sup> See R. C. Ferrara, K. T. Abikoff and L. L. Gansler, *Shareholder Derivative Litigation: Besieging the Board* (Law Journal Press 2005) Section 4.02 [3] [b].

<sup>521</sup> *Bateson v Magna Oil Corp.*, 14 F.2d 128, 130 (5<sup>th</sup> Cir.1969), cert. denied 397 U.S.911 (1970).

<sup>522</sup> *Brambles USA, Inc. v Blocker*, 731 F. Supp. 643, 650 (D. Del.), rehearing denied 735 F.Supp.1239 (D.Del.1990).

appropriate for adoption in China. In addition to the general aforementioned rationales behind this principle, there are some other circumstances that justify the adoption of this rule. First, the absence of contemporaneous ownership may create a market for claims. If an investor knows of wrongful behaviours taking place in a company in which he does not hold any shares, he may seek to purchase a shareholding of that company to bring an action. It may at first sight seem to be good for the company's shareholders as the initiation of such proceedings could protect their interests from being exploited. However, it fails to be advantageous for the capital market in the long run as buying claims is not only morally wrong but also against the capital market's aims. Generally, buying a company's shares implies that you value that company or at least believe that its shares price will increase sooner or later. However, if the purpose of buying those shares is to bring an action rather than make a profit, the objective of the capital market is affected or hampered. Secondly, a market for claims is not only conducive to investors and harmful to the entire market, but also hurts a company's development. A company can easily be rendered vulnerable to unmeritorious litigation as a result of such a market and its daily management would be inevitably affected. This is particularly serious in China in light of the short time that its capital market has been established and the imperfections of the country's legal system. Therefore, the contemporaneous ownership rule should be transplanted into China.

However, this rule must be relaxed to cater for the problems which have been identified above. The strict implementation of this principle may bring unfairness to shareholders, particularly when they buy shares without the knowledge of wrongdoing. As such, it is suggested that an individual shareholder should have standing to commence and maintain a derivative action even if he or she acquired the shares after the occurrence of alleged wrong provided that the alleged wrongdoing was not disclosed or specifically communicated to that shareholder. This approach

emphasises the importance of the public disclosure of alleged wrongs and it is believed that it can overcome the negative aspects of contemporaneous ownership rule.

#### **4.2.1.3.2 Is the Continuing Ownership Rule Needed?**

It is unclear in China whether a derivative action should be terminated if a plaintiff shareholder loses his or her qualification as a member of the company. It is also not clear in the UK whether a former shareholder is permitted to continue a claim as a derivative claim. In the US, plaintiff shareholders are required to continue to hold the relevant shares until the time of judgment. The rationale for this requirement is the prevention of the abuse of derivative actions, as a former shareholder, who would not benefit from the recovery, may be willing to accept an improper or inadequate settlement.<sup>523</sup> However, whilst understandable, this rule should not be overextended as it might cause problems in certain special situations, like during mergers. Indeed, the State of Delaware has established two exceptions to the application of this rule: (1) a former shareholder might be entitled to initiate a derivative action when the merger itself is for the purpose of depriving shareholders' standing to sue or is the subject of a claim of fraud; (2) a shareholder is also allowed to sue when shareholders receive different securities due to a merger but effectively remain the owners of the same business.<sup>524</sup>

It is submitted that the Delaware's approach could be adopted in China. Although the continuing ownership rule is not favourable for plaintiff shareholders as litigation would be terminated if they are no longer a member of the company, there are two reasons for adopting the US approach. First, former shareholders are unlikely to act

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<sup>523</sup> ALI Principles, section 7.02(a) (2), Comments D.

<sup>524</sup> X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 159.

in a company's interests; rather, they would probably act in their own interests as they have no direct relationship with the company. Second, even where a former shareholder is allowed to continue litigation, his or her claim would be rejected by the court because of their lack of direct interest in the outcome of the action.<sup>525</sup> Although it is argued that a failure to be a qualified shareholder may result from the manipulation of controlling shareholders or directors, this argument is addressed by Delaware's introduction of two exceptions aimed at protecting the interests of plaintiff shareholders under these circumstances.<sup>526</sup> These two exceptions should also be borrowed by China as a plaintiff shareholder could lose their qualification as a company member as a result of a manipulated merger. In view of the severe agency costs in China,<sup>527</sup> it is highly possible for controlling shareholders to disqualify plaintiff shareholders using mergers.

#### **4.2.1.3.3 Is Fair and Adequate Representation Needed?**

In the US, fair and adequate representation is needed to qualify shareholders to initiate derivative actions. This requirement, which derives from Rule 23.1 of the Federal Rules of Civil Procedure, reflects the recognition that a derivative action is above all a representative action and is thus subject to many of the same abuses and problems as are class actions. Traditionally, the law of fiduciary duties provides broad standing for shareholders to contest corporate practice. As a consequence, individual shareholders may take advantage of this and gain leverage to advance those of their interests that are not shared by such holders as a class. Where such conflicts have been identified by the courts, shareholder standing to initiate

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<sup>525</sup> Article 119 of Civil Procedural Law requires a plaintiff should have a direct interest with the case.

<sup>526</sup> The ALI Principles also recognise these two exceptions and thus provides that a former shareholders is allowed to commence and maintain derivative actions if his failure to own the shares until the time of judgment is 'the result of corporate action in which the holder did not acquiesce, and either (A) the derivative action was commenced prior to the corporate action terminating the holder's status, or (B) the court finds that the holder is more able to represent the interests of the shareholders than any other holder who has brought suit. See ALI Principles, section 7.02(a) (2).

<sup>527</sup> For more details about the agency costs in China, please refer to Chapter 2.

derivative actions is denied. In deciding whether plaintiff shareholders are fair and adequate representatives for the interests of the company's shareholders, the primary concern is how to define "adequacy". Three aspects have been identified in this regard: (1) the existence of any conflict of interest that would compromise the plaintiff's ability to serve as a representative of other shareholders; (2) the competence of the lawyer representing the plaintiff; and (3) any other evidence suggesting that the action will not be prosecuted vigorously.<sup>528</sup>

There is no such requirement in China or the UK. This standing requirement is good for the company as a whole, because the interests of the company could be harmed if a plaintiff shareholder cannot fairly and adequately represent the other shareholders. However, this requirement is not suitable for wholesale transplantation into the Chinese system as the interpretation and application of the principle are too vague and difficult for China's courts in practice. In order to ensure that litigation interests are adequately represented and the application is clear, two matters can be considered by the courts in determining that litigation is not adequately represented. These pertain to the following situation: (1) where the purpose of the plaintiff shareholder to bring a derivative action is to gain personal benefit. For example, the shareholder may use the action as a tool to threaten a company's managers in order to obtain compensation privately. In such a situation, a plaintiff shareholder loses their standing to bring a derivative action; and (2) where the plaintiff shareholder has authorised or acquiesced to the claimed wrongdoings. As a shareholder cannot come to court with clean hands and is actually a co-defendant in such a situation, they are surely disqualified from raising proceedings.

In light of the above, it can be concluded that the fair and adequate representation rule is not suitable for adoption in China. Instead, the court should assume that the

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<sup>528</sup> See ALI Principles, section 7.02 (a) (4), comments E.

claimant shareholder adequately and fairly represents the body of shareholders unless the two circumstances outlined in the preceding paragraph apply.

#### **4.2.2 Who Can be Sued?**

The scope of the defendants in derivative actions in China has been extended from directors or managers to include “other persons”. That means that a third person who is neither a company member nor a director could also be sued where they infringe the legitimate rights and interests of a company, and cause a loss. This approach is the same as that of the US where any person who damages the interests of a company may be subject to a derivative action.

In the UK, a new statutory rule has provided that a cause of action may be brought against a third party other than a director.<sup>529</sup> Unlike in China or the US, this provision does not mean that any third party who is not relevant to the directors could be a defendant. It only applies to those persons who have assisted directors in the breach of their duties.<sup>530</sup> Although the scope of defendants in the UK has been broadened, there are still some restrictions on a third party being sued, when compared to China and the US.

The current scope of potential defendants in China, particularly the scope of third parties, should be maintained for two reasons: first, “other persons” should be interpreted liberally to include shareholders or controlling shareholders under the Chinese Company Law. Restrictions on this would inevitably create a risk that some shareholders be excluded from being sued in derivative actions. Second, an empirical study has shown that about 45 percent of all defendants in China fall into the

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<sup>529</sup> S260(3) of the Companies Act 2006.

<sup>530</sup> D. Kershaw, *Company Law in Context: Text & Materials* (Oxford University Press 2009) 556.

category of “other persons”.<sup>531</sup> If the scope of third persons were confined to those who have assisted directors in the breach of their duties, some wrongdoers could not be disciplined.

There may be a counter-argument asserting that this broad scope of defendants could put a third person at risk, especially when they are doing the business with managers or directors in good faith. Furthermore, this wide scope could be harmful to commercial certainty, which is significantly important to economic development. Indeed, it would be unfair to third persons if they were to become a potential defendant because of a good faith transaction in which they had not colluded with directors or acts. However, the law does recognise this situation and thus provides a mechanism to protect such third parties. This is stipulated in China’s Property Law<sup>532</sup> rather than its Company Law. Article 106 of the Property Law stipulates that an assignee should be entitled to obtain the ownership of real property or movable property even if the assignor has no right to dispose of such property, as long as the following circumstances are met: (1) the assignee has accepted the real or movable property in good faith; (2) the property is transferred at a reasonable price; and (3) the property has been delivered to the assignee or registered, if that is required.<sup>533</sup> As such, concerns about the validity of transactions and commercial certainty are unnecessary if a third person acts in good faith.

#### **4.2.3 The Status of the Company**

One of the features of derivative actions is that they are initiated by individual

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<sup>531</sup> See H. Huang, ‘Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis’ (2012) 27 *Banking and Finance Law Review* 619-654.

<sup>532</sup> The Property Law of the People’s Republic of China (hereafter Property Law) was adopted at the 5<sup>th</sup> session of the Tenth National People’s Congress on 16 March 2007 and entered into force on 1 October 2007.

<sup>533</sup> Article 106 of the Property Law.



shareholders on behalf of the company owing to the fact that the company itself has failed to raise civil proceedings against the wrongdoers. It therefore seems that the company does not need to participate in this litigation as it has a plaintiff shareholder, and a director or third person as a defendant. However, as the results of the litigation will have a direct impact on the company, it should surely be involved in the derivative action in some capacity. Unfortunately, the Company Law does not stipulate what the legal status of the company is in China.

In the US, a company has a dual status in derivative actions. On the one hand, it can only serve as a nominal party defendant, as the company refuses to bring an action against wrongdoers on its behalf. On the other hand, it is the real party plaintiff as any compensation from the litigation will be ascribed to the company instead of the plaintiff shareholder.<sup>534</sup> In the UK, a company is also the nominal party defendant as the organ (general meeting or board of directors) of the company does not permit the initiation of an action and is thus disqualified from being a party plaintiff.

So what should the legal status of the company in China's derivative suit be? Obviously, it cannot be positioned as a party plaintiff for the following reasons: first, the Company Law specifically stipulates that the plaintiff must be a shareholder, which would be violated if the company is regarded as a party plaintiff. Second, a shareholder as the plaintiff in derivative litigation is widely accepted in various jurisdictions. Third, since the company refuses to bring a suit, it is inappropriate to treat it as a party plaintiff. Fourth, there are no cases indicating that the company should be positioned as a party plaintiff (see the table below). In light of this, can the company be treated as a nominal party defendant, like in the UK and US? The answer is negative for two reasons: first, there is no such concept of nominal party defendant in the Chinese legal system. Therefore, the civil procedural law would

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<sup>534</sup> See H. G. Henn, *Handbook of the Law of Corporations and Other Business Enterprises* (2<sup>nd</sup> edition, West Publishing 1970) §358 at 750.

have to be revised in order to accommodate this concept if it were adopted. Second, since there is a fundamental conflict of interests between wrongdoers and the company, a nominal defendant position would confuse or ignore this difference.

As a company is neither suitable to be regarded as a party plaintiff nor a nominal party defendant, naturally it falls within the scope of a third party without an independent claim in the litigation. According to article 56 of the Civil Procedural Law, a third party without an independent claim refers to a party who has no independent claim to the object of the litigation, but who has a legal interest in the outcome of the case.<sup>535</sup> Some commentators argue that a company is not qualified to be a third party without an independent claim as in actuality it actually does have such an independent claim.<sup>536</sup> Indeed, a company whose interests have been damaged by a wrongdoer is supposed to have an independent claim. However, that claim is transferred to the plaintiff shareholders after the company refuses to bring an action. Therefore, a company does not have an independent claim at least in the process of a derivative action.

Moreover, the position of a third party is recognised both in regulation and practice. In 2007, the Shanghai High People's Court issued the Several Opinions on the Cases of Shareholder Derivative Actions, in which article 2 stipulates that a company should be positioned as a third party when the People's Court is hearing shareholder derivative action case. Although these Opinions do not have any binding effect throughout the country as a whole, they do impact courts in other provinces. This has been proved by an empirical study conducted by Huang, in which the companies were treated as third parties in an overwhelming majority of cases between 2006 and

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<sup>535</sup> Article 56 of Civil Procedural Law.

<sup>536</sup> See J. Liu, *Xingongsifa de Zhidu Chuangxin: Lifazhengdian yu Jieshinandian* [Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies] (Law Press China 2006) 263.

2010.<sup>537</sup>

Table 6

| <b>Status of Company in Derivative Actions from 2006 to 2013</b> |                 |            |
|--|-----------------|------------|
| Position of Company in the suit                                  | Number of Cases | Percentage |
| Defendant  | 4               | 5%         |
| Third Party  | 49              | 64%        |
| Not Specified  | 24              | 31%        |
| Total  | 77              | 100%       |

#### **4.2.4 The Cause of the Action**

Potential defendants in derivative actions can be divided into two groups and the Company Law 2005 sets different causes for these two types of defendants. The first group, which is limited to directors, supervisors and senior managers, can be sued when they have caused losses to the company by breaching a law, administrative regulation or the company's articles of association, in the course of performing their company duties. The second group, which is referred as "others", may become defendants when they have damaged the company by violating its lawful rights and interests.<sup>538</sup> The wording of the above indicates that the causes for these two groups of defendants are not unified as the basis to sue the first group is narrow. According to article 152 of Chinese Company Law 2005, directors, supervisors or senior managers should not be held liable if they have violated the law, administrative regulations and articles of association causing losses to the company while acting in circumstances other than in the course of performing their company duties. However, this restriction is obviously unreasonable as such persons may engage in misconduct

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<sup>537</sup> H. Huang, 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis' (2012) 27 *Banking and Finance Law Review* 619.

<sup>538</sup> For details of the cause of derivative actions in China, please see Chapter 3.

and cause losses to the company even when they are not acting in the course of performing their duties.

In the UK, the cause of a derivative action is confined under section 260(3) of the Companies Act 2006 to the enforcement of director's duties. This is specified as being 'only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company'. From the wording of this section, it is clear that a derivative claim is no longer barred by common law requirements under the *Foss* rule. Furthermore, the types of breach under which a derivative action may be brought have also been extended. Under this new statutory rule, any breach of the general duties of directors stipulated in Chapter 2 of Part 10 of the Act, including the duty to exercise reasonable care, skill and diligence could form the basis for a derivative claim. The inclusion of negligence further broadens the scope of this basis as any instance of a breach of duty could lead to an action.

In the US, there are no express causes of action for which a derivative claim is to be initiated. Instead, the distinctions between direct actions and derivative actions outline such causes. In determining whether a particular claim is derivative or personal, the major test employed is the application of the injury and the right criteria.<sup>539</sup> Specifically, as stated in one case:

*Where the injury is personalized to a shareholder and flows from a violation of rights inherent in the ownership of stock, suit may be brought by the shareholder. On the other hand, where the injury is to the corporation and only affects the shareholders incidentally, the action is derivative.*<sup>540</sup>

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<sup>539</sup> Although there are some other factors which the courts may have to consider in some specific cases, such as policy bases for derivative actions, the competing interests of each party or even the results from the characterization; they are only 'of secondary significance' as the right/injury criteria are still the basic test. See J. W. Welch, 'Shareholder Individual and Derivative Actions: Underlying Rationales and the Closely Held Corporation' (1983) 9 *Journal of Corporate Law* 165.

<sup>540</sup> *Dowling v Narragansett Capital Corp.*, 735 F.Supp. 1105,1113 (D.R.I.1990).

As such, an individual shareholder could bring a derivative action against such a corporate injury. Since directors, senior managers and controlling shareholders are generally considered to owe fiduciary duties to the company rather than to individual shareholders, the breach of these duties occasioning “claims of gross negligence, mismanagement, self-dealing, excessive compensation, and usurpation of corporate opportunity” could entitle individual shareholders to raise derivative claims.<sup>541</sup>

In view of the above discussion, it seems that the basis to form a derivative claim in China is narrower than in the US, and even much narrower than in the UK. As noted above, directors or senior managers can only become defendants if they are acting in the course of performing their company duties. In other words, if they are acting under any other circumstances than performing those duties, they cannot be sued even where they engage in misconduct and cause loss to the company. This unreasonable basis should be changed and extended. However, such an extension should notably not be as broad as that under the new UK regime.<sup>542</sup> Indeed, allowing a broader range of claims to be brought might be beneficial in terms of general corporate accountability, but a wide basis may increase the already heightened fears of directors regarding potential litigation and could thus reduce the number of talented individuals willing to take directorships. Moreover, the essence of designing a derivative action system is to strike a balance between protecting the interests of the company and minority shareholders, and respecting the company’s management. Widening the application of derivative actions without restriction cannot achieve this balance. Third, although it is submitted in this thesis that derivative actions should be effectively encouraged, this does not mean that every aspect of derivative actions should be substantially widened or lessened. In fact, considering that this thesis

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<sup>541</sup> R. B. Thompson, ‘The Shareholder’s Cause of Action for Oppression’ (1993) 48 *The Business Lawyer* 732.

<sup>542</sup> The word ‘proposal’ obviously broadens the potential exposure of directors to risk as it does invite possible extra legal actions.

suggests lowering the rules regarding funding issue and the standing requirement, it is not necessary to widen the basis for a derivative claim to be brought without limit. Fourth, even in the UK where a wide basis has been adopted, this has not been without controversy during the legislative process.<sup>543</sup> Arguably, this change in the UK did not constitute any major change of principle to derivative actions as such actions remain under tight judicial control under the new procedure.<sup>544</sup> As a consequence, it is submitted that the circumstances under which a wrong is committed is not relevant to whether a defendant can be sued. As long as the defendant violates the related laws and damages the interests of the company, they should be eligible to become defendants in a derivative action regardless of whether the wrong is committed they are in the course of performing their duties.

#### **4.2.5 Settlement**

It is generally acknowledged that the judicial control of settlement or withdrawal of claims acts as an important check on derivative actions for the following two reasons: first, there is a potential risk that plaintiff shareholders may secretly reach a settlement with the defendants on terms advantageous to both parties while not in the interests of the company. Second, there is a disparity of interest between plaintiff shareholders and their lawyers in derivative actions as lawyers may find a smaller but speedier settlement more profitable and less risky than going to trial. This is particularly the case in the US owing to the contingency arrangement fees funding rule.<sup>545</sup> In such circumstances, lawyers have an incentive to settle with defendants although this may only have a minimal per share return on the plaintiff shareholders.

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<sup>543</sup> L. Roach, 'An Equitable Solution for Non-Executive Directors' (2006) 17 *International Company and Commercial Law Review* 117, 119.

<sup>544</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007) 137.

<sup>545</sup> The detail of this rule will be discussed in the next chapter.

Under UK law, the Civil Procedure Rules R19.9F also requires that a settlement should be approved by the courts where the court has given permission to continue a derivative claim. Regrettably, the law did not provide any specific rules for the court in deciding whether a settlement should be approved.<sup>546</sup>

However, the Chinese Company Law 2005 is silent on this important issue, while article 51 of Chinese Procedural Law merely states that the two parties may reach a settlement on their own accord without obtaining consent from the court. As there is no specific provision regulating derivative actions in the area of settlement, this inevitably leads to the assumption that the settlement of derivative claims is not subject to judicial controls. Nevertheless, the aim of redressing corporate wrong and recovering corporate losses cannot be achieved without a requirement for the courts' approval.

