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# THE SHAREHOLDER DERIVATIVE ACTION AND GOOD CORPORATE GOVERNANCE IN CHINA: WHY THE EXCITEMENT IS ACTUALLY FOR NOTHING

Zhong Zhang\*

## ABSTRACT

*Despite high expectations that shareholder derivative actions would serve as an important tool for improving corporate governance in China, only one lawsuit has been brought against a publicly listed Chinese company since such actions were formally introduced in 2005. Among the various barriers to such suits, and perhaps the most difficult obstacle for plaintiffs to surmount, is holding the requisite minimum of 1% of corporate shares. It is difficult to reduce the threshold figure to a more accessible level, in part because using the minimum shareholding requirement as a mechanism for screening out frivolous litigation is inherently flawed. Yet, attempting to screen frivolous litigation through a judicial determination on the merits of a suit rather than using a minimum shareholding requirement is unlikely to work properly in China. The judiciary is weak, unsophisticated, and riddled with corruption. When the judicial system is in such a condition, it is unrealistic to expect that a derivative action specifically, or indeed, the private enforcement of law in general, can play a significant role in corporate governance. This paper considers these points, and examines how to improve corporate governance in a country with a weak judiciary.*

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## I. INTRODUCTION

Corporate governance became a key concern in China during the late 1990s, as state-owned enterprises (SOEs) were reformed and the stock market developed.<sup>1</sup> By allowing individual shareholders to sue on behalf of companies that are inhibited from doing so themselves due to the influence of those in control of the corporation, shareholder derivative actions were expected to serve as a useful tool for combating abuse by corporate management and controlling shareholders.<sup>2</sup> Such lawsuits are partic-

1. For the development and issues of corporate governance in China, see generally Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1 (2002); Donald C. Clarke, *Corporate Governance in China: An Overview* 14 CHINA ECON. REV. 494 (2003). For the role of corporate governance in the Chinese SOE reform, see STOYAN TENEV ET. AL., CORPORATE GOVERNANCE AND ENTERPRISE REFORM IN CHINA: BUILDING THE INSTITUTIONS OF MODERN MARKETS 1-3 (2002).

2. See Deng Jiong, *Building an Investor-Friendly Shareholder Derivative Law-suit System in China*, 46 HARV. INT'L L.J. 347, 351 (2005); Gan Peizhong, *Lun Paisheng Susong Zai Zhongguo de Youxiao Shiyong (On Effective Application of the Shareholder Derivative Action in China)*, 39 BEIJIN DAXUE XUE BAO: ZHIXUE SHEHUI KEXUE BAN (J. PEKING U. HUM. & SOC. SCI.) 17, 19 (2002). For a theoretical discussion of the role of the derivative action in corporate governance in general, see Arad Reisberg, *Shareholders' Remedies: The Choice of Objectives and the Social Meaning of Derivative Actions*, 6 EUR. BUS. ORG. L. REV. 227 (2005).

ularly valuable in China, where the prevalence of state ownership of companies and concentrated ownership structures rendered minority shareholders exceedingly vulnerable.<sup>3</sup> The first piece of legislation by the People's Congress of China regarding corporate structure, the Company Law 1993, was widely criticized for failing to offer shareholders the right to take derivative actions. Repeated calls were made to revise the law to introduce derivative actions.<sup>4</sup> This goal was achieved in 2005 when the law was extensively amended.<sup>5</sup> The adoption of derivative actions was applauded as "a major development of Chinese company legislation" and was predicted to have "far-reaching implications for corporate governance" in China.<sup>6</sup>

However, as far as listed companies are concerned,<sup>7</sup> only one derivative action has been brought to court since the new Company Law took effect on January 1, 2006. Certainly, this is not because corporate governance in China has improved so much that there have been no cases of managers and controlling shareholders misusing their power. On the contrary, managerial misbehavior and corporate scandals are still routinely reported by the media, indicating that inadequate protection of minority shareholders remains a serious problem.<sup>8</sup> Why do shareholders fail to use the new legal protection afforded to them to hold ac-

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3. Corporate governance in China is concerned mainly with listed companies. See Clarke, *supra* note 1, at 494. The vast majority of listed companies in China are converted from traditional SOEs. Their ownership structures are highly concentrated and the state retains the majority of shares. This peculiar shareholding structure creates a double 'agency problem' and is generally regarded as one cause of the widespread abuse of power by corporate management and controlling shareholders at the expense of minority shareholders. For a description of such misbehaviour, see Zhong Zhang, *Legal Deterrence: The Foundation of Corporate Governance—Evidence from China*, 15 CORP. GOVERNANCE 741, 753-55 (2007).

4. See Deng, *supra* note 2, at 356-57; TENEV ET AL., *supra* note 1, at 149; Schipani & Liu, *supra* note 1, at 50.

5. See Company Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005), art.152.

6. See Hui Huang, *The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform*, 4 BERKELEY BUS. L. J. 227, 242 (2007).

7. This article deals with listed companies only, as listed companies are the focus of corporate governance in China. See Zhang, *supra* note 3, at 742. In China, the company law provides for two types of company, private limited liability companies and public joint stock limited companies. Listed companies are one category of the joint stock limited company. See Company Law art. 2, art. 3, art. 34 & art.78.

8. For example, it was reported on September 24, 2009 that three cases of insider dealing and one case of misappropriating corporate assets were under investigation by the China Securities Regulatory Commission (CSRC). See Baochen Zhu, *Zheng Jian Hui Tongbao San Qi Neimu Jiaoyi An He Yi Qi Qinzhan Shangshi Gongsi Liyi An (CSRC Circulates Three Cases Of Insider Dealing And One Case Of Misappropriating Corporate Assets)*, ZHENGQUAN RIBAO (SECURITIES DAILY), Sept. 24, 2009, available at [http://zqrb.ccstock.cn/html/2009-09/24/content\\_182512.htm](http://zqrb.ccstock.cn/html/2009-09/24/content_182512.htm).

countable those responsible? Why has the derivative action failed to meet the expectations that it would serve as an effective corporate governance tool in China?

To answer these questions, this paper examines the requirements for standing to bring a derivative action in China. Although additional reasons explain the absence of derivative action,<sup>9</sup> the 1% minimum shareholding requirement that shareholders of the joint stock limited company must satisfy to bring a lawsuit is the foremost barrier to derivative actions. Because few individual minority shareholders own 1% of the shares of a listed company, individual minority shareholders are generally excluded from initiating a derivative action. While institutional shareholders may meet the criterion, they face various disincentives to sue. I argue that a minimum shareholding requirement is inherently flawed as a mechanism for screening out frivolous litigation, because there is no threshold figure that is universally effective to avert frivolous litigations yet enable meritorious claims at the same time.

Having found that a minimum shareholding requirement is flawed, this paper discusses whether a derivative action can be reinvigorated by abolishing the requirement and instead introduce a “permission procedure” used in common law jurisdictions. Under the permission procedure, judges determine whether a proposed action could succeed and benefit the company before full evidence is presented at trial. Moreover, judges determine what harmful effects a proposed action would have on the company and whether such harm would outweigh the benefits. Such analysis is necessarily speculative because any harmful effects have yet to materialize.

The nature of the permission procedure is such that presiding over a derivative action lawsuit may present a very difficult task for judges. Broad judicial discretion is required, because it is unfeasible for the legislature to draw an exhaustive list of fac-

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9. These include the general rule of the derivative action that any recovery from a successful action goes to the company rather than to the shareholders bringing the action. This rule fails to incentivize minority shareholders, as there is no extra financial benefit for them to take derivative actions. See Arad Reisberg, *Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation*, 4 J. CORP. LEGAL STUD. 345, 355-56 (2004). The lack of incentive is exacerbated in China by the lack of rules on derivative litigation funding, which means that shareholders may not be indemnified for expenses they incur in conducting litigation on behalf of their companies. See Zhong Zhang, *Making Shareholder Derivative Actions Happen in China: How Should Lawsuits Be Funded?*, 38 HONG KONG L. J. 523, 529-30 (2008). Minority shareholders' difficulty in getting access to information is another problem. See Arad Reisberg, *Theoretical Reflection on Derivative Actions in English Law: The Representative Problem*, 3 EUR. CO. FIN. REV. 69, 83-84 (2006).

tors to assess the desirability of a derivative action. Because of this complication, judges need to be highly skilled and experienced to make sound judgments. Moreover, to ensure that the derivative action is taken seriously, the general public must hold the judiciary in high esteem and have confidence in its integrity. However, judges in China are widely criticized for their inadequate professional training and lack of skills. The reputation and authority of the judiciary has been seriously compromised as a result of political influences on judicial processes and rampant corruption.<sup>10</sup> Under these circumstances, it is doubtful that judges can exercise sound discretion and handle such complex cases effectively. Hence, it is unlikely that derivative actions can provide minority investors effective protection or become an important corporate governance tool in China.