In the US, in order to prevent any possibility of abuse by the company or minority shareholders, a derivative action should not be settled, discontinued, compromised, or voluntarily dismissed by agreement between the plaintiff and a defendant, except with the approval of the court. In the absence of circumstances leading the court to find that the interests of the other shareholders will not be substantially affected by the settlement or other disposition, a notice of the terms of the settlement agreement must be sent to all the shareholders on an individual basis to the extent practicable. If some shareholders object to the settlements, then a reasonable opportunity to prepare for the settlement hearing is provided to allow them to contest the adequacy of the settlement.<sup>547</sup> It is argued that this approach should be adopted in China so that any settlement or withdrawal of a derivative action is reviewed by the courts in order to prevent abuse by other shareholders and the company. However, regarding the rights

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<sup>546</sup> Also see A. Reisberg, 'Judicial Control of Derivative Actions' (2005) 8 *International Company and Commercial Law Review* 335.

<sup>547</sup> See *Girsh v Jepson*, 521 F.2d 153 (3d Cir. 1975).

of dissident shareholders, the US approach of opening a hearing may not be suitable for China, as it would cost money and time. More importantly, there is no law regulating the court hearings in China and thus there is a risk that such a hearing might become a virtual trial. In light of this, it is recommended that dissident shareholders be allowed to submit a report stating why they object to the settlement within a reasonable period. Failure to submit such a statement should be deemed to constitute consent to such a settlement.

If a settlement must obtain consent from the courts, then the issue of how the courts review the settlement must be determined. In other words, what are the criteria or standards that must be applied by courts to approve or reject a settlement? In the US, the standard applied by the federal courts in deciding whether a settlement should be accepted is whether it is “fair and reasonable and in the best interests of all those who will be affected by it.”<sup>548</sup> While the concept of fair and reasonable is ambiguous, the courts have developed a flexible test to consider the amount of the settlement in light of all the circumstances, this includes the following factors: (1) the complexity, expense, and probable duration of continued litigation; (2) the best possible recovery; (3) the likely recovery if the claims were fully litigated; (4) the risk of establishing damages; (5) the risk of maintaining the class action throughout trial; (6) the reaction of the class to the settlement; (7) the stage of the proceedings; and (8) the ability of the defendants to withstand a greater judgment.<sup>549</sup> When it comes specifically to China’s courts in evaluating whether to approve a settlement, the above factors can be adopted for consideration. However, China’s courts should also pay attention to two additional issues: (1) the legitimacy of the settlement. Besides fairness and reasonableness, the legitimacy of the settlement should also be emphasised;<sup>550</sup> and

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<sup>548</sup> C. A. Wright, A. R. Miller and E. H. Cooper, *Federal Practice and Procedure* (West Publishing Company 1997) 378.

<sup>549</sup> *Desimone v Industrial Bio-Test Laboratories, Inc.*, 83 F.R.D. 615, 618-19 (S.D.N.Y.1979)

<sup>550</sup> According to the article 52 of the Chinese Contract Law, a settlement cannot violate the compulsory provisions of the laws and administrative regulations and cannot damage the interests of the public or State, a collective or a third party.



(2) whether the plaintiff shareholder is acting in good faith in reaching such a settlement.

## **4.2.6 Procedural Restrictions**

### **4.2.6.1 Different Approach**

In order to weed out frivolous, dishonest, vexatious or abusive claims at an early stage in the process before the actual substance of a claim is addressed, various procedural restrictions have been adopted in different jurisdictions. In China, the Company Law 2005 sets a demand requirement in derivative action procedures. This requires the qualified shareholders to make a demand in writing to the appropriate body before raising proceedings. This rule is actually a nod to the principle of the exhaustion of intra-corporate remedies and is justified because the company should be offered the opportunity to remedy the wrong before going to court, as it is the company itself who suffers directly. This is the same in the US where all States have a generalized requirement for a demand from the board before a derivative action can be brought.

Nevertheless, the UK adopts a different approach. The Companies Act 2006 incorporates a two-stage test to be met by claimants before permitting a case to proceed to the merits stage. Previously under the *Foss* rule, individual shareholders had to demonstrate that a claim fell within an exception in order to bring a derivative action. Now, whilst individual shareholders can readily initiate such litigation against directors for breach of duty, they must nevertheless apply to the court for permission to continue.<sup>551</sup>

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<sup>551</sup> Section 261 (1) of Companies Act 2006.

Before examining which approach is the most suitable one for China, it is essential to ask whether such procedural restrictions are necessary in China. As discussed above, a procedural restriction is established to screen out unmeritorious suits. Without this restriction, companies might easily be distracted by unnecessarily lawsuits and the court would have to hear numerous trivial and abusive claims. Indeed, it is submitted that derivative actions in China should be encouraged and thus unnecessary restrictions should be removed. However, there is a balance that should be pursued in this procedure. Considering the fact that reform of the funding rule and the lower standards for the standing requirement would improve this system, it is essential to retain this procedural restriction in order to strike a balance between preventing frivolous suits and allowing meritorious actions.

The next question then, is to discuss whether China should continue to adopt this demand requirement or transplant the UK approach. This thesis argues that the current procedural rule should remain because the two-stage approach is ambiguous and demand requirements have notable advantages.

#### **4.2.6.2 The Ambiguity of the UK Approach**

At the first stage in the UK approach, claimants must satisfy the court that the evidence filed in support of their claim discloses a *prima facie* case. If so, the court may require that evidence should be provided by the company. If the court is satisfied that the evidence submitted discloses no *prima facie* case, it is obliged to dismiss the claim and may make any consequential order it considers appropriate.<sup>552</sup> If the court decides not to dismiss the claim at the first stage, at the second stage the court is required to take account of the matters specified in s 263 in deciding whether

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<sup>552</sup> Section 261(2) of Companies Act 2006.

to grant permission.

Initially, the first stage which requires the applicant to disclose a *prima facie* case was not recommended by the Law Commission as they had a concern that this could easily result in an expensive mini-trial.<sup>553</sup> However, this was adopted by Parliament because it was expected that a front-line safeguard for derivative actions could “avoid opening a Pandora’s Box to every disenchanted individual in the country.”<sup>554</sup> It was also thought that the removal of particular elements of the *Foss* rule such as the requirement to establish “wrongdoer control” and “fraud on the minority” could open the floodgates to derivative actions. As such, establishing the first stage would enable the court to dismiss frivolous actions without the involvement of companies at the earliest phase.

However, there are several problems with this approach. First of all, the type of documentation required for submission to the court at this stage remains unclear as the Act fails to make any explicit stipulation. Secondly, the test of ‘no *prima facie* case’ is also unclear. The concept of *prima facie* might be familiar to lawyers as it has been the primary test applicable in interim injunction applications.<sup>555</sup> However, there is little guidance on how to establish the probability of success in the context of the new statutory derivative action. Gibbs suggested that if an applicant could establish that there is more than a 0 percent chance of success, the *prima facie* case ought to be satisfied.<sup>556</sup> This approach was derived from the decision in *Australian Broadcasting Corporation v Lenah Game Meats Pty Ltd*,<sup>557</sup> which in turn is taken

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<sup>553</sup> Law Commission, *Shareholder Remedies: Report on a Reference under Section 3(1) (e) of the Law Commissions Act 1965* (No. 246, 1997) para 6.71.

<sup>554</sup> HL Deb 9 May 2006, vol 681, col 885 (Lord Sharman)

<sup>555</sup> A. Keay and J. Loughrey, ‘Something Old, Something New, Something Borrowed: an Analysis of the New Derivative Action under the Companies Act 2006’ (2008) 124 *Law Quarterly Review* 469, 480.

<sup>556</sup> D. Gibbs, ‘Has the Statutory Derivative Claim Fulfilled its Objectives? A *Prima Facie* Case and the Mandatory Bar: Part 1’ (2011) 32 *Company Lawyer* 41, 42.

<sup>557</sup> *Australian Broadcasting Corporation v Lenah Game Meats Pty Ltd* [2001] HCA 63, (2001) 208 CLR 199 (High Court of Australia).

from the case of *American Cyanamid Co v Ethicon Ltd*.<sup>558</sup> However, there is no mention of 0 percent chance of success in these two cases. Instead, the latter case established a principle that the courts must be satisfied if there is a serious question to be tried. This means that the merits of the derivative actions should not be examined at this stage in order to avoid a drawn out process.<sup>559</sup> In *Iesini v Westrip Holdings Ltd*, Lewison J noted that the judge at first instance had considered there was a *prima facie* case on paper and thus moved on to the second stage. He explained that:

*At the first stage, the applicant is required to make a prima facie case for permission to continue a derivative claim, and the court considers the question on the basis of the evidence filed by the applicant only, without requiring evidence from the defendant or the company. The court must dismiss the application if the applicant cannot establish a prima facie case.*<sup>560</sup>

Here, although Lewison J did not point out the specific criterion for demonstrating a *prima facie* case, he made it clear that the *prima facie* case should not turn into a mini-trial of sorts. In the Scottish case of *Wishart v Castlecroft Securities Ltd*, Lord Reed also shared the above view and stated that:

*The question is not whether the application and supporting evidence disclose a prima facie case against the defenders to the proposed derivative proceedings, but whether there is no prima facie case disclosed for granting the application for leave...It is to be noted that no onus is placed on the applicant to satisfy the court that there is a prima facie case: rather, the court is to refuse the application if it is satisfied that there is not a prima facie case.*<sup>561</sup>

This statement suggests that the court imposes a low threshold at the first stage, an

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<sup>558</sup> *American Cyanamid Co v Ethicon Ltd* [1975] AC 396 (HL).

<sup>559</sup> J. Tang, 'Shareholder Remedies: Demise of the Derivative Claim?' (2012) 1 *UCL Journal of Law and Jurisprudence* 178, 183.

<sup>560</sup> *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch), [2010] BCC 420.

<sup>561</sup> *Wishart v Castlecroft Securities Ltd* [2009] CSIH 65; [2010] BCC 161, 194 per Lord Reed.

approach that would be advantageous for claimants.<sup>562</sup> However, in *Stimpson v Southern Landlords Association*, the court held that the factors set out in Section 263(2), (3) and (4) should be considered in determining an application at the initial stage.<sup>563</sup> Consideration of such factors would naturally have implications regarding the filing burden on plaintiffs in raising a suit. This was certainly never Parliament's intention.

Furthermore, it has even been suggested in some cases that the first stage proceedings may be merged into the second stage, as occurred in *Franbar Holdings Ltd v Patel*.<sup>564</sup> Here, the judge explained this approach as follows:

*Franbar has not so far sought to establish a prima facie case for permission to continue its derivative claim [...and thus] it would be appropriate for me to deal with the entirety of the application for permission to continue at a single hearing.*<sup>565</sup>

In *Mission Capital plc v Sinclair*, the parties agreed to merge two stages into one process and the judge regarded this as "sensible".<sup>566</sup> According to this case, it seems that it would not be sensible to separate these two stages. However, this conflation would inevitably undermine the valid legislative purpose behind the adoption of a two-stage procedure in such actions. Also, this approach was not followed in *Langley Ward Limited v Gareth Wynn Trevor, Seven Holdings Limited*.<sup>567</sup> In this case, the judge clearly expressed his disappointment that the preliminary screen of a *prima facie* case had been bypassed or merged, which was an unfortunate distortion of the statutory procedure.<sup>568</sup>

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<sup>562</sup> Keay and Loughrey also noted that a low threshold is placed on the applicant at the first stage. See: A. Keay and J. Loughrey, 'Derivative Proceedings in a Brave New World for Company Management and Shareholders' [2010] 3 *Journal of Business Law* 151, 155.

<sup>563</sup> *Stimpson v Southern Landlords Association* [2009] EWHC 2072(Ch); [2010] BCC 387

<sup>564</sup> [2008] EWHC 1534 (Ch); [2008] BCC 885

<sup>565</sup> *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] BCC 885, 892

<sup>566</sup> *Mission Capital plc v Sinclair* [2008] BCC 866, 874 per Floyd J.

<sup>567</sup> [2011] EWHC 1893 (Ch)

<sup>568</sup> *Langley Ward Limited v Gareth Wynn Trevor, Seven Holdings Limited* [2011] EWHC 1893 (Ch) 6.

#### 4.2.6.3 The Strengths of the Demand Requirement

Although there are loopholes in the current procedure surrounding the demand rule, the rule has nevertheless been recognised as serving distinct purposes that are additional to the general justifications discussed above. This is particularly so in light of the modern-day backdrop in China.

First, the demand rule provides the board with an opportunity to determine whether to take appropriate corrective action or pursue other remedies, such as dismissal or demotion of a defendant employee. The modern enterprise system has been established for only fifteen years in China and there are inevitably some problems that persist in Chinese companies including director misbehaviours. Once a wrongdoing is identified, it is essential that the company is informed first, offering it a chance to resolve the matter within the corporation. This is not only good for the corporation in allowing it to protect its reputation, but is also beneficial to building the modern corporate system, as it allows companies to learn how to address issues internally.

Secondly, the demand rule could protect the court from unnecessarily hearing a case that is not ripe for decision. Although Chinese judges are capable of dealing with the increasing volume of cases given the significant rise in the appointment of judges in the past few years, it is obviously not wise for all cases to flow into the courts. Judicial resources would be wasted, and other meritorious cases may be affected and thus not properly dealt with. The implementation of the demand rule may allow some potential disputes to be resolved within companies without resorting to the courts.

Thirdly, the demand rule may induce a board to consider the disputes or issues and crystallise policies that otherwise might not be given attention. For example, they

may revise corporate policy statements, introduce new accounting controls or simply make a change in personnel or remuneration.<sup>569</sup> This means the demand rule can be efficient in improving corporate governance even where a board refuses a demand and the court ultimately permits the plaintiff shareholder to sue. This is particularly important for Chinese companies considering the short-period that the modern enterprise system has been established in China and the urgent need to improve corporate governance.

#### **4.2.7 Summary**

The foregoing discussion focuses on how to improve China's derivative action system by looking to UK and US jurisdictions. Although it is argued that legal transplant in the area of commercial law for China is not only inevitably but also necessary,<sup>570</sup> not every rule of derivative actions in the UK or US is suitable for China as demonstrated above. Under the existing derivative action rule, Chinese shareholders have raised proceedings to protect the interests of company and themselves from being exploited, though the number of such cases is quite rare. If the problems of this institution are resolved and the gaps are filled as discussed above, it is expected that this right would be much more friendly used and minority shareholders' interests would be better safeguarded.

#### **4.3 Who is Responsible for Assessing Derivative Actions?**

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<sup>569</sup> R. K. Payson, 'Dismissal of Derivative Actions: The Debate' (1981) 6 *Delaware Journal of Corporate Law* 522, 527.

<sup>570</sup> For the discussion on this topic, please refer to Chapter 1.

### **4.3.1 Introduction**

It may seem strange to ask where responsibility lies for assessing derivative actions given that this role is usually assigned to courts. Indeed, in Commonwealth countries where derivative actions have been enacted, courts assume a paternalistic role and are assigned significant flexibility and discretion in deciding whether derivative actions should be permitted.<sup>571</sup> Nevertheless, courts are not the only entities assessing derivative actions; other entities may also be entrusted with that role. For example, special litigation committee (SLC) is assigned with this role in the US where the courts normally only review the suitability of decision makers and the propriety of the decision-making process.

As such, there are two approaches to determining responsibility for assessing derivative actions: the SLC approach, adopted in the US; and the court approach, adopted in most Commonwealth countries, like the UK. This part will examine these two approaches and discuss suggestions that might be drawn from this examination for use in China.

### **4.3.2 Two Different Approaches**

#### **4.3.2.1 The US Approach: the Special Litigation Committee**

In the US, plaintiff shareholders must make a demand on the board of directors prior to initiating a derivative action.<sup>572</sup> If their demand is rejected, then the

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<sup>571</sup> Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 164.

<sup>572</sup> Many influential states such as Delaware and New York do not require the demand to be made upon the general meeting of shareholders as that would cost a great deal of time and money. The MBCA and ALI Principles also recognise this and thus have either abolished this or omitted any reference to this by simply referring to make a demand “upon the corporation”. See Section 7.42 of MBCA.



plaintiff shareholder can continue to bring litigation, though they cannot challenge the board's dismissal unless they demonstrate that the refusal was wrongful.<sup>573</sup> This so-called "wrongful refusal rule" is founded on the presumption that a corporate litigation decision is a business decision and should thus be decided by the board of directors. Indeed, were a board's decision not respected by the court, then the demand requirement would be merely tokenistic and deprived of any substantive meaning.

Likewise, where a board is controlled by the wrongdoer and is thus unlikely to render a sound decision in response to a demand, it would be futile for a plaintiff shareholder to make such a demand. Here, failure to secure permission may be excused in certain circumstances and the plaintiff shareholder can bring an action directly to the court. However, this does not mean that the company is no longer of any importance; the company still has a significant role to play in these situations. Recognising board disqualifications in deciding whether litigation should be allowed in demand-excused cases, a special litigation committee was established in the 1970s as an independent and appropriate body for making litigation decisions in place of boards where impartiality is questioned.<sup>574</sup> The SLC must decide, subject to judicial approval, whether the litigation is in the best interests of the company and thus litigate or dismiss the action accordingly. In order to be qualified to play this role, a special litigation committee is comprised of independent and disinterested directors who are appointed by the board of directors.<sup>575</sup> Now the question "how the court reacts to the decision of SLC" arises. If a court choose to

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<sup>573</sup> See *Levine v Smith*, 591 A. 2d 194 (Delaware 1991)

<sup>574</sup> The first reported case in which a special litigation committee was legitimized is *Burks v Lasker*. In this case, a special litigation committee sought to dismiss a shareholder derivative action. The United States Supreme Court legitimized the use of special litigation committees to terminate derivative action alleging wrongdoing by board majorities. See J. S. Solovy, B. Levenstam and D. S. Goldman, 'The Role of Special Litigation Committees in Shareholder Derivative Litigation' (1990) 25 *Tort and Insurance Law Journal* 864- 879.

<sup>575</sup> See J. S. Solovy, B. Levenstam and D. S. Goldman, 'The Role of Special Litigation Committees in Shareholder Derivative Litigation' (1990) 25 *Tort and Insurance Law Journal* 864- 879.

defer to the decision of SLC, then it is fair to say that the essence of the SLC approach is to assign the role of assessing derivative actions to a company. The reason is that special litigation committee is established by the board of directors while the board is acting on behalf of a company.

#### **4.3.2.1.1 The Special Litigation Committee Approach: Company Approach**

When the decision is made by SLC, how the courts react to that? From the perspective of legislation, although different states in the US adopt different standards in reviewing this decision, they are inclined to defer to the SLC's decision. For example, in New York where the standard is liberal, the court held in *Auerbach v. Bennett* that there were two aspects in SLC's decision: substantial and procedural.<sup>576</sup> Substantially, the court adopted the business judgment rule in reviewing the decision of SLC. Procedurally, the court would only review the process as well as the independence of the committee. This standard reveals the fact that if the process of the committee is fair and the members of the SLC are independent, the SLC's decision would normally be deferred by the court owing to the business judgment rule unless the plaintiff shareholder is able to overturn it. This liberal approach was later followed by some other states.<sup>577</sup>

In Delaware, the Supreme Court set a two-step test in the famous case of *Zapata Corp. v. Maldonado* in reviewing the decision of SLC: first: the court "must inquire into the independence and good faith of the committee and the bases supporting its conclusions"<sup>578</sup> and a company "should have the burden of proving independence,

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<sup>576</sup> D. A. DeMott, *Shareholder Derivative Actions: Law and Practice* (West Publishing Company 2006) Section 5.15.

<sup>577</sup> R. C. Ferrara, K. T. Abikoff and L. L. Gansler, *Shareholder Derivative Litigation: Besieging the Board* (Law Journal Press 2005) n 8.02.

<sup>578</sup> *Zapata Corp. v Maldonado* 430 A.2d 779, 788 (Delaware 1981).

good faith and a reasonable investigation”.<sup>579</sup> Unlike the application of business judgment rule, a company has to demonstrate the independence, good faith and reasonable as they cannot be presumed. Second, the court can still determine whether the suit should be dismissed by “its own business judgment” even if the first-step test is passed. When applying its own judgement, the court should give “special consideration to matters of law and public policy in addition to the corporation’s best interest”.<sup>580</sup> However, this approach is criticised in several respects. For example, it is argued that the application of the court’s own business judgment may endanger the traditional policies under the business judgment rule.<sup>581</sup>

In practice, as Demott points out, the court normally reaches a decision by reviewing the SLCs motion rather than by making an assessment by itself on whether an action is in the best interests of the company.<sup>582</sup> As such, the SLC’s decision will generally be deferred to unless the members of the SLCs are proved to be not independent or disinterested. In light of this, it is clear that courts in the US take a hands-off attitude in evaluating whether derivative actions are in the best interests of a company.<sup>583</sup> Rather, a SLC itself is primarily assigned to this role. Given the fact that the members of SLCs are appointed by the board of directors, it is sensible to say that company is entrusted with the role for assessing derivative actions.