This paper argues that private enforcement of law cannot play an important role in corporate governance in China.<sup>11</sup> Current studies show that private securities litigation, although pre-dating the birth of derivative actions in China, has also failed to offer minority shareholders protection.<sup>12</sup> Because derivative actions and private securities litigation are both ineffective, private enforcement of the law has failed. This paper further argues that the fundamental reason for this failure lies in the court system.

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10. See RANDALL PEERENBOOM, CHINA'S LONG MARCH TOWARD RULE OF LAW 280-330 (2002); Benjamin L. Liebman, China's Courts: Restricted Reform, 21 COLUM. J. ASIAN L. 1, 13-18 (2007). It is common knowledge that judicial corruption in China is widespread and even the Chief Judge of the Supreme People's Court admitted the 'grave situation' of judicial corruption. See Xie Chuanjiao, *Chief Judge pledges to fight judicial corruption*, CHINA DAILY, Mar. 24 2007, available at [http://www.chinadaily.com.cn/china/2007-03/24/content\\_835538.htm](http://www.chinadaily.com.cn/china/2007-03/24/content_835538.htm). In early 2010, the Vice President of the Supreme People's Court was sentenced to life imprisonment for taking bribes and embezzling funds. See Xie Chuanjiao, *Top ex-judge given life imprisonment*, XINHUA, Mar. 18, 2010, available at [http://www.china.org.cn/china/2010-03/18/content\\_19630713.htm](http://www.china.org.cn/china/2010-03/18/content_19630713.htm).

11. See Marlon A. Layton, *Is Private Securities Litigation Essential for the Development of China's Stock Markets?*, 83 N.Y.U. L. REV. 1948, 1965-68 (2008).

12. See Walter Hutchens, *Private Securities Litigation in the People's Republic of China: Material Disclosure about China's Legal System?*, 24 U. PA. J. INT'L ECON. L. 599, 655, 688-89 (2003) (discussing the private securities litigation rules introduced by the Supreme People's Court in 2003, identifying the restrictions and obstacles imposed by the rules, and predicting that the rules 'are highly unlikely to have any meaningful effect', while arguing 'there are reasons to be less pessimistic'; revealing that the obstacles to the development of private securities litigation in China have a deep root in the weakness of the court system); Donald C. Clarke, *Law Without Order in Chinese Corporate Governance Institutions*, 30 Nw. J. INT'L L. & BUS. 131, 182-87 (2010) (discussing problems in the court system and finding that the number of companies actually sued is small and 'actual judgments against defendants have been rare and perhaps non-existent'); Naomi Li, *Civil Litigation against China's Listed Firms: Much Ado About Nothing?* (Chatham House Asia Programme, Working Paper No. 13, 2004) (discussing the restrictions imposed by the Supreme People's Court and finding few actions had ever been brought), available at [http://www.chathamhouse.org.uk/files/3164\\_wpf04.pdf](http://www.chathamhouse.org.uk/files/3164_wpf04.pdf).

As long as the system remains unchanged, private enforcement will continue to be ineffective in protecting minority shareholders or promoting good corporate governance.

The findings in this paper raise the question of whether, and how, corporate governance can be improved in a country where the judiciary is weak. Moreover, the experience of China presents a paradoxical case for comparative corporate governance studies. Despite the failure of private enforcement, China's stock market has grown impressively in stature in less than twenty years.<sup>13</sup> This raises the possibility that private causes of action are not required for investor protection and growth of the stock market.<sup>14</sup> Meanwhile, it is interesting to consider whether the growth of the market is sustainable without improvements to the private enforcement of corporate law.<sup>15</sup> Even more intriguing is the question of why, given that public enforcement of law

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13. See Geoff Dyer, *Chinese Stock Market Bigger Than Japan's*, FIN. TIMES, Aug. 29, 2007, available at [http://www.ft.com/cms/s/0/96036374-557e-11dc-b971-0000779fd2ac.html?ncklick\\_check=1](http://www.ft.com/cms/s/0/96036374-557e-11dc-b971-0000779fd2ac.html?ncklick_check=1); *China's Market Value Overtakes Japan as World's No.2*, BLOOMBERG.COM, July 16, 2009, available at [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=A\\_84o9PPPGqk](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=A_84o9PPPGqk). Some have even predicted that China's stock market would surpass the US in 3 years. See Francine Lacqua & Michael Patterson, *Mobius Says China Market Value to Overtake U.S. in Three Years*, BLOOMBERG, July 18, 2009, available at [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=A4.VQEZdQ\\_M](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=A4.VQEZdQ_M).

14. Rafael La Porta, et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 27-28 (2006) (finding that the depth of stock market is positively correlated with the ease for investors to recover losses in courts and that public enforcement plays a modest role at the best). On the other hand, there are studies which find that public enforcement positively influences financial market development and private enforcement of corporate law is not a key foundation for strong securities markets even in the case of the UK and the US. See Howell E. Jackson & Mark J. Roe, *Public and private enforcement of securities laws: Resource-based evidence*, 93 J. FIN. ECON. 207, 235 (2009); John Armour et al., *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 J. EMPIRICAL LEGAL STUD. 687, 710-11 (2009).

15. Shares of listed companies in China were historically divided into tradable and non-tradable shares. Non-tradable shares, which accounted for roughly 2/3 of the total, could only be sold privately outside the stock exchanges and usually at a large discount to the market prices of tradable shares. It was thus argued that the official calculation of market capitalization was unrealistic, because non-tradable shares were valued at the market prices of tradable shares. See STEPHEN GREEN, *CHINA'S STOCKMARKET: A GUIDE TO ITS PROGRESS, PLAYERS AND PROSPECTS* 26-27 (2003); CARL E. WALTER & FRASER J.T. HOWIE, *PRIVATIZING CHINA: INSIDE CHINA'S STOCK MARKET* 175-177 (2nd ed. 2006). After the non-tradable share reform in 2005, the distinction between tradable and non-tradable shares no longer exists and, after the lock-in periods expire, non-tradable shares can be sold on the stock exchanges at the market prices. However, for the state-owned shares, there are restrictions on sales. Therefore, it may be still unrealistic to calculate all the shares at market prices, because market prices could significantly drop if selling state-owned shares were not restricted.

has been insubstantial,<sup>16</sup> the market has been able to grow at all.<sup>17</sup>

Section II briefly introduces the derivative action and its rationale. Section III discusses different strategies available to deal with the difficulty of screening out frivolous litigation. Section IV describes the law and practice of derivative action in China. Section V discusses why the 1% minimum shareholding requirement is a major barrier to derivative actions, and why reduction of the threshold is not a solution. Section VI argues that a permission procedure cannot work properly in China. Finally, conclusions are drawn in Section VII.

## II. THE DERIVATIVE ACTION AND ITS RATIONALE

In corporate law there is the “proper plaintiff rule,” which dictates that when a wrong has been done to a company, the company itself, rather than its shareholders, is the appropriate plaintiff.<sup>18</sup> This rule is a logical extension of the doctrine of independent corporate personality. It is fundamental to the proper functioning of a corporation as a form of business organization that business is managed without unnecessary interference from shareholders in the form of vexatious litigation. However, since the power to manage a company’s business, including deciding whether to initiate litigation, is vested in the central managerial organ of the Board of Directors,<sup>19</sup> the proper plaintiff rule, if strictly applied, may lead to unjust results. Directors could walk off with corporate assets without incurring liability, because directors would not decide on behalf of the corporation to take action against themselves.

It is therefore evident that the proper plaintiff rule should not be rigidly applied, and exceptions should be allowed where directors have conflicted interests in deciding whether to pursue litigation. Otherwise, the protection afforded to the company

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16. See Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China’s Securities Market*, 108 COLUM. L. REV. 929, 942 (2008) (providing the number of formal administrative sanctions issued by the China Securities Regulatory Commission (CSRC) from 2001-2006 and arguing that the number of sanctions is rather modest); Clarke, *supra* note 12, at 178 (arguing that enforcement actions taken by the CSRC indicates that it “actually devotes very few resources to ensuring that corporate governance norms are actually put into practice”).

17. See Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1149 (1997); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1152 (1998).

18. See *Foss v. Harbottle* [1843] 67 Eng. Rep. 189; *Hawes v. Oakland*, 104 U.S. 450 (1881).

19. This rule is based on the rationale of efficiency and the need for specialized managerial labour. See J.E. PARKINSON, *CORPORATE POWER AND RESPONSIBILITY: ISSUES IN THE THEORY OF COMPANY LAW* 51 (1993).



would be unobtainable.<sup>20</sup> To avoid the undesirable consequences that a strict application of the proper plaintiff rule would otherwise cause, the “derivative action” has long been recognized in common law jurisdictions. In a derivative action, individual shareholders file lawsuits on behalf of the company after the directors have failed to address a corporate injury.<sup>21</sup> Misappropriating directors, or their controllers, should not be able to escape liability.