#### **4.3.2.2 The UK Approach: the Courts**

Unlike the US approach, most Commonwealth countries where derivative actions

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<sup>579</sup> Ibid.

<sup>580</sup> Ibid.

<sup>581</sup> R. C. Ferrara, K. T. Abikoff and L. L. Gansler, *Shareholder Derivative Litigation: Besieging the Board* (Company Law Journal Press 2005) n8.03.

<sup>582</sup> See D. A. DeMott, *Shareholder Derivative Actions: Law and Practice* (West Publishing Company 2006) Chapter 5

<sup>583</sup> Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 164.

have been enacted have entrusted national courts to assume a more active role in deciding whether derivative actions should be permitted.<sup>584</sup> For example, in Canada and New Zealand, company law requires courts to assess whether a derivative action is in the best interests of a company before permitting or rejecting it.<sup>585</sup> Here, the courts are actually assigned with the role of assessing the appropriateness of an action in light of a company's interests.<sup>586</sup>

With the enactment of derivative actions in the Companies Act 2006, a similar approach was adopted in the UK. Here, courts have broad discretion in deciding the admissibility of applications for derivative actions. For example, whether a plaintiff shareholder acts in good faith may affect the result of litigation, though courts are not bound to refuse an application even if a member is not acting in good faith in pursuing a claim.<sup>587</sup> The precise meaning of good faith depends on the courts' interpretation.<sup>588</sup> Secondly, although courts must refuse the shareholder permission to proceed with a derivative action under Section 263(2) of the Companies Act 2006 in certain prescribed circumstances, they retain some discretion in this respect. For example, if the court is satisfied that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim, the court must terminate the application for derivative action. However, the term "success" still relies on the court's interpretation. Finally, and most importantly, while an effective ratification or authorisation constitutes an absolute bar to derivative actions, a company's decision not to pursue a claim cannot have a binding effect on the courts.<sup>589</sup> Thus, courts can still permit an application for

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<sup>584</sup> See Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 164.

<sup>585</sup> See Canada Business Corporations Act, ASC, 1985, C.c-44, section 239 (2) (c); Companies Act 1993 (New Zealand), s.165(2)(d).

<sup>586</sup> Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 164

<sup>587</sup> See Section 263 (3) (a) of Companies Act 2006.

<sup>588</sup> The recent cases of derivative actions show that the courts have various interpretations of good faith. See Part 2 of Chapter 4.

<sup>589</sup> Section 263 of Companies Act 2006.

permission for a derivative action even if a company has decided that the litigation should not be instituted or be terminated.

In *Lesini*, Lewison J. said that “the weighing of these considerations is essentially a commercial decision, which the court is ill-equipped to take, except in a clear case”.<sup>590</sup> Under this case, it suggests that the courts will defer to the decisions of the directors and thus the UK jurisdiction belongs to the company approach rather than the court approach. However, these remarks of his Lordship were criticised for the reasons that they are in the same vein as those of judges of the past who have resolutely refrained from passing judgment on what directors have done, on the basis that judges are not qualified to second guess the business decisions made by directors.<sup>591</sup> Furthermore, the judge can certainly have his or her own view about the business decision as this does not require him or her to become an expert on such matters. The judge can make an independent judgement by hearing evidence from those who are conversant with the business. If the approach in *lesini* is widely applied, namely refusing to make a judgment with regard to commercial decisions made by directors, the permission will be rarely given which would make the statutory derivative actions regime become virtually redundant.<sup>592</sup> As such, the courts are essentially bound to make a commercial judgment about the merits of the shareholder’s case against the director.

In view of the above discussion, it demonstrates that under English law, the courts are endowed with greater powers and discretion in deciding derivative actions.

### 4.3.3 Evaluating the Two Approaches

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<sup>590</sup> *Lesini* [2009] EWHC 2526 (Ch) at [86].

<sup>591</sup> A. Keay and J. Loughrey, ‘Derivative Proceedings in a Brave New World for Company Management and Shareholders’ (2010) 3 *Journal of Business Law* 151-177.

<sup>592</sup> *Ibid.*

There has been a long debate about who is eligible to assess litigation. Both the company approach and the court approach have their own justifications. This part evaluates each approach and examines which is better for deciding whether an action is in a company's best interests.

### **4.3.3.1 The Company Approach**

#### **4.3.3.1.1 Rationales**

One strong justification for the company approach is that a company is recognised as being an independent legal entity, and is thus entitled to decide whether or not to bring an action to redress a wrong done to it. As the decision to initiate a derivative action is no different from the decision to pursue an ordinary business transaction, companies undoubtedly have a prerogative to decide whether a derivative action should be commenced. Indeed, the decision to undertake a derivative action is similar to decisions on business matters, as both involve the application of a "company's resources to run a risk against an expected return".<sup>593</sup> However, it is argued that a company's autonomy is eradicated in a derivative action scenario as wrongdoers might have used the company as a tool for their own benefits. In such situations, a company cannot function effectively as an independent organisation. Where a company fails to sustain its independent personality, this approach becomes contrived and it is thus necessary for outsiders to intervene to decide whether litigation is in the best interests of the company.

The second rationale behind this approach is that it saves time and expense if the company is given the authority to make the decision itself. Without resorting to outsiders, considerable judicial resources and expenditures can be saved.

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<sup>593</sup> See H. C. Hirt, 'Ratification of Breaches of Directors' Duties: The Implications of the Reform Proposal Regarding the Availability of Derivative Actions' (2004) 25 *Company Lawyer* 197.

Furthermore, directors would be overcautious in managing a corporation if a company is not entrusted with making final litigation decisions. The overcautiousness in management may not only affect the company's returns, but could also hamper the economic development of society as a whole.

#### **4.3.3.1.2 Counter-arguments**

Despite the above justifications, it is still inappropriate to assign companies this role if wrongdoers might be in control of the company. Indeed, there are other reasons why a company is not an appropriate body to assess whether a derivative action is in its own best interests in these cases.

First, it is universally recognised that a company lacks an authentic decision-making body in circumstances where derivative actions are brought.<sup>594</sup> Where the majority of the directors are the defendants in the litigation, the board of directors obviously loses its standing as an appropriate decision-making body. Even where only a small number of directors have wronged the company, most of the other directors may be accused of having approved, acquiesced in, or at least failed to rectify the alleged misbehaviours. Although current US legislation does not exempt shareholders from making their initial demand for derivative litigation to the company because of inactivity or acquiescence on the part of directors, this does not mean that defendants who have not directly participated in or profited from the alleged wrongdoing are allowed to engage in deciding the fate of the suit.<sup>595</sup> Furthermore, even where most directors have not directly or indirectly profited from or engaged in the alleged wrongdoing, the board may be tainted as a result of inherent or

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<sup>594</sup> A. Reisberg, 'Theoretical Reflection on Derivative Actions in English Law: The Representative Problem' (2006) 3 *European Company and Financial Law Review* 69.

<sup>595</sup> See *Heit v Baird*, 567 F.2d 1157 (1<sup>st</sup> Cir. 1977).

structural bias, and thus not be suitable to make such a litigation decision.<sup>596</sup>

Current practice in the US provides a vivid example to illustrate this point. As outlined above, a special litigation committee will be established if a demand is excused in certain circumstances. SLCs are comprised of independent or disinterested directors who assume the role of determining whether a derivative action is in the interests of the company. This independent committee seems to be the best organ to assess a derivative action because of its independence and access to information. However, practical studies have cast some doubts over the use of these committees. Cox has conducted a survey of 30 cases involving SLCs and found that no committee recommended prosecution against claimed directors.<sup>597</sup> Another study also revealed a similar result where no committee had ever suggested that a derivative action is in the best interests of the company.<sup>598</sup> This data demonstrates that disinterested directors may be compromised for a variety of reasons, including what some commentators refer to as a structural bias.<sup>599</sup> Indeed, it is argued that “if the involved directors expected any result other than a recommendation of termination at least as to them, they would probably never establish the committee”.<sup>600</sup> From this perspective, it is correct to consider SLCs as tolling a death knell for derivative actions.<sup>601</sup> Above all, as reliance upon SLCs composed of independent directors is called into question, it is clear that companies lack an authentic decision-making body for determining whether a derivative action

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<sup>596</sup> K. Davis, ‘Structural Bias, Special Litigation Committees and the Vagaries of Director Independence’ (2005) 90 *Iowa Law Review* 1305, 1308.

<sup>597</sup> J. D. Cox, ‘Searching for the Corporate Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project’ (1982) 31 *Duke Law Journal* 959-1011.

<sup>598</sup> D. A. DeMott, ‘Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions’ (1987) 11 *Sydney Law Review* 259.

<sup>599</sup> See J. D. Cox and H. L. Munsinger, ‘Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion’ (1985) 48 *Law & Contemporary Problems* 83; R. A. Fink, ‘Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate Rubber-Stamping Boards’ (2006) 79 *South California Law Review* 455.

<sup>600</sup> See *Joy v North*, 692 F.2d 880 (2d Cir. 1982).

<sup>601</sup> G. W. Dent, ‘The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Action?’ (1980) 75 *Northwestern University Law Review* 96.



is in their best interests.

Secondly, allowing a company to make litigation decisions may widen the gap between shareholders and directors, with unethical consequences. While a company is entrusted to decide whether or not litigation is in its best interests, a derivative action that is originally taken against a defendant director may turn into a lawsuit between the plaintiff shareholder and the company. The divide generated by the vertical agency cost would be deepened as a result of this approach and the antagonism between the two parties may have a negative impact on the company's performance. Moreover, one of the functions of derivative actions is to enforce directors' duties, which may be comprised or rendered unachievable when the company is involved. Moreover, it is argued that the conversion of a dispute from one between an individual shareholder and a director to a clash between shareholders and the company, would change the focus of the judicial effort. Originally, judicial resources are supposed to resolve the disputes. However, after such a conversion, courts have to concentrate on the issue of the independence of those recommending the rejection of the litigation and the propriety of their decision-making procedure.<sup>602</sup> As a result of this loss of focus, judicial efforts to solve disputes could be misapplied, with the time and expense involved in rendering the court's decision becoming less justified.<sup>603</sup>

Thirdly, assigning a company the responsibility to assess a derivative action may increase time and cost and create the problem of duplicated effort. To begin with, a company must investigate a dispute in order to ascertain whether an action is in the best interests of the company. This inevitably incurs cost, which could be substantial if the investigation is conducted diligently. For instance, in the

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<sup>602</sup> Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 174.

<sup>603</sup> *Ibid.*

investigation phase of one US case, the special litigation committee interviewed 70 witnesses and produced a 1,100 page report.<sup>604</sup> The conduct of such an investigation is likely to have incurred considerable cost. It is argued that judicial resources can be saved if a company is assigned to make the litigation decision. However, this is not the true, as a judicial review of a recommendation is not necessarily easier than the direct assessment of the merits of a case. Gevurtz points out that the judicial review of a decision made by a company can be “as difficult as the issues raised by the underlying claims and could easily require the development and presentation of extensive evidence”.<sup>605</sup> In addition, the costs incurred during investigation and judicial review could be wasted if the recommendation made by the company is rejected by the court. In such a situation, duplication of work is created and thus the cost reduction aim sought to be achieved by the company approach becomes unattainable.

#### **4.3.3.2 The Court Approach**

In light of the previous discussion, it could be argued that the courts are better qualified to assume this role. Indeed, allowing courts to replace companies in this function would overcome the drawbacks of the company approach. For example, the objectivity and neutrality of a court avoids the fact that the company lacks an authentic decision-making body in derivative action scenarios. Furthermore, the court approach can also avoid the duplication of work and expense.

However, there are counter-arguments. Some question whether courts are the best organs to determine the merits of proposed litigations. First of all, it is argued that directors are in a much better position than courts to assess alleged wrongdoings as

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<sup>604</sup> See J. J. Kobeski, ‘In RE Oracle Corporation Derivative Litigation: Has a New Species of Director Independence Been Uncovered?’ (2004) 29 *Delaware Journal of Corporate Law* 849.

<sup>605</sup> F. A. Gevurtz, ‘Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits’ (1985) 46 *University of Pittsburgh Law Review* 265.

they have easier access to information and a better knowledge of the company's affairs.<sup>606</sup> It is further suggested that the courts may not be capable of reviewing business decisions as they lack the requisite business experience and expertise. As a consequence, they may not understand decision-making processes in the business world and thus sometimes fail to recognise that even a decision to dismiss a meritorious action might be justified. Last but not least, there is a concern that enabling courts to judge business decisions may intrude upon managerial authority and shift final commercial decision-making from the board room to the Bench.<sup>607</sup> In short, over-reliance on courts can be problematic.

However, these criticisms about the company approach are groundless. First of all, it is argued that decisions concerning whether a derivative action should be commenced are legal rather than business decisions. Such decisions are “not managerial decisions and do not require business specialists or those with an intimate knowledge of the company.”<sup>608</sup> Therefore, the “talents that a court is generally thought to lack – business intuition, a feel for the market place, and the ability to trade off risk for return – are not here called for to the same degree”.<sup>609</sup> Even if the decision can be regarded as a business decision, it cannot neglect the fact that this is a litigation decision. Given that the determination hinges on an appraisal of the merits of the action, it is suggested that “the court's perspective and expertise are superior to the boards.”<sup>610</sup> Secondly, considering the objectivity and neutrality of courts, there is no reason not to allow such an independent organ to assess the merits of litigation. Thirdly, courts have a long history of determining cases involving breaches of duty, giving them significant expertise and knowledge

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<sup>606</sup> D. R. Fischel and M. Bradley, ‘The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis’ (1986) 71 *Cornell Law Review* 261.

<sup>607</sup> See R. Thompson and R. Thomas, ‘The Public and Private Faces of Derivative Lawsuits’ (2004) 57 *Vanderbilt Law Review* 1747.

<sup>608</sup> M. A. Maloney, ‘Whither the Statutory Derivative Action?’ (1986) 64 *Canadian Bar Review* 309.

<sup>609</sup> J. C. Coffee and D. E. Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 282-283.

<sup>610</sup> *Ibid.*

in this area of business.<sup>611</sup> Lastly, even if courts lack expertise in some specialist areas of business, this does not render them incapable of making decisions. Independent experts can be appointed by courts to investigate actions and their advice be adopted.

#### **4.3.4. Suggestion for China**

The foregoing discussion clearly indicates that both the company and court approaches to derivative action determination have their own advantages and problems in deciding whether a derivative action is in the best interests of a company. This part will examine whether these approaches can assist in determining responsibility for assessing derivative actions in China. Other possible approaches will also be discussed for improving China's derivative action process.

##### **4.3.4.1 The US Approach: the Adoption of Special Litigation Committees?**

Although it is argued that company autonomy can be respected by the company approach, this argument is eradicated in derivative action scenarios where wrongdoers may have used the company as a tool for their own benefit. Moreover, time and judicial resources-saving advantages are also put into doubt as discussed above. Furthermore, lack of independence and unethical consequences of the shareholder/board divide also make this approach less favourable for transplantation to China. Besides these inherent deficiencies, there are some other reasons why this approach is not suitable for China.

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<sup>611</sup> A. Reissberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2009) 110.

First, China's failure to adopt truly independent directors may provide a lesson to learn. In order to oversee senior managers and protect the interests of minority shareholders, the institution of independent directors was transplanted from common law jurisdictions (particularly US law) into the Chinese regime. It was expected to play an effective role in checking and balancing management, but has failed to achieve this target partly because of a lack of true independence amongst such directors.<sup>612</sup> Given that special litigation committees are similar to independent directors with regard to their independence and objective judgement, it is difficult to see that the adoption of SLCs would make a positive contribution to determining derivative actions; rather, it could repeat the same mistakes of the independent director institution.

Secondly, the establishment of an SLC could impose financial burdens on companies. Whilst the investigation of an allegation could create duplication of work and wasted costs, the establishment of an SLC *per se* would induce unnecessary costs for companies. For example, the costs of the external SLC members must be paid by the company and could be substantial. In the US, these costs cannot be recovered from a plaintiff shareholder even if an action is dismissed by the court in accordance with the company's recommendation.<sup>613</sup> That means the costs of establishing an SLC have to be covered by the company alone regardless of the result of litigation. This generates two negative consequences: first, it creates unnecessary costs for small companies. For large companies, such costs may be tiny or insignificant, but for small companies, they could be a heavy burden. Secondly, it is not difficult to imagine that such a committee would normally recommend the dismissal of an action given that its funding comes from the company. This is particularly so in China where there it is said that "if you get something from

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<sup>612</sup> For further details on this institution, please refer to Chapter 2.

<sup>613</sup> See J. J. Kobeski, 'In RE Oracle Corporation Derivative Litigation: Has a New Species of Director Independence Been Uncovered?' (2004) 29 *Delaware Journal of Corporate Law* 849.

someone, you have to free of his or her snags”.<sup>614</sup>

Lastly, the establishment of SLCs may weaken the influence or effectiveness of the supervisory board (SB) in China.<sup>615</sup> In order to monitor internal management, the SB system was adopted and consists of shareholder representatives, employee representatives and outsiders.<sup>616</sup> One of the legitimate roles of the SB is to bring lawsuits against directors and senior managers when they have done something harmful to the company.<sup>617</sup> As such, Chinese legislation formally recognises the SB’s right to decide on litigation. Although the commencement of a derivative action implies that an SB has rejected or simply ignored a demand to bring an action, it does not mean the SB permanently lose its legitimate right to bring litigations in order to protect the interests of the company. However, the establishment of the SLCs may undermine the authority of the SB by making SLCs litigation decision-makers. In light of the ineffectiveness of the SB in China, its reputation might be damaged and its function might further deteriorate as a result of the establishment of the SLCs. Furthermore, the SB system was borrowed from Germany while there is no such an institution in the US. In view of this, the establishment of SLC in the US would counter no institutional obstacle while this is not the case in China. If the SLC is borrowed from the US, it would create a problem of how to deal with the relation between SLC and SB. Therefore, SLC is not suitable for China.

#### **4.3.4.2 The General Meeting: A Say for Shareholders?**

As boards of directors and special litigation committees are not suitable entities for

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<sup>614</sup> In English, the equivalent proverb is “he who pays the piper plays the tune”.

<sup>615</sup> For further details of the supervisory board, please see Chapter 2.

<sup>616</sup> Article 52 of Chinese Company Law 2005. For further details of the supervisory board, please refer to Chapter 2.

<sup>617</sup> Article 54.

deciding whether an action is in the best interests of a company, such a decision could be reserved to shareholders in a general meeting even though boards are generally granted exclusive management powers in a company's articles. As shareholders are the residual interest holders of the company, they can naturally be assigned the responsibility of making a final litigation decision. Furthermore, although the board is granted wide discretion and powers to run a company, such powers are authorised by the general meeting. As a consequence, shifting the final litigation decision from the board to the shareholders does not constitute an "infringement" upon the rights of management. In fact, the general meeting is exercising its legal rights over its legal status.<sup>618</sup> Last but not least, giving shareholders an effective voice on this issue is conducive to building an investor-friendly system. Liu, an authoritative Chinese company law expert, has appealed for the construction of an investor-friendly legal system in China.<sup>619</sup> One of the key components of such a system is the conferring of more rights to shareholders. Assigning to the general meeting the role of assessing whether a derivative action is in the best interests of a company is a good enactment of an investor-friendly legal system.

However, reliance on the collective body of shareholders is problematic for several reasons. First, the general meeting may also be controlled by the alleged wrongdoers, which might make it function in a subservient manner. In English law, there is a well-established concept that shareholders hold their vote as a proprietary interest.<sup>620</sup> As such, a shareholder can ratify a wrong he or she has committed in another capacity, like a breach of duty as a director. Here, if a director who has committed a wrong is also the majority shareholder of the company, the resolution passed by the general meeting is likely always to dismiss the litigation. Although

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<sup>618</sup> Chinese Company Law 2005 stipulates that the shareholders' meeting is the authority of the company. See article 37 of Chinese Company Law 2005.

<sup>619</sup> J. Liu, *Xiandai Gongsifa* [Modern Corporate law] ((Law Press China 2008) 189-199.

<sup>620</sup> *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589.

the Companies Act 2006 has now prohibited self-interested members from participating in ratification votes,<sup>621</sup> they may still attend, be counted towards the quorum and take part in the proceedings of the meeting where the litigation decision is considered. This might have an impact on how other shareholders cast their votes at the meeting.