In theory, in a corporate system such as that of Germany where board structure is two-tiered, conflicts of interests by directors will not prevent the corporation from pursuing litigation. If members of the management board injure the corporation, the supervisory board may act on behalf of the corporation, and vice versa. The German Stock Corporation Act (*Aktiengesetz*, hereafter, “AktG”) provides for such a mechanism precisely to make sure that liability may fall upon responsible directors. However, when the AktG was first adopted, lawsuits brought by companies against managerial or supervisory directors were extremely rare in practice<sup>22</sup> for a variety of reasons.<sup>23</sup> Therefore, provisions in the AktG were amended to supplement the “reciprocal enforcement” of directors’ liability, such that a claim against directors for damages may be asserted if a simple majority of shareholders,

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20. Of course, different mechanisms operate to protect minority shareholders’ interests or to mitigate the so-called ‘agency cost’, but all these mechanisms have their limits and disadvantages. For a review, see Ian Ramsay, *Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action*, 15 U. NEW S. WALES L.J. 149, 151-55 (1992). Moreover, for minority shareholders who suffer from the tyranny of the majority, legal remedies other than the derivative action are available. For example, in the UK, the statutory unfair prejudice action is available for aggrieved shareholders. See *Companies Act, 2006*, c. 46, § 994 (Eng.). In the US, injured minority shareholders could seek relief on the ground that the majority shareholders owe them a heightened fiduciary duty. See *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975). As a last resort, oppressed shareholders in different jurisdictions can apply to the courts for involuntary dissolution of the company. But these remedies mainly provide an exit for minority shareholders in close corporations.

21. See Lynden Griggs, *The Statutory Derivative Action: Lessons that May be Learnt from its Past!*, 6 U. W. SYDNEY L. REV. 64, 64 (2002). See generally Bert S. Prunty, Jr., *The Shareholders’ Derivative Suit: Notes on its Derivation*, 32 N.Y.U. L. REV. 980 (1957) (discussing the history of the shareholder’s derivative action in England and the United States). See also RALPH C. FERRARA, ET AL., *SHAREHOLDER DERIVATIVE ACTION: BESIEGING THE BOARD* 15-22 (2005).

22. *Id.*; Theodore Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, 53 AM. J. COMP. L. 31, 52 (2005).

23. For a summary, see HANS C. HIRT, *THE ENFORCEMENT OF DIRECTORS’ DUTIES IN BRITAIN AND GERMANY: A COMPARATIVE STUDY WITH PARTICULAR REFERENCE TO LARGE COMPANIES* 281-82 (2004).

or by shareholders holding 10% or more of shares.<sup>24</sup> This round of amendments to the AktG also allowed a court, upon the request of shareholders who hold no less than 10% of shares or one million Euros of stock at market prices to appoint a special representative to assert the claim for damages on behalf of the company.<sup>25</sup> In 1998, this threshold was lowered to 5% of shares or 500,000 Euros.<sup>26</sup>

Despite these amendments, the mechanisms for enforcing directors' liabilities provided by the AktG were still widely criticized and regarded as a failure in Germany.<sup>27</sup> Legal actions against directors remained rare. Consequently, the German Government Panel on Corporate Governance suggested a radical change to the enforcement of directors' duties: it proposed the abolition of the special representative and the introduction of the common law derivative action, thereby allowing shareholders to take actions on behalf of the company.<sup>28</sup> This proposal was accepted by the German federal legislature in 2004.<sup>29</sup>

### III. FORMULATING A RULE OF STANDING TO SUE: THE DIFFICULTY AND STRATEGIES FOR SOLUTION

The difficulty in a derivative suit lies with the issue of *locus standi*: under what circumstances should individual shareholders be allowed to act? Litigation is not always a desirable response to a corporate injury. A legal action brings both benefits and costs, both pecuniary and non-pecuniary, and benefits are not invariably greater than costs. Moreover, individual shareholders may be motivated by personal abhorrence,<sup>30</sup> family feuds,<sup>31</sup> gold-

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24. Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, § 147(1) (Ger.).

25. *Id.* at § 147(3).

26. Aktiengesetz [AktG] [Stock Corporation Act], June 9, 1998, BGBL. I at 1242, § 147(3) (Ger.).

27. See Klaus J. Hopt, *The German Two-tier board (Aufsichtsrat): A German View on Corporate Governance*, in *COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS* 3, 17-19 (Klaus J. Hopt & Eddy Wymeersch eds., 1997); Baums & Scott, *supra* note 23; HIRT, *supra* note 23, at 303-16.

28. See GERMAN GOV'T PANEL ON CORPORATE GOVERNANCE, SUMMARY OF RECOMMENDATIONS paras. 72-73 (Shearman & Sterling trans. 2001), available at [http://www.ecgi.org/codes/documents/baums\\_report.pdf](http://www.ecgi.org/codes/documents/baums_report.pdf).