Secondly, it is argued that it would in itself be a Herculean task to garner the support required to initiate such lawsuits.<sup>622</sup> Not every individual shareholder is eligible to summon a meeting of the shareholders. Shareholders representing ten percent or more of the voting rights can convene and preside over such meetings on their own initiative under the Chinese Company Law.<sup>623</sup> Moreover, even if such a meeting were easier to convene, shareholders may be unwilling to participate and vote in the general meeting because of rational apathy.<sup>624</sup> This well-known phenomenon identifies the problem of collective action for minority shareholders in general meetings, recognising that their voting rights tend to be a less potent force, particularly in large companies. This is because firstly, participation requires the investment of time. Such expenditure may be justified where shareholders have control over decision or their voices are decisive. However, shareholders tend to believe that their vote has only minimal impact on proposals. Furthermore, even where their voices are decisive they may still be reluctant to vote because even if the action they support is successful, the gain or compensation will go to the company rather than the individual shareholders themselves. The benefit that shareholders can receive is a pro rata share of the gains from such an action. This lack of incentive undoubtedly has a negative impact on shareholders' willingness to exercise their voting rights.<sup>625</sup> Moreover, some shareholders may seek to take a free

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<sup>621</sup> Section 239 of Companies Act 2006.

<sup>622</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2009) 81.

<sup>623</sup> See article 41 of Chinese Company Law 2005.

<sup>624</sup> See R. C. Clark, *Corporate Law* (Little Brown 1986) 390-392.

<sup>625</sup> This involves the funding issue of derivative actions, which will be discussed in Chapter 5.



ride on other shareholders' efforts. If many individual shareholders share this view, the determination of whether litigation is in the best interests of the company cannot reflect the true thoughts of the shareholders as a whole.

Thirdly, there are two other issues to be addressed in addition to costs and perverse incentives if litigation decisions are entrusted to the general meeting. The first issue is that of access to information. Information is critically important in litigation. As Grundfest and Huang point out, lawsuits are all about the process and cost of securing information, and the optimal response to such information.<sup>626</sup> In this sense, it is no exaggeration to assert that information is the lifeblood of litigation. In derivative actions, shareholders must gather the facts in order to evaluate accurately whether an action should be commenced or to assess the strength of any potential action.<sup>627</sup> However, derivative lawsuits are characterised by information asymmetry: shareholders have little information about the frequency and amount of harm caused by managerial misconduct, while managers have all such information. Even where shareholders become aware of possible internal irregularities through other channels, like news reports, they still face the difficulty in obtaining more detailed information and gathering sufficient evidence to evaluate the merits of litigation. This is extremely important as the majority information may be controlled by wrongdoers. Although the right to know has been established in the Chinese Company Law 2005, there are still some defects in this institution.<sup>628</sup> Disadvantages concerning access to information seriously affect a shareholders' ability in accurately assessing the merits of litigation. Moreover, shareholders may lack the expertise and related knowledge needed to assess the merits of litigation.

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<sup>626</sup> J. A. Grundfest and P. H. Huang, 'The Unexpected Value of Litigation' (2006) Minnesota Legal Studies Research Paper No 04-18.

<sup>627</sup> Although generally the more information shareholders can gather, the more accurate the decisions they make. It does not mean the disclosure would encourage more litigation. In fact, the recent evidence has suggested that disclosure potentially deters litigation rather than trigger it. See L. Field, M. Lowry and S. Shu, 'Does Disclosure Deter or Trigger Litigation?' (2005) 39 *Journal of Accounting & Economics* 487.

<sup>628</sup> For Further details on this institution, please refer to Chapter 2.

As such, they may be incompetent to determine which management decisions run against the maximum benefits of the company even where they do have access to relevant information. Indeed, as shareholders do not run the company directly, what appears to them to be a rushed decision may simply reflect a company managers' knowledge and desire to avoid the expense of hiring outside experts.<sup>629</sup>

#### **4.3.4.3 The Court Approach**

From the above, it can be concluded that the shareholders' meeting is not an appropriate body to assess the merits of the litigation in derivative actions. This conclusion, however, leaves a fundamental contradiction: on the one hand, leaving the decision to sue with any individual shareholder runs the risk that he or she might pursue litigation for personal interests rather than to protect the interests of the company as a whole. On the other hand, conferring an unfettered right in favour of a general meeting to decide such matters, even if interested shareholders are prohibited from voting, encounters the collective problem which may create a less optimal amount of litigation.<sup>630</sup> As a result, the courts are naturally brought in to adjudicate. In fact, some unclear rules could be resolved if the courts are entrusted with this role. For example, the concept of "urgent circumstances" is not easy to be defined and it would encounter less difficulty if it is left to be clarified by the courts.

However, entrusting courts with the function of deciding such matters may encounter a risk of unfair judgement in China as it is recognised that there is currently no true judicial independence in the country. Indeed, the lack of meaningful judicial independence casts some doubt over adopting the court approach. Nevertheless, some evidence has shown that the courts are less prone to

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<sup>629</sup> D. Fischel and M. Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate law: A Theoretical and Empirical Analysis' (1986) 71 *Cornell Law Review* 273.

<sup>630</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2009) 83.

interference from outside vested interests in private litigation than other types of lawsuits. As such, this part will first examine the sources of judicial interference and will then demonstrate why private litigations face less interference. In light of the conclusions from this analysis, it will be concluded that the court approach is suitable for China regardless of the lack of meaningful judicial independence in the country.

#### **4.3.4.3.1 Lack of Judicial Independence**

In every jurisdiction, judicial independence is not an absolute concept as some mechanisms must be adopted to hold judges to account. China is not an exception in this regard as it has established many forms of intervention to prevent potential judicial corruption. Ironically, it is precisely some of these mechanisms that have been criticised for leading to a lack of judicial independence.

There are generally five sources which have a greater or lesser impact on judicial independence:<sup>631</sup> (1) party organs. This includes the Party Committee, Political-Legal Committee and the Disciplinary Committee. Although there is no explicit constitutional or legal basis for the Party to intervene in specific cases, the Communist Party has tightly controlled judicial organisations in order to further its rule. The implementation of the “Three Supremes”,<sup>632</sup> proposed by the Supreme People’s Court, has even attempted to emphasise the key role of the Party in adjudicating cases. (2) The judiciary itself. For example, the adjudicative committee has a final say on almost every case even if some members of the committee have not heard the case before making their decision. The president of the court may also

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<sup>631</sup> Fu and Peerenboom identify seven sources in affecting judicial independence. See Y. Fu and R. Peerenboom, ‘A New Analytical for Understanding and Promoting Judicial Independence in China’ In R. Peerenboom (ed), *Judicial Independence in China: Lessons for Global of Law Promotion* (Cambridge University Press 2009) 95-133.

<sup>632</sup> It means the judges should always adhere to the supreme of the Party’s career, People’s interests and the constitution and laws in adjudicating specific cases.

intervene in cases via informal directives or instructions. (3) Local governments and administrative departments. Government officials have formal and informal powers to affect the independence of the judiciary. Formally, they are able to pass regulations to direct the courts on how to adjudicate where statutes are unclear. Informally, courts may refer certain issues to them and their opinions will normally be deferred to. This power is strengthened by the fact that courts are funded by this level of government. The ability to determine a court's budget undoubtedly confers on local governments' substantial power to influence the judiciary. (4) Media, public and/or academic opinions. Although news coverage or public opinions have no formal power to interfere in a court's adjudication, their comments on specific cases may influence judges. Similarly, academics may be asked to provide opinions in some cases. (5) The parties or their lawyers may try to influence a case through social acquaintances, such as relatives, friends or classmates.

#### **4.3.4.3.2 Less Interference in Commercial Cases**

Although as mentioned above, China currently lacks meaningful judicial independence, this does not mean that every type of case is interfered with by outside sources. In fact, only some types of case are seriously affected by formal organisations such as the Party and government agencies: namely political and politically-sensitive cases.<sup>633</sup> It is regarded that the former type of case is a direct threat to the authority of the ruling regime, and includes, for example, cases involving national security, the Falun Gong, and high-level corruption. When the courts hear such cases, they normally refer to the Political-Legal Committee and adjudicate them in accordance with the Committee's opinion. The latter type of case

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<sup>633</sup> See Y. Fu and R. Peerenboom, 'A New Analytical for Understanding and Promoting Judicial Independence in China' In R. Peerenboom (eds.), *Judicial Independence in China: Lessons for Global of Law Promotion* (Cambridge University Press 2009) 95-133.

consists mainly of socio-economic cases, which include environmental and labour disputes, land seizures and some entitlement claims, such as pension or unemployment cases. This kind of lawsuit may pose a less direct threat to the regime, but could affect socio-political stability, economic growth and China's international reputation. Therefore, these cases too can be subject to direct interference.

The above types of case may take the form of criminal, administrative and civil lawsuits. Apart from these, there is little systemic interference in other kinds of case. Derivative actions, as private shareholder litigations, do not normally raise the interest of Party organs. Where there is any interference, it comes from local government and/or social acquaintances. However, their impact on shareholder litigation is declining.

This is because, firstly, local protectionism is decreasing because of the changing nature of the economy. With the development of economic reform, the economy in many cities is now changing from a single to diversified system. In the past, under the influence of the planned economy policy, many urban areas had a simple economic mix with a higher percent of the economy being constituted by the public sector. Now, the private sector is playing an increasingly dominant role. As such, a local government is unlikely to intervene in a specific derivative action because a single company is less important to its local area. Furthermore, less interference in private litigation could protect that locality's reputation and thus attract more investment. In light of this, local governments have little incentive to intervene in private shareholder litigation.

This is demonstrated by the empirical research. Ying and Gechlik conducted a study of over twenty thousand cases in Shanghai and found that less than 0.4% involved

attempts to use outside powers or connections to intervene in court decisions.<sup>634</sup> Another empirical study focusing on the adjudication of corporate law also revealed a similar conclusion. Howson examined more than 200 reported cases in Shanghai from 1992 to 2008 and found that Shanghai courts supported non-state/party interests in the vast majority of the cases.<sup>635</sup>

Secondly, although it is possible for particular individuals to intervene in a case, it is not easy for them to influence the outcome of that case. Their ability to affect the result depends on various factors, such as the nature of the case, the amount at stake, the parties involved and the level of the court. Generally, a case will be handled by three judges. If the case is too complex or those judges are in dispute, it may be referred to the adjudicative committee. This means that a party would have to influence at least two judges on the panel and key members of the adjudicative committee; it would be very difficult for an individual party to have such connections. Furthermore, if the case is appealed to a higher-level court, the successful party, who won the lawsuit using their influence, would have to exercise that same influence again over another group judges and committee members. This obviously increases the difficulty for individuals seeking to interfere with the results of a case.

#### **4.3.4.4 The Arbitration Approach**

##### **4.3.4.4.1 Arguments for the Arbitration Approach**

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<sup>634</sup> M. Y. Gechlik, 'Judicial Reform in China: Lessons from Shanghai' (2006) 19 *Columbia Journal of Asian Law* 100.

<sup>635</sup> However, he also points out that many cases involving political factors or public bureaucratic direction are simply not accepted. Even if initially accepted, such cases are not subject to adjudication or not reported as such for fear of bumping up against extralegal power. See N. C. Howson, 'Judicial Independence and the Company Law in the Shanghai Courts' In R. Peerenboom (eds.), *Judicial Independence in China: Lessons for Global Rule of Law Promotion* (Cambridge University Press 2009) 134-153.

Besides the above approaches, there is another possible approach which may be a better mechanism for resolving disputes: arbitration. It is argued that arbitration is much more adversarial than litigation. First of all, parties are judged by an arbitrator who is often a peer of their trade or an experienced professor, which may ensure a fair judgement to some extent. Secondly, parties are less fettered by procedures in arbitration. In litigation, there are many strict procedures that have to be followed by the parties. Nevertheless, procedures are more flexible and are thus more accommodating of the parties in arbitration. Thirdly, an arbitration decision is final and binding, allowing for quick dispute resolution.

Indeed, arbitration is becoming increasingly used by business persons, not only because of China's desire to participate in world trade, but also because of the suspicions of party-dominated legal institutions. China has witnessed significant change after its reform and opening, resulting in an increasing volume of trade with and investment in China. Accession to the World Trade Organization has further enhanced this phenomenon and led to China's emergence as a major economic power. Accompanying ever-increasing globalisation is a corresponding growth in the number of commercial disputes. As such, arbitration is used as the means to settle some of these disputes. In addition, one of the fundamental differences between arbitration and litigation is that the parties in arbitration can choose the applicable substantive law. Although China's legal system is becoming increasingly sound and robust, it is argued that it is unstable and easily changeable mainly because of the short-time in which the rule of law has been implemented. In addition, some parties are uncomfortable with the unreliability of the nation's courts. Therefore, arbitration enables them to bypass the Chinese legal system and courts in resolving disputes. Ideally, as Lauchli asserts, "arbitration is suited to the resolution of a dispute in a friendly personal and business relationship; in some circles arbitration is appropriate because it is taboo to force the other party before a

governmental tribunal.”<sup>636</sup>

#### **4.3.4.4.2 Arguments Against the Arbitration Approach**

However, the above arguments are untenable in the context of derivative actions in China.

First, although arbitration is a fast way of resolving disputes, it is not a cheaper method of doing so. In fact, it is much more expensive than litigation as a result of several factors. For example, unlike the courts, an arbitration commission is not a governmental agency. It is a revenue-producing organisation aiming to make profit. Moreover, disputes are judged by an arbitrator who is professional in the specific area. As such, it is obvious that the parties have to pay higher arbitration fees for resolving such a dispute.

Secondly, although it is argued that arbitration can bypass the courts in resolving a dispute, the courts still have a role to play in the enforcement of arbitral awards. Obtaining a favourable arbitral result is only the first step in the process as the enforcement of such an award still relies on the court.<sup>637</sup> Without the cooperation of the courts, an arbitral award is only a piece of paper indicating little more than who won the dispute.

Thirdly, arbitration is mainly used in international business disputes rather than domestic disputes. As mentioned above, arbitration is a growing area of dispute resolution mainly because of the increasing development of international trade and

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<sup>636</sup> U. M. Lauchli, ‘Cross-Cultural Negotiations, With A Special Focus on ADR with the Chinese’ (2000) 26 *William Mitchell Law Review* 1045, 1067.

<sup>637</sup> Article 62 of Arbitration Law of the People’s Republic of China stipulates that “the parties concerned shall execute the arbitral award. If one of the parties refuses to execute the award, the other party may apply for enforcement with the people’s court according to the relevant provisions of the Civil Procedure Law.”



investment. Foreign investors may be uncomfortable with relying on China's legal system and thus many would choose to resolve disputes by arbitration rather than litigation. However, for disputes between domestic parties, these parties normally first try to resolve the conflict among themselves, failing which, resort is made to the courts.

Fourthly, there are a number of reasons why Chinese people not to choose arbitration. Besides being expensive, it is generally believed that Chinese people are inclined to surrender to power and thus respect the decisions made by the courts because behind these decisions there lays a strong state power. By contrast, arbitration is undertaken through a non-governmental organisation without the direct support of state power. Chinese people may fear state power more owing to China's history. Since Emperor Qin unified the Country in 221 BC, there has been and continues to be one central government irrespective of China's existence as an empire or a Republic. In order to keep this country unified, the central government has tried every means available, including educating people to obey the country and its central government. For example, children are taught from a very young age that "subjects must obey their emperor absolutely even if he orders them to die; son must obey his father absolutely even if his father orders him to die". Even now as western culture spreads in China, Chinese people still respect state power and are thus keen to become a part of this.<sup>638</sup>

Lastly, the arbitration of the disputes within the context of derivative actions is highly unlikely. Not every dispute can be arbitrated. For example, disputes arising from marriage, adoption, guardianship, bringing up of children and inheritance

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<sup>638</sup> One example can vividly illustrate this phenomenon. Nowadays, the majority of Chinese students want to work in the government instead of in the enterprises or other organisations after they graduate. This is particularly true among law students where most of them wish to work in the courts or other judiciary rather than go to the law firms or companies.

cannot be put to arbitration.<sup>639</sup> Under article 1 of the Chinese Arbitration Law, disputes can go to arbitration if the following requirements are met: (1) if the disputes arises from contract or property rights; (2) both the parties are equal; and (3) the plaintiff has the right of disposition.<sup>640</sup> Under derivative actions, a company's interests have been damaged by alleged wrongdoers and thus it meets the first requirement. Also, there is no doubt that an alleged wrongdoer is equal to a plaintiff shareholder. However, there is a problem with regard to the last prerequisite. Individual shareholders are required to have the right of disposition in order to make the dispute one capable of arbitration. However, first of all, although an eligible shareholder could raise a dispute against wrongdoers and drop the case if he or she wishes to do so, this does not mean that the dispute is settled when it is dropped; other eligible shareholders are still entitled to raise such concerns. Furthermore, arbitration requires both parties to reach an agreement for arbitration. Without this agreement, the arbitration commission will refuse to accept the application for arbitration by any one single party.<sup>641</sup> However, individual shareholders are not eligible to reach such an agreement for arbitration as this is entrusted on the company. Here, a problem is created: if a company is determined to put the dispute to arbitration, then it becomes a dispute between the company and the alleged wrongdoers. If a company is controlled by such wrongdoers, the arbitration is impossible without the participation of the company. In light of this, if a dispute arising from the causes of derivative actions is to be settled through arbitration, a company has to participate as one single party. However, it is very rare that a company is willing to refer a dispute to arbitration. This is demonstrated by empirical studies showing that there has not been a single arbitration case taken since the adoption of derivative actions in the Company Law 2005.

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<sup>639</sup> Article 3 of Arbitration Law of the People's Republic of China.

<sup>640</sup> Article 2 of the Arbitration Law of the People's Republic of China stipulates the application of this law that contractual disputes between citizens of equal status, legal persons and other economic organisations and disputes arising from property rights may be put to arbitration.

<sup>641</sup> Article 4 of the Arbitration Law of the People's Republic of China.

#### **4.3.5. Summary**

In view of the above discussion, there are several approaches to determining responsibility for assessing derivative actions. The SLCs approach which is adopted in the US is not suitable for transmission to China as it lacks an authentic decision-making body where derivative actions are brought. Although the detailed rules of statutory derivative actions in the Companies Act 2006 may not be appropriate for China to borrow as discussed in the previous part, the UK's court approach is the most suitable approach for adoption in China considering its historical tradition, its current legal system and the drawbacks of other approaches.

## Chapter 5 Making Derivative Actions Work in China: The Funding Issue

### 5.1 Introduction

Litigation is not free and can be expensive.<sup>642</sup> Generally, prospective plaintiffs consider the amount at stake, legal costs and the probability of success in deciding whether an action should be brought.<sup>643</sup> Litigation is rational where sums recoverable and the chances of success exceed the cost of legal expenses and the probability of losing the action.<sup>644</sup> However, the unique nature of derivative action makes the incentive for shareholder litigation different from that of other types of action. As discussed above, shareholders are not entitled to initiate litigation against wrongdoer directors or majority shareholders on behalf of the company as the company itself is considered to have suffered the wrongdoing rather than the shareholders. A derivative action allows company claims to be raised by shareholders, making those shareholders nominal claimants while the company is the actual claimant in terms of the underlying interest. In recognition of the unique economic nature of the derivative lawsuit, the conclusion can be drawn that any recovery from the litigation would be accrued by the company rather than plaintiff shareholders. This obviously has a considerable impact on the latter's decision to raise proceedings as they would need to consider the gains and losses before doing so. In derivative

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<sup>642</sup> That is one of the justifications for legal aid.

<sup>643</sup> See W. M. Landes, 'An Economic Analysis of the Courts' (1971) 14 *Journal of Law and Economics* 61; J. P. Gould, 'The Economics of Legal Conflicts' (1973) 2 *Journal of Legal Studies* 279; R. A. Posner, 'An Economic Approach to Legal Procedure and Judicial Administration' (1973) 2 *Journal of Legal Studies* 399.

<sup>644</sup> B. Cornell, 'The Incentive to Sue: An Option Pricing Approach' (1990) 19 *Journal of Legal Studies* 173.

actions shareholders have to pay lawyers' fees or/and the legal costs of the defendant if an action is unsuccessful.<sup>645</sup> On the other hand, they are not eligible for compensation directly from the defendant if they win the case. In consequence, a rational shareholder might not choose to bring derivative litigation. Instead, they might prefer to sell their shares and leave the company. Furthermore, bearing in mind that any compensation or other relief obtained from the defendants flows directly to the company, the phenomenon of the "free-ride" problem is also brought into operation. Here, individual shareholders would be strongly discouraged from bringing derivative actions as each shareholder would expect others to raise such proceedings. However, if all shareholders share the same view, then no derivative action is likely to be initiated even if such litigation may bring substantial benefits to the company.