29. See Ulrich Noack & Dirk Zetzsche, *Corporate Governance Reform in Germany: The Second Decade*, 16 EUR. BUS. L. REV. 1033, 1042 (2005).

30. See F.A. Gevurtz, *Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits*, 46 U. PITT. L. REV. 265, 288 (1985) (citing *Grynberg v. Farmer*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97, 683 (Oct. 8, 1980); *S. Solomont & Sons Trust v. New England Theatres Operating Corp.* 93 N.E.2d 241, 244 (1950)).

31. For English examples, see *Nurcombe v. Nurcombe* [1984] B.C.L.C. 557 (Eng.); *Barrett v. Duckett et al.* [1995] 1 B.C.L.C. 243 (Eng.).

digging,<sup>32</sup> or other ulterior motives to initiate unmeritorious legal actions. Because individual shareholders bear the cost of a corporate lawsuit only indirectly, there is less incentive to avoid lawsuits that will be more harmful than beneficial for the corporation to pursue.<sup>33</sup> Such unwarranted lawsuits should not be allowed; yet, meritorious lawsuits should be permitted. Formulating a rule which prevents frivolous litigation while permitting meritorious lawsuits has long been a thorny issue in corporate law.

There are two strategies to address this difficulty. Common law countries do not require shareholders to own a minimum amount of shares to be able to bring a derivative suit. The *locus standi* rules of common law countries concern what wrongful acts are actionable, rather than which shareholders are qualified to sue. On the contrary, many civil law jurisdictions, such as Germany, Italy, Sweden, Spain, South Korea and Taiwan, have a minimum shareholding requirement.<sup>34</sup> The same is true with the new derivative action in China.<sup>35</sup>

#### 1. *LOCUS STANDI* RULES IN COMMON LAW JURISDICTIONS

The traditional common law rule of *locus standi* originated in England, as an exception to the doctrine of *Foss v. Harbottle*.<sup>36</sup> Only “fraud on the minority” could be challenged by derivative suits. What constitutes “fraud on the minority” is somewhat ambiguous, and there is contradictory case law regarding the rule.<sup>37</sup> In general, the term refers to misappropriation of corporate assets<sup>38</sup> or a transaction that benefits directors at the expense of the corporation.<sup>39</sup> The traditional rule also required “wrongdoer control” before a derivative action could be pursued. Again, it is difficult to determine what would amount to “wrongdoer control.” One case suggests that “wrongdoer control” could mean “an overall absolute majority of votes at one end to a majority of votes at the other end made up of those likely to be cast by the

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32. See Reisberg, *supra* note 2, at 239.

33. See generally David Rosenberg & Steven Shavell, *A Model in Which Suits are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3 (1985); Lucian A. Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEGAL STUD. 437 (1988).

34. See discussion *infra* Part III.2.

35. See discussion *infra* Part IV.

36. *Foss v. Harbottle* (1843) 67 Eng. Rep. 189.

37. See, e.g., *Regal (Hastings) Ltd v. Gulliver* [1942] 1 All E.R. 378; *North West Transportation Ltd v. Beatty* (1887) 12 App. Cas. 589; *Queensland Mines v. Hudson* (1978) 52 A.L.J.R. 399; *Pavlidis v. Jensen* [1956] Ch. 656.

38. *Burland v. Earle* [1902] A.C. 83.

39. *Daniels v. Daniels* [1978] Ch. 406.

delinquent himself plus those voting with him as a result of influence or apathy.”<sup>40</sup>

The traditional *locus standi* rule has been criticized as being illogical, complex, and ambiguous.<sup>41</sup> It has been largely abandoned in common law countries after England introduced the statutory derivative action in 2006,<sup>42</sup> following the example of Canada, New Zealand, and Australia.

The statutory derivative actions adopted in these countries grant courts great power and wide discretion in determining whether an action should be permitted to go to trial. “Fraud on the minority” and “wrongdoer control” are no longer prerequisites for taking a derivative action; rather, judicial approval is. To this end, the respective legislatures of these countries have provided broad and general criteria for judges to consider in deciding whether a proposed action should be allowed.

The most important criterion is whether an action would be in the best interests of the company. In Canada,<sup>43</sup> New Zealand<sup>44</sup> and Australia,<sup>45</sup> the interests of the company are all designated as a test of the admissibility of derivative actions.<sup>46</sup> The fact that, of all the criteria, only ‘the interests of the company’ is present in the legislation of all these countries indicates the paramount importance of this test. Provisions in other sections of the legislation of some of these countries actually signal that ‘the interest of the company’ is the ultimate test, and that the other criteria are subordinate.<sup>47</sup> The English Companies Act of 2006 is explicit that “the interests of the company” are the highest concern. That statute states that judicial permission to pursue a derivative action should not be granted where “a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim.”<sup>48</sup> “Success” in this context is interpreted to mean “long-term increase in value.”<sup>49</sup>

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40. *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. et al.* (No. 2) [1982] Ch. 204, 219.

41. See LAW COMMISSION, *Shareholder Remedies: A Consultation Paper* paras. 1.6, 4.35 (1997), available at [http://www.justice.gov.uk/lawcommission/docs/cp142\\_Shareholder\\_Remedies\\_Consultation.pdf](http://www.justice.gov.uk/lawcommission/docs/cp142_Shareholder_Remedies_Consultation.pdf).

42. See *Companies Act*, 2006, c. 46, Part 11 (U.K.).

43. See *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 § 239(2)(c) (Can.).

44. See *Companies Act* 1993 § 165(2)(d) (N.Z.).

45. See *Corporations Act*, 2001 (Cth) s 237(2)(c) (Austl.).

46. For other countries, see LAW COMMISSION, *supra* note 41, at app. G.

47. See e.g., *Companies Act* 1993 § 165(3) (N.Z.); *Corporations Act*, 2001 (Cth) s 237(3) (Austl.).

48. *Companies Act*, 2006, c. 46, § 263(2)(b) (U.K.).

49. According to then Attorney General Lord Goldsmith, for a commercial company, “success” will normally mean “long term increase in value.” 678 *PARL.*

Among the other criteria also specified, the “good faith” criterion is common, but is controversial and widely criticized.<sup>50</sup> Case law from Australia indicates that if it is established that a lawsuit is in the interests of the company, the lawsuit will not be barred even if it cannot satisfy the good faith criterion.<sup>51</sup> Another common criterion is the seriousness of the wrongdoing,<sup>52</sup> or the importance of a derivative action relative to the interests of the company.<sup>53</sup> This seems to direct the courts to conduct a cost/benefit analysis as to whether an action would bring an overall benefit.<sup>54</sup> Such cost/benefit analysis is explicitly specified by New Zealand’s Companies Act, which instructs the courts to consider “the likelihood of the proceeding succeeding” and “the costs of the proceedings in relation to the relief likely to be obtained”.<sup>55</sup>

In summary, under the statutory derivative action, courts decide whether or not a derivative action should be allowed, and the ultimate test of the admissibility of an action is the “interests of the company” test. To assess whether an action would be in the interests of the company, courts may carry out a cost-benefit analysis of the action. Legislation provides for some factors which courts could take into consideration when making such an assessment.

The United States adopted a different strategy. American courts take a hands-off approach regarding the admissibility of a proposed action, and judges themselves do not assess whether a derivative action would be in the interests of the company. Cor-

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DEB., H.L. (2006) GC256 (U.K.), available at [http://www.publications.parliament.uk/pa/ld200506/ldhansrd/vo060206/text/60206-29.htm#60206-29\\_spnw4](http://www.publications.parliament.uk/pa/ld200506/ldhansrd/vo060206/text/60206-29.htm#60206-29_spnw4).

50. First, it has been criticized as a rhetorical device that is “replete with uncertainty in conception and highly unworkable in practice.” See Andrew Keay & Joan Louhrey, *Something Old, Something New, Something Borrowed: An Analysis of the New Derivative Action Under the Companies Act 2006*, 124 L. Q. REV. 469,485 (2008). Secondly, if ‘good faith’ is interpreted as a requirement for ‘clean hands,’ the test is misconceived, since a derivative claim is a claim of the company and the fact that an applicant has not acted with all propriety should not end up penalizing the company and protecting those against whom the proceedings should be brought. See Jennifer Payne, ‘Clean Hands’ in *Derivative Actions*, 61 CAMBRIDGE L. J. 76, 81 (2002).

51. See *Lewis v. Nortex Pty Ltd.* [2006] NSWSC 768 ¶ 5 (Austl.).

52. See *Corporations Act*, 2001, (Cth) s 237(2)(d) (Austl.).

53. See *Companies Act*, 2006, c. 46, § 263(3)(b) (U.K.).

54. See *Franbar Holdings Ltd. v. Patel et al.*, [2008] EWHC (Ch) 1534, [36] (Eng.). According to Judge William Trower QC, when assessing the importance of continuing a claim, a wide range of considerations are relevant, including such matters as “the prospects of success of the claim, the ability of the company to make a recovery on any award of damages, the disruption which would be caused to the development of the company’s business by having to concentrate on the proceedings, the costs of the proceedings and any damage to the company’s reputation and business if the proceedings were to fail.”