Although it is argued that a plaintiff shareholder can benefit indirectly from recovery, the average value of any expected award that such a shareholder could receive pursuant to a successful claim is low.<sup>646</sup> The value of a plaintiff's shareholding would probably be increased if recoveries accrue to the company and thus augment its asset base; however, this is a somewhat hypothetical benefit and far less certain as the value of a company's shares are determined by a large number of factors beyond underlying asset value.<sup>647</sup> In fact, the value of a company's shares may be reduced if the company's reputation is damaged or the public loses confidence in its management as a result of the litigation. Even if an action is successful and thus increases the value of a company's shares, what shareholders will receive is a *pro rata* share of the gains from such an action. In light of the small amount of shares

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<sup>645</sup> In English law, the plaintiff shareholders face the risk of paying not only the legal expenses of themselves but also the legal costs incurred by the defendants owing to the 'loser-pays' rule that costs follow the event. In the US, a plaintiff shareholder has to bear his or her own legal cost even if an action is successful. Further details of funding rules in these two countries will be discussed below.

<sup>646</sup> J. D. Wilson, 'Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholder's Derivative Action' (1985) 5 *Windsor Yearbook of Access to Justice* 171.

<sup>647</sup> Wilson, *ibid.*, 142.

that plaintiff shareholders as minority shareholders hold, one would imagine that they will gain insignificant or even negligible benefits indirectly from any successful litigation. This is particularly true in the case of listed companies which are very big and have highly dispersed share ownership.

In view of the unique economic nature of the derivative action, shareholders would be strongly discouraged from raising proceedings without other sources of funding. If funding rules were appropriately established and effectively used, the hurdles hindering the operation of derivative actions would be largely removed, and the interests of the company and minority shareholders better protected. In China, there is no special funding rule for derivative actions, which partly explains why they are rarely used by Chinese shareholders. In order to address the economic disincentives for prospective plaintiffs of derivative lawsuits, some general costs rules applicable in derivative actions should be changed and other financial resources to fund such lawsuits introduced. This chapter will first introduce the current legal costs regime in China before going on to discuss and evaluate funding rules in English and the US law. This chapter will conclude with an examination of which model would be suitable China.

## **5.2 Legal Costs in China**

As discussed above, a plaintiff shareholder who has brought a derivative action has to pay the same legal costs that he or she would have had to pay in a general lawsuit. Under the Measures on the Payment of Litigation Costs (hereafter MPLC),<sup>648</sup> shareholders who wish to bring actions to the People's Court have to pay court fees

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<sup>648</sup> 'Susong Feiyong Jiaona Banfa' [The Measures on the Payment of Litigation Costs] (MPLC) was first enacted in 1989, revised on 8<sup>th</sup> December 2006 and entered into force on 1<sup>st</sup> April 2007.

and lawyers' fees.

### 5.2.1 Court Fees

Court fees consist of filing fees, application fees and court expenses.<sup>649</sup> Filing fees, also called case acceptance fees,<sup>650</sup> are the fees that any person who files a suit counterclaim or appeal has to pay to the court within seven days upon a notification made by the court on the payment for such court fees. If a plaintiff fails to submit such fees to the court without justification,<sup>651</sup> the case will be treated as withdrawn by the litigant. Application fees include the costs of applying for security over property, order of payment, public notice, etc.<sup>652</sup> Court expenses are the fees that are incurred during the hearing of the case, including the costs of travelling, accommodation, living allowances and subsidies paid to witnesses, experts and translators.<sup>653</sup>

Application fees and court expenses are charged according to the amounts that are actually incurred and covered by the initiating party. Generally, the amount of such fees is low in practice and thus they would not constitute an obstacle to a shareholder wishing to bring a derivative action. On the other hand, filing fees follow the principle of "loser pays". This means if a plaintiff wins the case, he or she could recover these fees from the defendant. If an action is unsuccessful, then the plaintiff has to bear this cost. This could be a real problem for a prospective shareholder as the amount of such a fee could be huge and thus unaffordable. According to article 13 of the MPLC, court fees can basically be calculated in two ways. Where the

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<sup>649</sup> Article 6 of MPLC.

<sup>650</sup> F. Meng, 'Funding derivative actions in China: Lessons from *Wallersteiner v Moir* (No.2) for the Court' (2010) 31 *Company Lawyer* 29-30.

<sup>651</sup> A party does not need to pay the court fees in the circumstances where he or she is eligible for judicial aid. See Chapter 6 of MPLC.

<sup>652</sup> Article 10 of MPLC.

<sup>653</sup> Article 6(3).

nature of a case is monetary, the court will charge the case by a percentage of the claimed amount. Where the filing is non-monetary, the court fees are fixed, derivative actions are regarded as being of a monetary nature. As such, a plaintiff shareholder has to pay the filing fees calculated on a percentage of the value of the claim before continuing to the trial stage. According to article 13(1) of MPLC, the standards of the amount of filing fees in respect of monetary cases are as follows:

Table 7

| <b>The standard of the amount of filing fees in monetary cases</b> |                   |
|--|-------------------|
| <b>Disputed amount (yuan)</b>                                      | <b>Filing fee</b> |
| < 10,000   | 50 (yuan)         |
| 10,001 - 100,000   | 2.5%              |
| 100,001 – 200,000  | 2%                |
| 200,001 – 500,000  | 1.5%              |
| 500,001 – 1,000,000  | 1%                |
| 1,000,001 - 2,000,000  | 0.9%              |
| 2,000,001 - 5,000,000  | 0.8%              |
| 5,000,001 - 10,000,000   | 0.7%              |
| 10,000,001 - 20,000,000  | 0.6%              |
| >20,000,000  | 0.5%              |

If a plaintiff shareholder decides to withdraw an action, he or she still has to pay half of the above filing fees.<sup>654</sup>

A derivative action is regarded as being monetary in nature and thus the filing fees could be very high under the above standard. For example, if a plaintiff shareholder wishes to raise proceeding in court claiming damages of twenty million yuan, he or she would have to pay 120,000 yuan in filing fees. If he or she is lucky enough to

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<sup>654</sup> Article 15.



win the case at the first instance and no appeal is raised by the defendant, he or she can recover those fees. However, this would not be the end of the matter as the plaintiff may have to apply for the enforcement of the judgment and thus have to pay an additional 20,000 yuan in application fees.<sup>655</sup> If a plaintiff loses a case at the first instance and decides to appeal, he or she would have to pay the same amount of filing fees again, which would be a total of 240,000 yuan. Although this is a hypothetical example, some plaintiffs have even had to pay more than this amount in practice. For example, in the case of *Xin Jiangnan*, the plaintiff had to pay 152,573 yuan in filing fees. In the *Zhongqi Qihuo* case, the filing fee was approximately 830,000 yuan; here as the lawyers in that case pointed out, the plaintiff could not afford such a large sum if they were not financially sound and strong.<sup>656</sup> Some plaintiffs therefore have to reduce the disputed amount so as to pay lower filing fees. For instance, in *Hongshi Shiye* case, three plaintiff shareholders claimed only 100 million yuan while the actual damage caused have been over one billion. Even here, it was still difficult for the plaintiffs to pay 500,000 yuan for the filing fees - one can only imagine how hard it would be for the plaintiff shareholders to pay 5 million yuan if they claimed for the true disputed amount.<sup>657</sup> Although filing fees can be recovered from the defendant if the plaintiff wins the case, the prospects for this are far from certain. Furthermore, few plaintiffs as minority shareholders are likely to be able to afford this filing fee as they are unlikely to have such large amounts of money. However, if this practice were to be widely followed by other prospective plaintiffs, two issues would emerge: first, the company's damages would not be fully recovered and thus the compensation function of derivative action would not function properly. Secondly, directors or controlling shareholders are unlikely to be deterred by a derivative action if prospective plaintiff shareholders are compelled to reduce the

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<sup>655</sup> Article 14(1).

<sup>656</sup> J. Zhao and G. Wu, *Gudong Daibiao Susong* [Shareholders' Derivative Actions] (Falv Chubanshe [Law Press] 2007) 31.

<sup>657</sup> D. Liu, *Woguo Gudong Paisheng Susong Zhidu Yanjiu* [Study on Shareholders' Derivative Actions in China] (Qunzhong Chubanshe [People' Press] 2011) 103.

disputed amount in order to pay lower filing fees. If the deterrent function of derivative actions is compromised in such a severe way, they would be reduced to a glamorous-looking mechanism that lacks effectiveness in constraining misconduct.

### 5.2.2 Lawyer' s Fees

There is currently no law regulating lawyer's fee as this is regarded as a private business matter for plaintiffs and lawyers. Therefore, a plaintiff shareholder has to pay his or her lawyer's fees regardless of the outcome of the action.<sup>658</sup> This means a plaintiff shareholder has to pay not only court fees but also lawyer's fees if an action is unsuccessful. Indeed, even where a lawsuit is successful, plaintiffs must still pay lawyer's fees. This is somewhat confusing, and at worst absurd, if one considers the economic nature of derivative actions. As stated above, any compensation recovered from the defendants will accrue to the company rather than plaintiff shareholders if they win the case. Plaintiff shareholders will only benefit indirectly from an increase in the value of the company's shares which is uncertain because the value of a company's shares is affected by many factors. As such, it seems that a plaintiff shareholder "has nothing to gain, but much to lose"<sup>659</sup> under the current legal system.

It is argued that the lawyer's fees rule operates in a similar way to the American rule. This is because each party does not need to pay the counter-party's lawyer's fees

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<sup>658</sup> The lawyer's fees are normally left to be decided by the plaintiffs and their lawyers. The courts thus will not interfere with this matter except in some exceptional cases. In practice, there is a tendency that the lawyer's fees would be paid by the losers in the cases involving the infringement of patent, trademarks and copyright. For example, in the case of *Walter Disney v Beijing Press*, the judge supported the claim that the plaintiff's lawyer's fees should be compensated by the defendant. However, this practice is not applied in derivative actions and thus the lawyer's fees will still be paid by each party irrespective of the result of the lawsuit. See J. Liu, *Gudong Paishengsusong Yanjiu* [Study on Shareholder's Derivative Actions], PhD thesis (Chinese University of Political Science and Law 2007) 90.

<sup>659</sup> *Wallersteiner v Moir* (No 2) [1975] 1 All ER at 849

irrespective of the outcome of the lawsuit.<sup>660</sup> Therefore, a plaintiff can conclude an agreement with his or her lawyer that the lawyer's fees would only be charged contingent on the result of the action, which is similar to the American contingency fee arrangement.<sup>661</sup> This practice is not uncommon in China as there is no law regulating the issue, and thus such an arrangement can be reached as long as both the plaintiffs and lawyers are willing to accept it. Indeed, contingency fee arrangement could help to reduce a plaintiff's burden as he or she does not need to pay the lawyer's fees if the action is unsuccessful. As such, the practice in China functions in a reverse fashion to that in the US. Unlike in the US, there is no law in China stipulating that lawyer's fees must be compensated out of the sums recovered if an action is successful. In practice, a defendant rarely bears the burden of paying the plaintiff's lawyer's fees when he or she loses a derivative action. Therefore, under the Chinese so-called "contingency fees arrangement", a plaintiff shareholder does not need to pay the lawyer's fees if the case is unsuccessful, but has to pay such an amount if the lawsuit is successful. Another absurd issue may thus arise: a successful action would increase the legal costs payable by a plaintiff shareholder. In this situation, rational shareholders would prefer to adopt other mechanisms to protect their interests and those of the company.

### 5.2.3 Other Issues

Besides the above legal costs, it is also necessary to consider whether a prospective plaintiff should provide security prior to initiating, or pursuant to, a derivative action. If statutory derivative actions were designed to be an investor-friendly system and shareholders are strongly encouraged to use this tool, there is a risk that this legal

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<sup>660</sup> J. M. Zimmerman, *China Law Deskbook: A Legal Guide for Foreign-Invested Enterprises* (2<sup>nd</sup> edn, American Bar Association 2005) Chapter 3.

<sup>661</sup> Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 212.

right might be abused, imposing burdens and costs on the company. In order to strike a good balance between encouraging meritorious lawsuits and preventing frivolous litigation, some scholars suggest that security should be provided when a plaintiff shareholder raises proceedings. However, this is not without its controversies and is currently absent in Chinese legislation.

#### **5.2.4 Summary**

This section is devoted to the legal costs of derivative actions in China. As discussed above, there is no special funding rule for such lawsuits and thus shareholders who wish to commence such proceedings are in a disadvantageous position in light of the disincentivising economic nature of the derivative action. In the absence of proper and reasonable funding rules, the obstacles confronting the initiation of a derivative action would not be removed and its effectiveness in constraining managerial misconduct is highly doubtful. In order to build a new funding system that better encourages plaintiff shareholders to raise such proceedings, the funding rules in England and Wales and the US will be examined and evaluated in the next section. English and US law regarding the provision of security for such actions will also be addressed.

### **5.3 Funding Derivative Actions in English Law: The Indemnification**

#### **Order**

In most Commonwealth jurisdictions, the obstacle of funding derivative actions is addressed by recognising that claimant shareholders have a right to be indemnified

for costs incurred by litigation.<sup>662</sup> This rule is established in the well-known case of *Wallersteiner v Moir (No2)*.<sup>663</sup> In this case, Dr Wallersteiner, the defendant who was a director of the company at issue, had successfully prolonged the case for over 10 years. In spite of exhausting all his financial resources in obtaining judgment against Dr Wallersteiner, Mr Moir had been unable to enforce and recover compensation for the company.

Considering the plight of Mr Moir, the Court of Appeal held that although a plaintiff in a derivative action was not entitled to apply for legal aid and the contingency fee arrangement was beyond the court's mandate, the shareholder should be indemnified by the company for the costs incurred, and to be incurred, in proceedings. The rationale behind this judgment is that the court established a rule based on trust law in which a plaintiff shareholder is like a trustee and the company is analogous to a beneficiary. As such, a plaintiff shareholder is entitled to be indemnified by the company in the proceedings. The test for the plaintiff shareholder to obtain the indemnity order is that he or she is acting in good faith and it would be reasonable for an independent board of directors to initiate such a litigation in the company's name.<sup>664</sup> The Court also ruled that a plaintiff shareholder is still entitled to indemnity regardless of the result of the action. This means that a plaintiff is eligible to apply for an indemnity order even if an action is unsuccessful. This is justified on the ground that the company who receiving the benefit of a venture also ought to bear the risk of losing the case.

It was further held that an indemnity order should be applied at the stage when the plaintiff applies for leave to initiate the action, but that an exception should be allowed if the court thinks it is appropriate to grant such order by the end of the

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<sup>662</sup> A. Reisberg, 'Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation' (2004) 4 *Journal of Corporate Law Studies* 345.

<sup>663</sup> *Wallersteiner v Moir (No2)*[1975]1 All ER 849.

<sup>664</sup> *Ibid.*

proceedings.<sup>665</sup> The Court further held that such an application should be made *ex parte* and the procedures should be “simple and inexpensive”.<sup>666</sup> However, this rule eventually came to be regarded as oppressive for companies as they would have to pay costs without advance notice shortly after the beginning of the proceedings. In *Smith v Croft (No.1)*, Walton J recognised that the *Wallersteiner* rule was unfair to the company and thus held that the company should participate in the application so that the indemnity order could be made on the basis of sufficient evidence.<sup>667</sup> He also held that a plaintiff shareholder should pass a financial need test, so that an indemnity order is available only if a plaintiff is genuinely in need. Although this narrow approach has been followed by courts in other Commonwealth countries,<sup>668</sup> it was not adhered to in a later case.<sup>669</sup>

In order to simplify the procedure, the Civil Procedure Rule (Amendment) (hereafter CPR) r 19.9 stipulated that a court is authorised to grant an indemnity order to the claimant in respect of costs incurred in the proceeding as it thinks appropriate.<sup>670</sup> This provision remains unchanged as the Companies Act 2006 does not mention legal costs in derivative actions. However, the provision in the CPR is simple and does not lay down any specific procedure that the party or the court must follow. The problems this creates will be examined below.

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<sup>665</sup> *Wallersteiner v Moir (No2)*[1975]1 All ER 871.

<sup>666</sup> *Wallersteiner v Moir (No2)*[1975]1 All ER 859.

<sup>667</sup> *Smith v Croft (No.1)* [1986] 2 All ER 551.

<sup>668</sup> For example, *Intercontinental Precious Metals Inc v Cooke* [1994] WWR 66 in Canada and *Farrow v Register of Building Societies* [1991] 2 VR 589 in Australia.

<sup>669</sup> *Jaybird Group Ltd v Greenwood* [1986] BCLC 318, 327.

<sup>670</sup> The rule first can be found in the Rules of Supreme Court (Order 15, r.12A), and then the Civil Procedure Rules 1998 (Schedule 1 at 162-3).

## 5.4 Funding Derivative Actions in the US: The Contingency Fee Arrangement

The position in the US is quite unique in comparison to English law. The general rule is that each party is responsible for his own lawyer's fees regardless of the result of litigation. This is called the "American rule" and is also applicable to derivative actions. In addition, it is very common for a plaintiff shareholder to have a contingency fee arrangement with his lawyer in derivative litigation. This means that a claimant does not need to pay his lawyer's fees if the litigation is lost. However, a plaintiff shareholder has to pay the lawyer's fees if an action is successful. Two questions arise in relation to this 'no win no fee' principle: first, considering the fact that any recovery from litigation will accrue to the company rather than the plaintiff shareholder, it seems that such shareholders are still strongly discouraged from bringing such litigation as they have to pay lawyer's fees. Second, the question arises as to what makes a lawyer take on a derivative action under the contingency fee arrangement?

Two approaches have been adopted in order to address the above concerns: the 'common fund' and the 'substantial benefit' tests. First of all, if a lawsuit is successful and thus creates a fund for the company, then the plaintiff shareholder is entitled to be compensated out of the fund for his lawyer's fees. This principle is based on the theory of unjust enrichment. According to this doctrine, legal costs can be treated as a first charge against the fund if this benefits a class of shareholders beyond the nominal plaintiff.<sup>671</sup> During the early application of this doctrine, the

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<sup>671</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2009) 227; Also see C. G. Hammett, 'Attorney's Fees in Shareholder Derivative Suits: The Substantial Benefit Rule Re-examined' (1972) 60 *California Law Review* 164.

common fund was confined to a monetary fund: this was obviously unfair for the plaintiff in the situation where an action was successful and brought non-pecuniary recovery to the company. Recognising the shortcomings of this restrictive approach, the judiciary established a substantial benefit test: This requires determining whether litigation has achieved “a result which corrects or prevents an abuse which would be prejudicial to the rights and interests of the corporation or affect the enjoyment or protection of an essential right to the stockholders’ interest”.<sup>672</sup> Under this test, a monetary relief apparently constitutes a substantial benefit, but non-pecuniary relief may also meet this test and thus lawyer fees can be paid out of the fund. For example, it was held that an action resulting in a judicial declaration of the defects of proxy statements soliciting votes for a corporate merger conferred benefits upon the company.<sup>673</sup> Nevertheless, although the test has been established as entitling a plaintiff to payment even if an action brings non-pecuniary relief, it is still unclear under which precise circumstances the plaintiff would be qualified for fee awards. It is argued that this needs to be decided on the individual circumstances of each case.<sup>674</sup>

Under the contingency fee arrangement, lawyers may gain nothing if a case is lost. Derivative actions can be made attractive for lawyer via two ways of deciding how much a plaintiff’s lawyer can be paid. The first method is the percentage scale, which rewards lawyers with a percentage of the total recovery. This is normally applicable when the case generates a tangible monetary relief.<sup>675</sup> Historically, lawyers can be paid in the range of 20% to 30% when the total recovery is below one million dollars and 15% to 20% when it is over that amount.<sup>676</sup> The other method of calculating

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<sup>672</sup> *Bosch v Meeker Coop. Light & Power Ass’n*, 257 Minn 362 (1960).

<sup>673</sup> *Mills v Electric Auto-Lite Co.*, 396 US 375 (1970).

<sup>674</sup> See Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 209.

<sup>675</sup> L. Thai, ‘How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand’ (2002) 30 *Australian Business Law Review* 118, 123.

<sup>676</sup> Principles of Corporate Governance: Analysis and Recommendations, Comment on s7.17.



lawyer's fees in derivative actions is known as the "lodestar method". Here, lawyers' fees are determined by their work including the reasonable time they spent in conducting the litigation, the lawyer's customary hourly rate and the quality of their work.<sup>677</sup>

## **5.5 Which Model is most suitable for China? A Critical Evaluation of English and US Rules**

### **5.5.1 The Solution in English Law: Indemnity Costs Orders**

As discussed above, the common law recognises the special economic nature of derivative actions and thus confers the right on a plaintiff shareholder to apply for an indemnity order. Although this attempt to deal with the funding problem was regarded as imaginative at that time,<sup>678</sup> its inherent deficiencies have become evident with the passage of time. This part of this thesis will demonstrate the major flaws of the indemnity costs order approach and how the funding rule applicable in English law may not be suitable for China.

First of all, it remains unclear in what circumstances an indemnity cost order can be granted. Although the Civil Procedure (Amendment) Rules 2000 stipulate that a

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<sup>677</sup> The lodestar method was formally recognised in *Mills v Electric Auto-Lite Co* 396 US 375, 392 (1970), in which the US Supreme Court held that the lodestar method is based on the time the lawyers reasonably spent on their work and their applicable hours rate. However, this does not mean the lawyers can charge without any restrictions as the final figure is subject to the court's scrutiny. The court can adjust the figure considering several factors, such as the complexity of issues and the quality or the risk of representation.

<sup>678</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2009) 232.

court may order a company to indemnify a claimant, they do not detail the conditions in which a claimant would be allowed to obtain such an order. As such, the court has to examine each case as it thinks fit. However, this substantial discretion may create uncertainty and cause great concern for shareholders.

Indeed, case law itself is also vague in many respects. The financial test provides a good example to explain this. In *Smith v Croft*, Walton J approached the funding issue cautiously and added a financial needs test for the application of indemnity orders. He found that a company should not have to bear the cost of indemnity if a claimant has sufficient resources to fund the action.<sup>679</sup> In other words, a plaintiff shareholder has to demonstrate that they genuinely require funding support; otherwise they will not be granted an indemnity order. This narrow approach has been criticised on the grounds of both principle and practicality.<sup>680</sup> In principle, the rationale in favour of allowing an indemnity is that the plaintiff brings an action as a “representative” of the company. As such, the financial status of the claimant should be an irrelevant consideration in deciding whether an indemnity order should be granted. Thus, the court in a Canadian case pointed out that a test based on the financial means of the claimant offended against the principle that the claimant is acting as the agent of the company.<sup>681</sup> Practically, this financial need test could be easily evaded by a shareholder whose financial status precludes them from obtaining an indemnity order. For example, if the aforementioned shareholder wishes to bring a derivative action against wrongdoers, he or she can ask a shareholder who meets the financial need test and who is also willing to act as a nominal claimant. In this situation, the financial need test seems useless in considering whether an indemnity cost order should be granted.

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<sup>679</sup> *Smith v Croft (No.1)*[1986] 1 WLR 597.

<sup>680</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2009) 238.

<sup>681</sup> *Turner v Mailhot* (1985) 50 OR (2d) 561.

In addition to the above drawback, the procedure to grant an indemnity cost order is also ambiguous. Two problems have been identified in this regard: first, the court emphasized in *Wallersteiner* that an application for an indemnity costs order should be kept “simple and inexpensive” and thus should not be allowed to “escalate into a minor trial”.<sup>682</sup> The simple and inexpensive procedure requires the court not to spend much time on the application. However, it is argued that it would be “palpably unjust” for a court to grant an indemnity costs order without a full investigation.<sup>683</sup> The second problem is the peculiar relationship between granting an order for indemnification and permitting an action to continue which is related to the first problem. In *Smith v Croft*, the procedure for the application of an indemnity order was separated from the procedure for the evaluation of the *locus standi* to bring an action. This separate approach may create a paradoxical situation wherein an indemnity order has been granted while the action is dismissed at a later stage. In this situation, a company would have to indemnify the claimant even if the action is unsuccessful. With these procedural obstacles, the court would be very cautious in awarding an indemnity order to a plaintiff shareholder.

Thirdly, it is argued that one of the fundamental problems of an indemnity order is that it fails to provide incentives for shareholders. An indemnity order can be granted to a plaintiff shareholder after he or she has initiated proceedings, which presupposes that an individual shareholder is willing to commence the derivative action in the first place. In other words, an indemnity order does not provide the shareholder with any incentive to raise proceedings, but rather, once he or she has decided to bring an action, permits him or her to be indemnified for costs incurred in this decision.<sup>684</sup> Although the deterrent to the initiation of derivative actions is removed as the claimant shareholder may be indemnified for costs involved in the proceedings, it

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<sup>682</sup> *Wallersteiner v Moir* (No2) [1975] QB 373, 394.

<sup>683</sup> *Ibid.*, per Lord Denning MR at 859.

<sup>684</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2009) 232.

does not mean these orders provide a “significant incentive” for shareholders to use derivative actions.<sup>685</sup> As Reisberg points out, removing a deterrent is simply not the same as providing an incentive.<sup>686</sup> In fact, it has been confirmed in the case law that the indemnity order is not a direct incentive given to a claimant shareholder to facilitate the use of a derivative claim, but rather a reflection of the rights being protected in the action or a form of legal aid.<sup>687</sup>

In addition to the fact that indemnity orders do not provide direct incentives for shareholders, other disincentivising factors may discourage the use of derivative actions. A claimant shareholder will only receive a percentage of the recovery that reflects the shareholding that this person holds if the litigation is successful. This might not be a real or immediate cash return for shareholders as the recovery may be invested in some venture instead of being paid by way of dividend. Furthermore, not all successful litigation leads to tangible relief: the relief might take the form of a tracing order against, and a charge over, the assets that wrongdoers misappropriated from the company.<sup>688</sup> These factors, which discourage the use of derivative actions cannot be dislodged by an indemnity order.

A further drawback that is often overlooked is that a claimant shareholder will not be recompensed if the company is found to be insolvent even if an indemnity order is granted.<sup>689</sup> This is obviously another disincentive for shareholders. Under the

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<sup>685</sup> J. E. Parkinson, *Corporate Power and Responsibility---Issues in the Theory of Company Law* (Clarendon Press 1993) 241.

<sup>686</sup> Reisberg argues that a reward given directly to shareholders can be regarded as a form of an incentive. For example, according to the s201 of the Israeli Companies Act 1999, the court has discretion to grant part of the proceeds of a successful action to plaintiff shareholders beyond their indirect recovery. In such situation, a plaintiff shareholder can benefit directly from the litigation. This may increase the accessibility of the remedy for the potential plaintiffs as it sends a clear message to prospective shareholders that the derivative actions are strongly encouraged by legislators. See, A. Reiberg, ‘Promoting the Use of Derivative Actions’ (2003) 24 *Company Lawyer* 250, 251.

<sup>687</sup> *Smith v Croft* [1986] 1 All ER 551, 565.

<sup>688</sup> One example is *Clark v Cutland* [2003] EWCA Civ 810.

<sup>689</sup> D. D. Prentice, ‘*Wallersteiner v Moir: The Demise of the Rule in Foss v Harbottle?*’ (1976) 40 *Conveyancer* 51, 59.

funding rule in English law, a shareholder has to make a decision on whether they will pursue litigation where they do not know if an indemnity order would be granted. Moreover, even if an indemnity order is granted and the action is successful, a claimant shareholder may still not be compensated if the company is insolvent. This is because an indemnity order does not confer any security in the nature of a lien on the company's assets.<sup>690</sup> This would strongly discourage shareholders from bringing derivative actions as they may feel that they are “going to throw away good money after bad” or are putting their own money at risk.<sup>691</sup>

In sum, as discussed above, there are several serious flaws in the operation of indemnity orders. First, it is still unclear on what basis an indemnity order will be granted. Secondly, the interrelationship between the application for an indemnity and the application for leave to continue is problematic. Thirdly, such orders do not provide a direct incentive for shareholders to litigate: a claimant shareholder will have little or nothing to gain if the result of the litigation is successful. Finally, a shareholder will not be recompensed if it transpires that the company is insolvent. In view of these factors, English law does not provide an adequate response to the formidable funding problem inherent in derivative claims. In China, considering the severe double agency costs and the infrequent use of derivative actions, it is necessary to establish a funding mechanism that offers a strong incentive for shareholders to initiate derivative actions for the purpose of protecting their interests. As such, the indemnity order regime found in English law is not suitable for China, not only because of its uncertainty, but also its under-incentivising problems. Although indemnity orders recognise that a claimant should be indemnified for costs involved in litigation at the courts' discretion, the deterrent effect is not fully addressed. Therefore, the transplantation of this method does not offer shareholders any significant benefit in raising proceedings.

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<sup>690</sup> *Qayoumi v Oakhouse Property Holdings plc* [2003] 1 BCLC 352.

<sup>691</sup> *Wallersteiner v Moire (No 2)* [1975] QB 395 *per* Lord Denning.

## 5.5.2 The Recent Development of the UK Funding Rule: Conditional Fee Arrangements

Recognising the problems associated with the indemnity order, a new system of conditional fee arrangement was developed in England.<sup>692</sup> Under the Access to Justice Act 1999, parties to litigation other than criminal and family proceedings can now have a conditional fee arrangement with their lawyers.<sup>693</sup> This opens up new possibilities in derivative actions as claimant shareholders can use this new arrangement to fund their claims.

Generally, a conditional fee arrangement is a 'no-win-no-fee' system, which allows a lawyer to charge his client only if the case is won. Under this system, claimant shareholders are relieved from paying their lawyers for work that has been done where a case is unsuccessful. If a case is won, the costs of the lawyer will be paid by the losing party instead of the plaintiff shareholder who wins the case. As a result, a plaintiff shareholder does not need to pay fees to his or her lawyer in any event under the conditional fee arrangement. From this perspective, it is fair to say that this new system has an effective function in encouraging the use of derivative actions.

Nevertheless, it is argued that a conditional fee agreement provides only a partial solution to the funding issue in English law. Although a plaintiff shareholder does not need to pay his or her lawyer in any event, he or she still has to pay the winning opponent's legal costs if the case is lost. This makes conditional fee agreements different from contingency fee arrangements and makes them impractical or

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<sup>692</sup> See A. Hogan, 'Conditional Fees: Problems Solved and Problems yet to Come' (2006) 1 *Journal of Personal Injury Law* 40.

<sup>693</sup> See Access to Justice Act 1999, s 58A(1).

unsuitable for funding derivative actions. Under a conditional fee agreement, an economically rational shareholder may not want to bring a derivative action in light of the risks and benefits of the action. If a minority shareholder raises proceedings and is successful, he or she only receives a pro rata share of the gains from such an action which may be negligible. However, if a case is unsuccessful, he or she has to pay the defendant's legal fees which could be substantial. Since a derivative action cannot be guaranteed to be successful a rational shareholder is thus highly unlikely to take on a derivative action in light of the potential significant risks and negligible benefits.

As a result, whilst the deterrent effect of English indemnity orders may be mitigated by conditional fee agreements, the inherent disincentives against plaintiff shareholders remains unless some sort of mechanism is implemented in supplement. For example, is there a mechanism that can insulate prospective claimant shareholders from the risk of paying the opponent's legal fees? In theory, one way to overcome the negative aspect of this new system is the insurance market.<sup>694</sup> Here, claimant shareholders can insulate themselves from paying the defendants' legal costs by buying an insurance product specifically tailored to cover the client's potential liability for the legal costs. Whilst it seems that the deterrent effect under conditional fee agreements would be eliminated with the intervention of such insurance, closer examination reveals that many difficulties faced by minority shareholders remain. There are basically two forms of insurance available to cover the risk of litigation: before-the-event (BTE) and after-the-event (AFT) insurance.<sup>695</sup> It is highly unlikely that a shareholder would take out BTE insurance when investing in a company. It is widely recognised that minority shareholders normally do not enthusiastically participate in the monitoring of a company's management owing to

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<sup>694</sup> G. Robinson, 'The CFA is here to Stay—A Litigator's Guide to Conditional Fee Agreements and Other Funding Arrangements' (2001) 1 *Journal of Personal Injury Law* 44.

<sup>695</sup> See S. Sime, *Practical Approach to Civil Procedure* (5<sup>th</sup> edn, Oxford University Press 2002) 33-32.

the existence of rational apathy or free riding, particularly for those who are members of listed companies. In light of this, it is difficult to imagine that shareholders would buy this insurance to cover possible legal action in the future. Twenty years of experience in England shows that such legal insurance is not popular notwithstanding that it is relatively inexpensive in comparison with AFT insurance. It is anticipated that this is unlikely to change significantly,<sup>696</sup> particularly in the area of insurance for funding derivative actions. For the AFT insurance, a plaintiff shareholder has to pay a significant premium up front. Many shareholders would be deterred by this as some of them would not be able to afford such a considerably-priced premium. If they are able to afford it, their willingness to do so is still questionable as they will not recover the cost of such a premium if the case is lost. As such, the disincentivising effects of conditional fee agreements cannot be addressed by the insurance market.

There is another argument that the up-front costs or premiums could be paid by a plaintiff's lawyer in advance. This suggests that a plaintiff shareholder could enter into a conditional fee agreement without paying any fee regardless of the outcome of the action as his or her lawyer would advance the expense of the premiums. However, it is unreasonable and unrealistic to expect lawyers to be willing to shoulder this fee out of their own pockets.<sup>697</sup> Under traditional conditional fee agreements, lawyers may be willing to take on an action because here the worst case scenario is to be paid nothing for their work. An up-front premium arrangement however, would risk not only that these lawyers are not paid, but also that they bear a substantial loss for costs paid to the defendants. Lawyers would not be willing to bear such costs unless they were certain that the probability of success is very high. However, successful litigation cannot be guaranteed, and they are thus forced to take a risk. Moreover,

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<sup>696</sup> M. Zander, 'The Government's Plans on Legal Aid and Conditional Fees' (1998) 61 *Modern Law Review* 538.

<sup>697</sup> A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2009) 254.



even where a lawyer agrees to take on a case because they are certain on the basis of their experience and competence that the litigation will succeed, the majority of potential derivative actions are unlikely to be able to generate such certainty and will thus be rejected by lawyers. This may constitute another barrier for shareholders to pursue derivative actions.

In light of the above, conditional fee agreements cannot provide a comprehensive solution to address the funding issue. As such, they are not suitable for China. More importantly, conditional fee agreements are established based on the system of costs follow the event. However, the notion of ‘costs follow the event’ in China is only applied to court fees rather than lawyer’s fees. Lawyer’s fees in China are paid by their clients regardless of the outcome of the action. As a result, if a conditional fee agreement is transplanted for application to China’s lawyer costs, it would create an absurd phenomenon because of the fact that a plaintiff shareholder has to pay the fees if an action is successful while they do not if the case is lost. It might be argued that successful litigation could generate benefits that can cover lawyer fees. However, such recoveries are allocated to the company rather than the plaintiff shareholder, with the latter only receiving an indirect *pro rata* share of the gains. This would obviously not be sufficient to cover the lawyer’s fees. To benefit plaintiff shareholders would have to hope to lose the litigation to avoid paying costs out of their own pockets, though this runs against their initial purpose. Here, there is no point in raising proceedings. Otherwise, plaintiff shareholders are inviting their own troubles.

### **5.5.3 The Assessment of Contingency Fees Arrangements**

#### **5.5.3.1 The Advantages of Contingency Fee Arrangements**

Contingency fee arrangements are much more favourable for individual shareholders compared to condition fee agreements. Under this US-style system, plaintiff shareholders are not liable for their lawyers' fees under any circumstance. Although they might have to pay some costs that are not lawyer's fees in proceedings, it is very common for them to sign a contingency fee arrangement with their lawyers asking the latter to advance such expenditures or providing that plaintiff shareholders are not liable for the expenditures in any event.<sup>698</sup> Even where there is no such contract and thus plaintiff shareholders have to pay the defendant some non-fee costs, such costs are very limited.<sup>699</sup> As such, the costs of the litigation are shifted to the plaintiff's lawyer while plaintiffs are insulated from exposure to the risk of paying litigation costs. For the plaintiff's lawyers, it seems that they bear a high risk of working for nothing or even losing money out of their pocket if they agree to advance up-front expenses. However, this loss is not significant, or at least much smaller, compared to the situation for English plaintiffs and lawyers where one of them would have to pay the legal costs of the defendant under the conditional fee agreement. As a result, the financial disincentive against derivative actions is not an issue under the contingency fee arrangement. This is principally why derivative actions in the US are much more active than in other countries.

In fact, a key role in derivative actions is thereby shifted from the plaintiff to the lawyer under this arrangement. There are even some lawyers who are dedicated to derivative actions, spending much time on monitoring companies. After detecting a corporate wrongdoing, they seek a nominal plaintiff shareholder to bring an action against the wrongdoer. Since shareholders can receive some *pro rata* benefits from the recovery and have little financial risk in doing so, they are at least not difficult to

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<sup>698</sup> See R. L. Rossi, *Attorneys' Fees* (Westlaw Database) s.2.13.

<sup>699</sup> See L. D. Martin, *American Jurisprudence – Costs* (Westlaw Database, 2<sup>nd</sup> edn) Chapter 5.

find. In this sense, lawyers act as private lawyer generals.<sup>700</sup>

### 5.5.3.2 Criticisms of Contingency Fee Arrangements

It is argued that contingency fee arrangements have two serious problems: strike suits and cheap settlement.

#### 5.5.3.2.1 Strike Suits

It is believed that while derivative actions are strongly encouraged under the contingency fee arrangement, unmeritorious lawsuits may also be brought at the same time. Given that litigation itself can hurt a company in damaging its reputation, and distracting management from focusing on business matters, unmeritorious or malicious lawsuits can do even worse to a company. Some empirical studies have demonstrated that this is the case in practice. Wood conducted a study involving 573 derivative actions and found out that only 13 cases resulted in judgments in favour of plaintiffs.<sup>701</sup> Another empirical study conducted by Jones also confirmed this research. He examined both securities actions and derivative lawsuits in 1980 and revealed that only about 0.6% of the total sample cases resulted in judgments in favour of the plaintiffs.<sup>702</sup>

One fundamental explanation behind these so-called strike suits may be that a plaintiff shareholder does not need to bear the costs of lawsuits under contingency fee arrangements. Here, they have nothing to lose but something to gain for bringing

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<sup>700</sup> The term “private attorney generals” was first coined by Judge Jerome Frank in *Associated Industries of New York State, Inc. V. Ickes*, 13 F.2d 694, 704 (2d Cir. 193). For further details on this phrase, please see: J. A. Rabkin, ‘The Secret Life of the Private Attorney General’ (1998) 61 *Law & Contemporary Problems* 179.

<sup>701</sup> F. Wood, ‘Survey and Report Regarding Stockholders’ Derivative Suits’ (The Wood Report) 32.

<sup>702</sup> T. M. Jones, ‘An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits’ (1980) 60 *Boston University Law Review* 542.

litigation. Furthermore, defendants are more likely to settle with plaintiff shareholders,<sup>703</sup> thereby facilitating the use of derivative actions. Plaintiff shareholders know that initiation would be unlikely to proceed to trial as the costs for defendants to defend an action may be more than the settlement; they may thus be amenable to filing frivolous cases as long as the costs of filing are less than the value of the settlement. Bebchuk raises another opinion suggesting that an information asymmetry between a plaintiff and a defendant may explain also strike suits.<sup>704</sup> In some circumstances, the total costs of litigation may exceed the expected judgement for a plaintiff shareholder and the initiation of this kind of suit would bring no good for the plaintiff. However, the defendant may not know this as a result of information asymmetry.<sup>705</sup> Therefore, he or she might still wish to settle the case owing to the uncertainty of the outcome of litigation.

However, the allegation that strike suits are linked to contingency fee arrangements is questionable. First of all, it is argued that the aforementioned empirical studies are not adequate to support the assertions about strike suits as the data collections are doubted by some scholars.<sup>706</sup> Secondly, it is unconvincing to claim that strike suits are prevalent by demonstrating that a majority of derivative actions are not in favour of plaintiffs. As most derivative actions end in settlements, a favourable judgment for a defendant does not mean that most actions, including settled cases, are

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<sup>703</sup> This will be discussed in detail below.

<sup>704</sup> L. A. Bebchuk, 'Suing Solely to Extract a Settlement Offer' (1988) 17 *Journal of Legal Studies* 43.

<sup>705</sup> In economics theory, information asymmetry deals with the study of decisions in transactions where one party has more or better information than the other. This creates an imbalance of power in transactions which can sometimes cause the transactions to go awry. Specifically in derivative actions, a defendant may not know the precise circumstances where a plaintiff shareholder stands. In order to resolve the disputes as soon as possible without affecting the company and himself/herself, a defendant may thus wish to settle the dispute. For more details on information asymmetry, please see: G. A. Akerlof, 'The Market for 'Lemons': Quality Under Uncertainty and the Market Mechanism' (1970) 84 *Quarterly Journal of Economics* 488-500; S. Balakrishnan, 'Information Asymmetry, Adverse Selection and Joint-venture: Theory and Evidence' (1993) 20 *Journal of Economic Behaviour & Organization* 99-117;

<sup>706</sup> See M. I. Weiss, 'Shareholder Litigation – Reform Proposals to Shift Fees: Limit 'Professional Plaintiffs' and Cap Punitive Damages' in Corporate Law and Practice Course Handbook Series (Practising Law Institute Westlaw Database 1994) No. B4-7068.

unmeritorious. Furthermore, the risk of the litigation is shifted from a plaintiff shareholder to his or her lawyer under contingency fee agreement. As such, even if a plaintiff shareholder wishes to pursue an unmeritorious suit, it may be that no lawyer will accept such a case. Since lawyers risk not being paid for their work, they are more inclined to choose cases with a high probability of success. As frivolous cases normally have a low probability of success, lawyers are naturally unwilling to take on such actions, preventing cases like this from being initiated.

### 5.5.3.2.2 Cheap Settlements

The contingency fee arrangement also has the problem of cheap settlements. Most derivative actions are ultimately settled instead of resorting to the courts under the American style funding system. Settlement itself is good for the company as well as other participants. However, it produces unsubstantial benefits for the company while significant awards go to the plaintiffs' lawyers. Several empirical studies have demonstrated the prevalence of cheap settlements. Jones found out that only about one fourth of derivative actions eventually proceed to trial. The rest, which is 75% of such cases, are settled out of court.<sup>707</sup> Another study conducted by Romano also confirms this phenomenon. Romano examined derivative actions from the 1970s to the 1980s and found that 64.8% of cases ended in settlements.<sup>708</sup> Of all these settled cases, only half of them generated some financial recovery for shareholders.<sup>709</sup> Where non-monetary remedies were obtained, it is alleged that they were "inconsequential" and "cosmetic", which is most likely used to justify the lawyers' awards.<sup>710</sup> By contrast, the fees paid for lawyers were significant despite the

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<sup>707</sup> See T. M. Jones, 'An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits' (1980) 60 *Boston University Law Review* 542.

<sup>708</sup> R. Romano, 'The Shareholder Suit: Litigation Without Foundation?' (1991) 7 *Journal of Law, Economics & Organisation* 55.

<sup>709</sup> *Ibid.*

<sup>710</sup> *Ibid.*

minimal monetary value received by shareholders.<sup>711</sup> As a consequence, derivative actions are criticised by some commentators. For example, one US circuit judge stated that “derivative actions do little to promote sound management and often hurt the firm by diverting the managers’ time from running the business while diverting the firm’s resources to the plaintiffs’ lawyers without providing a corresponding benefit.”<sup>712</sup>

This result obviously runs against the purpose of derivative actions as they are expected to protect the interests of minority shareholders and the company as a whole. However, cheap settlements are understandable after a closer examination of each side. Under the contingency fee arrangement, risk is shifted from plaintiffs to their lawyers as discussed above. The efforts of plaintiffs’ lawyer would be made for nothing if they fail to win the case. If the case is successful, they would receive some - but limited - benefit. In light of this, rational lawyers would try their best to settle cases in order to gain some benefit. Although a payment from a settlement may be less than from a judgment, it would be a definite payment and thus lawyers do not have to risk losing their efforts and gaining nothing. In addition, it is argued that the method of calculating fees by the percentage provides another incentive for lawyers to reach settlements as soon as possible.<sup>713</sup>

Defendants also have incentives to settle cases without resorting to the courts. After a derivative action is filed, defendants face three possible results: win, lose or settle. Winning a case is definitely a good result for the defendant. Even so, they have to defend themselves and costs might be incurred during this proceeding. Furthermore, litigation may damage their reputation and thus affect their business activities. By

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<sup>711</sup> See T. M. Jones, ‘An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits’ (1980) 60 *Boston University Law Review* 542.

<sup>712</sup> *Felzen v Andreas*, 134 F.3d 873, 877 (7<sup>th</sup> Cir. 1998).

<sup>713</sup> J. C. Coffee, ‘Understanding the Plaintiff Attorney: The Implication of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions’ (1986) 86 *Columbia Law Review* 669.

contrast, if they lose the case, they have to pay litigation costs as well as damages. Their reputation will also be damaged. In this dilemma, it is natural and understandable that defendants choose to settle as a compromised way of resolving issues.

For plaintiff shareholders, although they have some interest in the outcome of the litigation, any recovery from the defendants generates trivial value for them as they only hold minority shares in the company. As such, they do not have an economic incentive to monitor their lawyers. In fact, the named plaintiff in most derivative actions is nothing but a figurehead. Moreover, as risk has been shifted from plaintiffs to their lawyers under a contingency fee arrangement, plaintiff shareholders have much less financial stake than their lawyers in an action, creating legitimacy for lawyers to control decision-making.<sup>714</sup> In view of the above, it is not surprising to see that cheap settlements are prevalent under contingency fee arrangements.

#### **5.5.4 Why Contingency Fee Arrangements are suitable for China**

##### **5.5.4.1 Why the English Funding Rule is not suitable for China**

Before demonstrating why the US funding rule is suitable for China to adopt, it is essential to illustrate why the UK funding rule cannot be transplanted to China. As discussed above, there are many inherent drawbacks to indemnity cost orders, which make such orders inappropriate for China. For example, the circumstances under which an indemnity cost order can be granted remain unclear. As such, it would be difficult for Chinese courts to apply this rule fairly and systematically without clear clarification. Given that Chinese judges only decide cases strictly following the law,

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<sup>714</sup> Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 227-228.

it is even more essential to clarify this rule. If it were to be transplanted to China, this key and important issue would therefore have to be addressed. However, this problem still exists even in the UK from which this rule originates. Arguably, it would be even more difficult for Chinese legislators to clarify this rule.

In addition to their ambiguousness, the disincentive that indemnity cost orders generate in discouraging shareholders from bringing derivative actions, constitutes another obstacle. As revealed above, an indemnity order presupposes that shareholders would want to pursue litigation on behalf of the company in the first place. Here they only have the possibility of being indemnified after they have made the decision to sue. Although it is true that a deterrent to the initiation of a derivative actions has been removed by this order, this does not mean that an incentive has been provided for shareholders. In light of this, indemnity orders are not suitable for China because Chinese shareholders need to be encouraged to raise proceedings against wrongdoers.

#### **5.5.4.2 The Grounds for Adopting the US Funding Rule**

The US funding rule can overcome the above shortcomings. Under contingency fee arrangements, plaintiff shareholders do not need to pay their lawyer's fees if the action is unsuccessful. If he or she wins the litigation, the lawyer's fees will be paid out of the recovery received from the defendants. As such, plaintiff shareholders are not liable for their lawyers' fees regardless of the outcome of the litigation. As a consequence, Chinese shareholders would be encouraged to bring derivative actions if this rule were adopted in China. Two main factors can justify the possible transplantation of this rule to China.

First, shareholders in China should be encouraged to bring litigation against



wrongdoers. As discussed in previous chapters, there are severe double agency costs in China that leave minority shareholders vulnerable to exploitation by majority shareholders and/or managers. Therefore, it is extremely important that their interests be safeguarded. Unfortunately, current mechanisms designed to protect their interests are either ineffective or cannot provide sufficient protection for minority shareholders upon a closer examination. If contingency fee arrangement is adopted in China, it can be expected that shareholders would be encouraged to bring derivative actions in order to protect their interests and the company.

Second, the transplantation of a contingency fee arrangement is not without foundation in respect of lawyer's fees in China. As mentioned above, lawyer fees are not regulated under Chinese law as they are considered to be a private business matter for plaintiffs and their lawyers. Normally, a plaintiff shareholder has to pay their lawyer's fees regardless of the outcome of the litigation.<sup>715</sup> However, it is not uncommon for a plaintiff to reach an agreement with his or her lawyer that the lawyer's fees would only be charged contingent on the outcome of the suit. This is similar to the American contingency fee arrangement under which a plaintiff does not need to pay fees when the action is successful as they would be compensated out of the recovery. As such, there would be no real or substantial difficulties if the contingency fee arrangements were to be transplanted given the fact that there is a similar system for lawyer's fees in place in China.

#### **5.5.4.3 The Potential Problems in Adopting the US Funding Rule**

As discussed above, contingency fee arrangements are not without drawbacks. Two major problems have been identified in the application of this funding rule: strike

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<sup>715</sup> It is very common for plaintiffs to sign contracts with their lawyers that plaintiffs may only pay a small amount of money to their lawyers if the litigation is unsuccessful while they have to pay a larger amount of fees when they win the litigation. As such, a plaintiff shareholder has to pay his or her lawyer's fee under any circumstance.

suits and cheap settlements. For the former, it is argued that the incentives a contingency fee arrangement creates for shareholders may generate unmeritorious actions and thus the device of derivative action may be abused. For the latter, it is said that cheap settlements would prevail as lawyers prefer definite rather than probably substantial but uncertain payment. These two problems may hinder the effectiveness of derivative actions if a contingency fee arrangement is adopted in China. Indeed, shareholders would be encouraged to raise proceedings as the risk of litigation would shift from plaintiff shareholder to lawyer under the contingency fee arrangement. However, this does not necessarily mean that the above problems would be inevitably occur, or if they did, could not be tackled. Indeed, they could be avoided or addressed with proper mechanisms.

#### **5.5.4.3.1 Strike Suits**

The assertion that strike suits are generated by contingency fee arrangements is not without a dispute. As discussed above, empirical studies indicating that strike suits are increased have been met with doubt by some scholars. For example, Weiss demonstrated that the data collected in these empirical studies were inadequate to support the assertion that the funding rule resulted in a prevalence of strike suits.<sup>716</sup> Furthermore, a greater volume of litigation would be created by this funding rule; this does not necessarily mean that many of these suits are unmeritorious. Whether an action is meritorious or not cannot be simply measured by the amount of monetary benefit received in the settlement or outcome decided by the courts.

Secondly, derivative actions cannot be initiated freely by plaintiff shareholders. In China, there are some restrictive procedural rules which shareholders have to meet if

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<sup>716</sup> See M. I. Weiss, 'Shareholder Litigation – Reform Proposals to Shift Fees: Limit 'Professional Plaintiffs' and Cap Punitive Damages' in *Corporate Law and Practice Course Handbook Series* (Practising Law Institute Westlaw Database 1994) No. B4-7068.

they wish to pursue litigation. For example, not every shareholder in a joint stock limited company is eligible to bring a derivative action under the current law as there is a standing requirement entitling only those shareholders who hold at least 1% of the total shares of the company for 180 consecutive days or more to do so. Although this standing requirement is to be relaxed in the future reform, the procedural restriction remains in place to ensure that the balance between monitoring managers and protecting minority shareholders is achieved. As such, it is expected that the adoption of a contingency fee arrangement in China would not necessarily lead to groundless suits.

Thirdly, the advantages brought by a contingency fee arrangement would outweigh its disadvantages if it is transplanted to China. There have only been a small number of derivative action cases in practice since their introduction through Chinese Company Law 2005. This caused disappointment for many scholars and lawyers as it was expected that the new statutory derivative action would have a key role to play in reducing agency costs. In light of this, the derivative action system should be improved and actively used. With the adoption of a contingency fee arrangement, shareholders are at least not hindered from bringing derivative actions and it might be expected that the use of this new institution would be promoted in China. There may inevitably be some frivolous suits among such derivative actions. However, this would be better than the current situation where the right of initiating derivative suits is rarely exercised.

#### **5.5.4.3.2 Cheap Settlements**

Under a contingency fee arrangement, risk shifts from plaintiff shareholders to their lawyers. Here, a rationale lawyer would try his or her best to settle a case because potential failure may mean his or her efforts are expended for no reward. Settlement

is regarded as an appropriate way to resolve disputes, not only by saving judicial resources, but also because of its unique characteristic of avoiding widening disagreements. In fact, the settlement of civil disputes is strongly encouraged in Chinese judicial culture. There is even a separate chapter in Chinese Civil Procedure Law stipulating rules on mediation.<sup>717</sup> As a matter of fact, settlement itself is not a problem. Rather, the problem is that lawyers may use the settlement for their personal gain as they have different interests from their clients under a contingency fee arrangement. A common concern in this respect is that companies may receive little or no monetary recovery while lawyers are rewarded with substantial fees. In addition, a settlement may be secretly reached on terms advantageous to both parties while not in the interests of the company. Therefore, courts should step in and such settlements should need judicial approval. With the rigorous judicial control, it could be expected that the settlement problems can be addressed.

### **5.5.5 Other Issues**

#### **5.5.5.1 Filing Fees**

In addition to the lawyer's fees, the filing fees may constitute another obstacle for the promotion of derivative actions. Filing fees follow the principle of "loser pays", which means a plaintiff shareholder may have to bear this cost if an action is unsuccessful. If the amount of this fee is not much in practice, it would not be a problem for shareholders. However, under current legislation, the filing fee is charged in proportion to the claimed amount because it is calculated as a monetary claim.<sup>718</sup> Under this calculation, filing fees can be very high, particularly in derivative actions, which normally involve a large disputed claim. Although filing

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<sup>717</sup> See Civil Procedure Law (2012 Admendment), Chapter 8.

<sup>718</sup> Article 13 of MPLC. For the details of this calculation, please see the above discussion.

fee might be recovered from the defendants if the plaintiff wins the case, the prospect of this is far from certain. As a consequence, plaintiff shareholders risk paying large filing fees out of their own pocket when they decide to bring derivative actions.

Experience in Japan has shown that the above problem is not difficult to address. In 1950, Japanese corporate law was substantially revised under the influence of US corporate law and derivative action was adopted for the first time.<sup>719</sup> Such actions were regarded as one of the most important features in this reform as they were expected to provide a formidable weapon to protect the interests of minority shareholders.<sup>720</sup> However, for the first forty years after its enactment, derivative action was rarely used by Japanese shareholders.<sup>721</sup> The situation was significantly changed from 1990s when the rate of derivative actions started to increase enormously.<sup>722</sup> The vast majority of scholars believe that the explanation behind this is clear and simple: the rule of percentage calculation of filing fees, which was similar to China's current rule, was changed. Filing fees were reduced to a small fixed amount in 1993 following the Tokyo High Court's decision in the Nikko Securities case.<sup>723</sup> Under this amendment, derivative actions were treated as incalculable claims and the filing fees of such cases were lowered to a nominal fixed

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<sup>719</sup> It was set out in articles 267 of the Commercial Code. See S. Kawashima and S. Sakurai, 'Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms' (1997) 33 *Stanford Journal of International Law* 15.

<sup>720</sup> See L. Salwin, 'The New Commercial Code of Japan: Symbol of Gradual Progress towards Democratic Goals' (1962) 50 *Georgetown Law Journal* 478-517.

<sup>721</sup> From 1950 to 1985, there was on average fewer than one derivative action per year in the whole of Japan. See S. Kawashima and S. Sakurai, "Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms" (1997), *Stanford Journal of International Law* 33, p17.

<sup>722</sup> In 1993, there were 84 cases pending before Japanese courts. The number rose to 174 in 1996 and reached a peak with 286 cases in 1999. Although the number of new actions declined slightly from 2000-2009, it still maintained a previously unimaginably high average rate of 73.7 new actions filed per year. See M. D. West, 'The Pricing of Shareholder Derivative Actions in Japan and the United States' (1994) 88 *Northwest University Law Review* 1436; M. Nakahigashi and D. W. Puchniak, 'Land of the rising derivative actions: Revisiting Irrationality to Understand Japan's unreluctant Shareholder Litigant' In D. W. Puchniak, H. Baum and M. Ewing-Chow (eds.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012) 128-185.

<sup>723</sup> M. Nakahigashi and D. W. Puchniak, 'Land of the rising derivative actions: Revisiting Irrationality to Understand Japan's unreluctant Shareholder Litigant' In D. W. Puchniak, H. Baum and M. Ewing-Chow (eds.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012) 128-185.

rate of ¥8.200 (about £54 ).<sup>724</sup> The significant increase in the number of derivative actions since has demonstrated that filing fees can have a key role to play in derivative litigation and the reduction of such fees could encourage shareholders to raise proceedings.<sup>725</sup> In light of Japan's experience, it is clear that filing fees should be reduced and changed to a fixed rate if China's shareholders are to actively use derivative actions as a tool for the enforcement of directors' duties. Given the current classification of the court fees system in China, the filing fees for derivative actions can be categorized as non-monetary which would make them a lower and fixed amount.

### 5.5.5.2 The Calculation of Lawyer's Fees

There are two ways of computing lawyer's fee under a contingency fee arrangement: the lodestar method which basically rewards the lawyer for time reasonably spent in the action; and the percentage method in which the lawyer is paid on the basis of the percentage of the recovery.

The lodestar method was established to reflect the risk assumed by the lawyer and the quality of the work done.<sup>726</sup> However, this time-based formula may provide a strong incentive for lawyers to expend needless time in order to maximize their rewards. This unfortunate formula would not only delay the progress of an action and

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<sup>724</sup> Tomotaka Fujita, an authority in Japanese corporate law, even proclaims that this amendment was undoubtedly 'one of the most influential events in the history of the Japanese corporate governance regime'. See T. Fujita, 'Transformation of the management liability regime in Japan in the wake of the 1993 revision' In H. Kanda et al. (eds.), *Transforming Corporate Governance in East Asia* (Routledge 2008) 15-35.

<sup>725</sup> It is argued that the bursting of Japan's economic bubble in the early 1990s may also partly account for the increasing number of derivative actions as the decline of the economy may decrease the transaction cost of pursuing derivative actions by making it easier to establish damages resulting from managers' wrongdoings. However, West also argued that the reduction of filing fees explains 'much of the increase in [derivative action] filed'. See M. D. West, 'Why Shareholders Sue: The Evidence from Japan' (2001) 30 *Journal of Legal Studies* 351.

<sup>726</sup> *Lindy Bros. Builders v American Radiator & Standard Sanitary Corp.*, 487 F.2d 161 (3d Cir. 1978).

thus impose unnecessary workload on the judiciary, but also aggravate a latent conflict of interest between the lawyer and the class a plaintiff shareholder represents as the greater the fee, the smaller the net recovery ascribed to the company.<sup>727</sup>

By contrast, a percentage method can avoid the above problems as it is calculated in proportion to the recovery. In addition, it is a simple method which does not encounter the problem of determining the lawyer's hourly rate and adjustment multiplier. However, the percentage method has its own problems. When the lawyer's fee is calculated in proportion to the recovery, lawyers could encourage premature settlements which might not be in the best interests of the company. In addition, as the rewards that lawyers receive do not represent the amount of work they did, they may obtain windfall profits if a case is settled immediately. This would result in public criticism and damage to derivative actions.

Both of the above methods have their advantages and disadvantages. As for which one is suitable for China to adopt, this thesis argues that the percentage method is relatively better for China. First of all, the lodestar method is rarely used in China. It is very uncommon for Chinese lawyers to charge on the basis of an hourly rate. Instead, they charge either on a percentage of the claimed amount or fixed fees. As such, the adoption of the percentage method in derivative actions would encounter no real difficulties in China. Second, the lodestar method requires the calculation of the time that lawyers have spent on the action. This means that lawyers have a final say on the amount of the fees to be paid. However, Chinese shareholders may not be confident about this as they may be doubtful of the actual time that lawyers have spent. Given the fact that China's legal service market is still developing and the quality of lawyers greatly varies, such concern is not without reason. Third, the problem of windfall inherited in the percentage method can be addressed by setting a

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<sup>727</sup> ALI 7.17 Comment C.

ceiling on the maximum fee. This means a lawyer could charge in proportion to the money value of claim, but they cannot charge over a maximum fee.

### 5.5.5.3 Security-for-expenses

In order to prevent the potential problem of abusing derivative actions, some argue that a requirement of security-for-expenses provided by plaintiff shareholders can be adopted.<sup>728</sup> There is currently no law regulating security-for-expenses in derivative actions in China and there are three opinions available in discussing whether this mechanism could be introduced. The first is that plaintiff shareholders be required to provide security when they wish to pursue derivative actions.<sup>729</sup> This option is based on the presumption that derivative actions may be abused for personal gain and the company may also be damaged by the action. Security-for-expenses would require plaintiff shareholders to post security, which could deter some unmeritorious suits and thus protect the interests of the company as a whole. The second opinion is that China does not adopt a security-for-expenses requirement provided by plaintiff shareholders.<sup>730</sup> The argument for this opinion is that any recovery from the litigation will go to the company rather than the plaintiff shareholders. Requiring those shareholders who cannot benefit directly to provide security would obviously discourage them from using derivative actions. The last opinion is a compromise theory which argues that security-for-expenses should be used cautiously.<sup>731</sup> This

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<sup>728</sup> This mechanism was originated in the US where in 1940s the abuse of derivative actions had become a serious problem. Under this mechanism, plaintiff shareholders who hold less than the statutorily required minimum interest in the company would be required to post security for reasonable expenses incurred in the litigation. This was regarded as the death knell for derivative litigation. However, it did not have that effect as plaintiffs were able to avoid the application of this mechanism. In the end, many states including Delaware have not adopted this requirement any more. See X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 176.

<sup>729</sup> See J. Li, 'Lun Gudong Daibiao Susong Zhidu zhi Jianli' [The Establishment of Shareholder's Derivative Action] (2003) 12 *Renmin Sifa* [People's Jurisprudence].

<sup>730</sup> See X. Zhang, *Gudong paisheng Susong Yanjiu* [Study on Shareholders Derivative Actions] (Law Press China 2007) 155.

<sup>731</sup> See B. Daodai and G. Gu, *Gongsi Zhili: Guoji Jiejian yu Zhidu Sheji* [Corporate Governance: International Transplants and Institutional Design] (Beijing Daxue Chubanshe [Peking University



approach is basically in favour of adopting the security-for-expenses requirement while at the same time recognises the disadvantages of this mechanism. To be specific, it is argued that this mechanism could be introduced and only be used in a situation where the defendants can prove that the litigation brought by the plaintiff shareholder is not in good faith.

In view of the above debates, this thesis argues that a requirement of security-for-expenses provided by the shareholder should not be introduced in China for the following reasons. First of all, the adoption of such a mechanism is unfair for plaintiff shareholders. As mentioned above, a derivative action is a unique form of litigation as plaintiff shareholders would not benefit directly if they win the case. If this mechanism is adopted, it would mean a plaintiff shareholder will lose a certain amount of money which is used as security. In this situation, it is unfair to plaintiff shareholders as they have nothing to gain directly but something to lose. Second, derivative actions need to be encouraged in China. As emphasized repeatedly, the use of derivative actions in China should be promoted considering the severe double agency costs and ineffective protective mechanisms. The security method would discourage shareholders from raising proceedings to protect their interests and thus hinder the exercise of derivative actions. Third, the abuse of derivative actions could be avoided even without the adoption of security. Besides the procedural restriction, lawyers would have a key role to play in screening frivolous suits. Under the contingency fee arrangement, lawyers bear the risk of gaining nothing. This would make lawyers consider the merits of cases before taking them on. As such, those cases that are frivolous or unmeritorious might not be accepted by the lawyers. Last but not least, although the compromise approach seems to be welcomed by many scholars, it is not necessarily different from the first opinion. The compromise approach is in favour of adopting security-for-expenses while maintaining that it

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Press] 2005) 265.

should be used cautiously. Whether security should be provided depends on the merits of the case, and the courts are conferred such powers to make this decision. This means a plaintiff shareholder has to face the potential risk that he or she might be required to provide security after he initiates an action. It is this potential risk that might deter shareholders from undertaking derivative litigation. In addition, it is difficult to judge whether a derivative action is meritorious or unmeritorious as a successful or unsuccessful result cannot simply be the standard. The ambiguous criterion for judging this casts further doubts over this compromise approach.

## **Chapter 6 Conclusion**

### **6.1 The Approach of This Thesis**

After much consideration and public consultation, derivative action was finally enacted by Chinese Company Law 2005. This enactment was regarded as a milestone in the development of company law. This was because (1) the interests of minority shareholders had been frequently exploited over the last twenty years and remedies remained limited; (2) the legal and non-legal constraints on majority shareholders and directors seemed ineffective; and, most importantly, (3) the modernization of Chinese company law requires good corporate governance in balancing the interests of various groups. Derivative action was recognised as a strong tool in protecting minority shareholders interests and establishing good corporate governance. As such, it was expected that this investor-friendly system would be actively used by shareholders to protect their interests and have a strong deterrent effect on potential wrongdoers. In fact, it turned out that this reform effort seemed futile as the right to engage in such actions was rarely exercised compared to other mechanisms. This raises a question about the role of derivative actions in China; namely, should a derivative action system play a key role in protecting shareholder interests? If the answer is positive, the next question is how such a system could be improved in order to effectively discipline management. The essence of this thesis is to try to address these issues.

This thesis argues that derivative action should and can play a key role in protecting the interests of minority shareholders and monitoring management and majority shareholders. In forming this argument, this thesis is structured as follows.

First, since the main purpose of derivative action is to protect shareholders' interests and thus reduce agency cost, the first issue that needs to be addressed is the agency problem. The more serious an agency problem is, the more necessary derivative action becomes. Chapter 2 examines this problem and demonstrates that there are double agency costs in China: vertical agency cost between shareholders and managers and horizontal agency cost between majority shareholders and minority shareholders. Although these two types of agency problem can coexist, they are usually mutually exclusive as countries generally have dispersed ownership or concentrated ownership structures. However, this is not the case in China owing to its special policy on SOEs. Reform of the modern enterprise system undoubtedly motivates a company's development whilst also inducing the phenomenon of owner absence and thus leading to the problem of insider control. This creates vertical agency cost. In addition, China's concentrated ownership structure also makes minority shareholders vulnerable to exploitation from blockholders. This generates horizontal agency cost. Thus, minority shareholders in China face double agency problems within the company and thus protective mechanisms must be put in place.

Second, in order to reduce double agency cost, legal and non-legal mechanisms should be in place. Derivative action is one of the legal methods used to constrain agency cost and thus whether it needs to be improved depends on other mechanisms available. If market forces and other legal mechanisms can be demonstrated as being effective in reducing agency cost and protecting minority shareholders, then the necessity to reform statutory derivative action is weakened as both of legal and non-legal mechanisms have a similar function in protecting the interests of minority shareholders. As such, this thesis formulates its argument by demonstrating the ineffectiveness of market forces and other legal methods. For example, the labour market for managers does not work effectively because of political intervention. The influence of the capital market is weakened because of the policy market. Incomplete

reform of non-tradable shares also hinders the function of the market for corporate control. With regard to legal methods, various mechanisms have been introduced and their drawbacks have also been identified in Chapter 2. As a consequence, derivative action ought to retain a central role in regulating the misbehaviour of controlling shareholders and managers and deterring them from abusing their powers.

Notably, this does not mean that other protective mechanisms have only a small role to play in protecting minority shareholders. Indeed, they are very important in the sense that all these methods together can complement each other, playing a vital role in corporate governance.

The next stage is to examine the relation between direct actions and derivative actions. Although there is a connection between these two forms of action, the line between them is quite clear as there are many different aspects to them. For example, one of the fundamental distinctions between these forms of action is that the purpose of direct action is to safeguard the personal interests of individual shareholders, while a derivative action aims to protect the interests of the company. More importantly, the causes of these two actions are different. A direct action is initiated by a shareholder claiming that his personal interests are injured by wrongful acts. For derivative actions, shareholders are only entitled to bring such actions when the interests of the company are damaged by wrongdoers. In other words, if the wrongful acts incurred an injury to the interests of the shareholder rather than the company, then it is a direct action that the shareholder should raise. However, even though shareholders can bring direct actions to protect their own interests; they still need derivative actions in some circumstances.

After demonstrating the need to strengthen and improve derivative actions in China, this thesis starts to explore China's derivative actions system. Despite the absence of

a clear statutory basis for derivative actions in Company Law 1993, such cases have nevertheless appeared in the courts from time to time before the entry into force of Company Law 2005. Some of these cases were accepted, while some were refused. For those cases that were accepted, the reasons for this were various as there was no such statutory rule at that time.

In 2005, derivative action was finally introduced into Chinese company law. After almost eight years of implementation, less than 80 cases were raised. Whilst this seems a good figure in comparison to other jurisdictions, closer examination shows this not to be the case for various reasons. For example, the standing requirement for such actions is too high for shareholders in Joint Stock Companies, which partly explains why there were almost no JSC cases. Also, the opacity of the demand requirement constitutes a further barrier for shareholders wishing to exercise this right.

More importantly, the funding rule of derivative actions is treated as the same with other forms of litigation. In view of the unique economic nature of the derivative action, shareholders would be strongly discouraged from raising proceedings without other sources of funding. In order to establish a new funding rule for derivative actions, this thesis looks at the funding rules in English and US law and argues that contingency fee arrangements are suitable for China. The adoption of contingency fee arrangements would shift risk from plaintiff shareholders to their lawyers and thus encourage shareholders to initiate litigation against wrongdoers.

The above discussion only addresses why derivative actions should play a significant role in monitoring management and how they should be improved; it does not address whether shareholders can and should be encouraged to exercise this right. In other words, even if the derivative action system is improved and thus rendered more

investors friendly, would shareholders be willing to take this action to protect their rights and interests? If the answer is positive, the next question arises as to whether the courts are capable of dealing with these cases. The thesis first argues that Chinese people are nowadays increasingly willing to resolve disputes through the courts. There is a concern that the traditional culture of unwillingness to raise proceedings may hinder the use of litigation. However, there is another traditional culture, namely the Legalist School, which emphasizes the notion that a nation's cohesion can be secured by the application of strict legislation. This school has co-existed with Confucianism and its impact should not be neglected. In addition, a commercial culture is gradually becoming established in China owing to the rapid economic miracle, which inevitably leads to the phenomenon whereby one party will not hesitate to initiate an action against another if they have violated an agreement. Hence, this thesis addresses the first question from the perspective of culture.

With regard to the question of whether the courts have capacity to deal with the increasing volume of litigation, it cannot be denied that the competence of Chinese judges has been criticised for a long time owing to an earlier policy permitting retired military officers to work as judicial authorities. However, the situation has been changing in recent years, rendering the judiciary more capable of dealing with derivative action cases because of the enactment of the Judges Law and the increasing recruitment of more qualified people to the judiciary. As such, the improvement of derivative actions and the encouragement of shareholders to raise more proceedings would not encounter many difficulties in China.

## **6.2 Striking a fair balance between (a) protection for the company and minority shareholders and (b) corporate efficiency**

Agency cost originating from the separation of ownership and control cannot be eliminated. Indeed, there will always be fraud and corporate malpractice in the real world. Legal and non-legal mechanisms can only diminish rather than remove this agency problem. Derivative action, as one means of monitoring management and controlling shareholders, is no exception. However, this does not mean that derivative action has a minor role to play in this area. In fact, its monitoring role and deterrent effect has been demonstrated in this thesis. As such, it is very important that this right can be actively exercised without hindrance so that shareholders can prevent the interests of the company and themselves being abused. Without the establishment and improvement of a derivative action system, it is hard to imagine that shareholders could be provided with strong and sufficient protections, particularly in China where mechanisms provided for shareholders are either ineffective or not strong enough.

At the same time, shareholders cannot be allowed to bring derivative actions without restriction; otherwise, management would be deterred from engaging in any great “risk-reward” business and the corporate efficient would be affected, ultimately, leading the company and its members to suffer. As such, it is extremely important to maintain a fair balance between the corporate efficient and protection for the company and its members.

Various approaches to derivative actions were taken towards achieving this balance. In the area procedure, China has borrowed the demand requirement from the US, which basically requires an individual shareholder to make a demand upon the board of directors or supervisors before bringing an action. In the area substance, shareholders in joint stock companies have to meet the standing requirement in order to be qualified to raise proceedings. These methods are intended to strike a balance between management and shareholders.



Furthermore, as discussed in the previous chapter, another issue in securing this balance is determining the appropriate body to assess whether the litigation is in the best interests of the company. As the comparative study shows, the US and UK have adopted different approaches to tackling this question. For example, the US has adopted an independent organ (Special Litigation Committees) to make this decision, though they have been criticised for enabling prejudice and lacking independence. In the UK, it was traditionally recognised that only the general meeting of shareholders had the right to make a decision on corporate litigation, as individual shareholders can initiate derivative claims only in exceptional cases. However, the strategy of conferring rights on the general meeting of shareholders has the problem of collective action. The Companies Act 2006 has now granted more rights to the court, which is given greater discretion in deciding whether a derivative action is permitted. In this sense, the courts play a key role in assessing whether an action is in the best interests of the company. In China, this issue not been considered. Although each organ has its own advantages and disadvantages, this thesis argues that the court approach is suitable for China in light of the defects of other approaches and the merits of the court approach.

Lastly, it is worthwhile noting that the balance between protecting minority shareholders and monitoring management should be maintained in a fair way. This means that the vulnerable position of minority shareholders should be recognised and other factors which may hinder the use of this right should also be noted. This is why this thesis argues that derivative actions should be improved and could thus be more actively used given that other mechanisms are ineffective and exploitation is prevalent.

### **6.3 Derivative Actions in Corporate Governance**

As repeatedly mentioned in the previous chapters, derivative action is only one means of monitoring management and protecting minority shareholders in corporate governance. Its effectiveness depends not only on its own legal rules but also other factors and mechanisms. This is because corporate governance is a system which sets out the internal relations between various interests groups in a company. Therefore, it is fair to say that the role of derivative actions is inversely proportional to the effectiveness of other available mechanisms. The more effective other methods are, the less important the role of derivative actions is. As a result, it simply cannot be asserted that one country provides a better system of derivative action while the other one has a poor institution. For example, it cannot be said that the system for derivative actions in the US is much better than that in the UK where the courts are much more conservative towards this right. This is because unfair prejudice is popularly used by shareholders in the UK and thus derivative actions are less important. As a consequence, whether detailed rules of derivative action should be borrowed from a given jurisdiction does not depend on whether they are good or bad, but relies on their suitability for the receiving jurisdiction.

### **6.4 Beyond This Thesis: Future Direction**

Although this research attempts to examine China's derivative action system, it cannot explore all aspects in this area. In fact, it is hoped that the theoretical examination this research has developed can provide new insights on China's derivative actions for future study. Several avenues of further research are identified as follows, though this is obviously not an exhaustive list.

First, the ineffectiveness of derivative actions may be relevant to China's special corporate governance structure.<sup>1</sup> There are basically two board types of structures: one-tier structure and two-tier structure. For one-tier jurisdictions, such as the US, UK and Japan, only one board manages and supervises a company. The monitoring role is allocated to independent directors or non-executive directors.<sup>2</sup> In two-tier jurisdictions, such as Germany, the board of directors is mainly in charge of running the company, while the board of supervisors assumes the role of checking and supervising. Generally, both systems have their respective advantages and disadvantages. The one-tier system is commonly more welcomed by management as it facilitates the decision-making process while two-tier boards favour collective decision-making. On the other hand, two-tier boards encourage labour participation in corporate governance, which therefore mitigates potential conflicts between labour unions and the managers.

However, it is difficult to categorise China into a one-tier or two-tier system, as it not only requires listed companies to establish independent directors, but also has a board of supervisors system for almost every large and medium sized company.<sup>3</sup> This is partly because Chinese company law has been influenced by German law since its inception and thus the vestigial supervisory board has been retained. At the same time, common law is becoming increasingly important for China within the area of commercial law. An independent director, a typical common law feature, was transplanted into Chinese law in order to keep an eye on managers and directors. For legislators, this special mixed board structure might be expected to curb the harmful behaviour of managers more effectively and thus derivative action is not deemed to

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<sup>1</sup> For the details of this, please refer to S. Lin, 'Derivative Actions in China: One Step Forward, Two Steps Back' (2012) 23 *International Company and Commercial Law Review* 197.

<sup>2</sup> See R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 56.

<sup>3</sup> See Articles 52, 118 and 123 of Chinese Company Law 2005.

be an urgent need since it generally has many disadvantages. This might partly explain why the procedure for derivative action is so vague that individual shareholders are hardly able to bring such litigation. However, this mixed board structure generates incompatibility as well as the intrinsic problem that these two supervisory bodies have overlapping functions. This raises questions about who is going to supervise whom<sup>4</sup> and how the two bodies can effectively be prevented from engaging in possible collusion.<sup>5</sup> As such, the relation between corporate governance structure and derivative action could be further examined.

Second, although this research argues that derivative action should be improved so that shareholders are encouraged to bring litigation against wrongdoers, this does not necessarily mean that litigation is the best choice for shareholders seeing to protect their rights. In fact, litigation has its own disadvantages. For example, it is expensive and will take a long time to finish the lawsuit procedure. Moreover, it damages the reputation of the company and a plaintiff shareholder of the company may suffer from this indirectly. From this perspective, it is indeed clear that shareholder litigation can be neither the initial nor the principle means of protection for shareholders to reduce agency cost. As such, shareholders may choose other methods to protect their interests. Alternative dispute resolution (ADR) has grown in less than a decade from a bravely-voiced hope to an accumulation of practices aiming to resolve legal disputes without going to court.<sup>6</sup> ADR means that disputes can be addressed by other methods than lawsuits. For example, it includes arbitration, mediation, conciliation and negotiation. It can even be expanded to include a mini-trial<sup>7</sup> and involve certain officials and quasi-officials (such as court-appointed

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<sup>4</sup> A. M. Han, 'China's Company Law: Practicing Capitalism in a Transitional Economy' (1996) 5 *Pacific Rim Law and Policy Journal* 457.

<sup>5</sup> This possible collusion is similar to the collusion between the manager and the auditor. See F. Kofman and J. Lawarree, 'Collusion in Hierarchical Agency' (1993) 61 *Econometrica* 629.

<sup>6</sup> J. K. Lieberman and J. F. Henry, 'Lessons from the Alternative Dispute Resolution Movement' (1986) 53 *The University of Chicago Law Review* 424.

<sup>7</sup> See D. M. Parker and P. L. Radoff, 'The Mini-Hearing: An Alternative to Protracted Litigation of Factually Complex Disputes' (1982) 38 *The Business Lawyer* 35.

masters or neutral experts).<sup>8</sup> With the implementation and expansion of ADR, the burden on the courts and disputants would be reduced and judicial resources would also be saved. As discussed in Chapter 4, the author believes that the law governing derivative actions concerns the right of minority shareholders and the checking of abuses by managers and majority shareholders, which is mandatory regulation in nature. As such, it seems that there is no room for ADR to be considered in the area of derivative actions, as matter that lead to derivative actions cannot be contractually waived or modified. However, ADR still has a role to play in the sense that derivative action could be taken in a different form without raising proceedings before a court.<sup>9</sup>

A third avenue for further study is the role of the court. It is recognised that courts should become increasingly important in derivative actions. Indeed, the rapid development of business creates an unpredictable society. Companies may face different situations and the way to deal with business disputes should also be different. This requires that company law be sufficiently flexible. However, one of the drawbacks for civil jurisdictions is that the law is too rigid and inflexible. In order to overcome this difficulty, the courts should be granted greater discretion in deciding derivative actions on a case-by-case basis.

At the same time, granting the court greater discretion requires that judges be competent to hear such cases. This thesis has demonstrated that Chinese judges are increasingly competent to hear commercial cases as a result of the adoption of Judges Law. However, how judges approach and decide derivative actions is not clear and thus it would be interesting and valuable to know more about the courts' role in this form of lawsuit.

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<sup>8</sup> See E. D. Green, 'Getting Out of Court- Private Resolution of Civil Disputes' (1984) 28 *Boston Bar Journal* 18.

<sup>9</sup> Also see A. Reisberg, *Derivative Actions and Corporate Governance : Theory and Operation* (Oxford University Press 2007) 303.

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*Taiwan Kailin Company v China Bank* (Jiangsu Provincial Higher People's Court (2011) *su shang wai zhong zi* No 0071)  
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*Yu Huihui v Yu Zhenxuan* (Zhejiang Jinhua District Intermediate People's Court (2010) *zhe jin zhi chu zi* No 29)  
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*Zhanwang Corporation v Shanghai Jinshan liangyou Company* (Shanghai Municipal First Intermediate People's Court, (2002) *luyizhong min san(shang) chu zi* No144)  
*Zhao Yu v Zhou Yuchao re: Shunde Municipal Zhaoyu Electronic Hardware Company Limited* (Guangdong Province Foshan Municipal Shunde District People's Court (2006). *Shun fa miner chuzi* No. 02196; on appeal Guangdong Province Foshan Intermediate People's Court (2007) *fo zhong fa miner zhongzi* No.348)  
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## Annex 1

### Derivative Actions Cases Prior to Company Law 2005

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- Beijing Tianyi Technology Company v Shenhong Company* (Beijing Municipal Haidian District People's Court (2002) *gao min chu zi* No 364)
- Chengdu Lida Ltd. Cop v Chunsheng Zhou, Wenzhang Zhou, et al.* (2005)
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- Guangxi Changdu Company v Nanning Hongshan Company* (Guangxi Higher People's Court (2001) *gui min si zhong zi* No 67)
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