55. *Companies Act* 1993 § 165(2)(a)-(b) (N.Z.).

porations play the role of assessing the benefits and can ask the court to dismiss a proposed action. The power of assessment is usually delegated to a special litigation committee consisting of disinterested directors. The court exercises control only by reviewing the independence of individual assessors and the propriety of the assessment made by them on behalf of the corporation

It is a default rule in America that although "demand" can be exempted on the ground of futility in certain circumstances,<sup>56</sup> shareholders must first request that the company file suit.<sup>57</sup> If a demand for suit is refused or can be exempted, then a shareholder can initiate a derivative suit. However, if the assessment of the litigation committee is that the company's interests would not be served by the action, the corporation can move to dismiss the case.<sup>58</sup> In order to establish whether the case should be dismissed, the court generally reviews the independence and good faith of the assessors as well as the adequacy of investigation.<sup>59</sup> The procedure is similar in most American states and at the federal level; the difference lies in the standard of judicial review.

Regarding the standard of judicial review, in *Auerbach v. Bennett*<sup>60</sup> the New York Court of Appeals held that the assessment of a special litigation committee is a matter of business judgement. As such, the merits of the assessment are beyond judicial review if made in good faith and following sufficient investigation. Thus, courts should only assess the independence and good faith of the committee and the adequacy of investigation.<sup>61</sup> This approach has been followed by some states<sup>62</sup> but rejected by others. In *Miller v. Register & Tribune Syndicate, Inc.*,<sup>63</sup> an Iowa court held that if a special litigation committee is appointed by a board of directors, the majority of whose members were defendants in the present litigation, then the committee has no power to terminate a derivative action because the board itself lacks the power to delegate such a decision to the committee.

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56. See 13 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 5965 (perm. ed., rev. vol. 2004 & Supp. 2011).

57. *Id.* at § 5963.

58. See DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 5:14 (perm. ed. 2003 & Supp. 2011).

59. *Id.* at § 5:15.

60. *Auerbach v. Bennett*, 47 N.Y.2d 619, 630-31 (1979).

61. See, DEMOTT, *supra* note 58, at § 5:15.

62. See, e.g., *In re Hirsch v. Jones Intercable, Inc.*, 984 P.2d 629, 638 (Colo. 1999); *Miller v. Bargaheiser*, 591 N.E.2d 1339, 1343 (Ohio Ct. App. 1990).

63. *Miller v. Register and Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718-19 (Iowa 1983).

The standard of review in Delaware focuses on whether or not a demand to the corporation can be exempted.<sup>64</sup> If a demand is not exempt, Delaware's position is similar to that of *Auerbach v. Bennett*,<sup>65</sup> and the business judgment standard is accordingly applied. In *Zapata Corp. v. Maldonado*,<sup>66</sup> the Delaware Supreme Court held that the independent litigation committee had the power to make decisions on behalf of the company to move for dismissal, even if demand is excused. However, the court should make a two-step review. First, the court "should inquire into the independence and good faith of the committee and the basis supporting its conclusions."<sup>67</sup> Second, the court "should determine, applying its own independent business judgment, whether the motion should be granted."<sup>68</sup> It is notable that the second step is discretionary rather mandatory.<sup>69</sup>

The American Bar Association (ABA) and the American Law Institute (ALI) positions on the standard of judicial review differ. The Model Business Corporation Act adopted by the ABA states that an action should be dismissed if a majority of disinterested directors, or a majority of members of a litigation committee comprised of disinterested directors, have determined, in good faith and following reasonable inquiry, that such an action is not in the best interests of the company.<sup>70</sup> Disinterested directors are those who do not have a material interest in the outcome of the action or do not have a material relationship with an interested person. The mere fact that a director has been nominated as a defendant or elected to the board by interested persons, or has otherwise taken part in the approval of the challenged wrong, does not automatically disqualify them from being disinterested.<sup>71</sup>

On the other hand, the ALI stance is that in reviewing a dismissal request the business judgment rule applies if the challenged wrong is a violation of directors' duty of care; however, when a wrong involves a violation of the duty of loyalty, the courts would also be required to assess the reasonableness of the

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64. Whether a plaintiff can be excused from making demand depends on: (1) whether the pleaded facts are sufficient to cast doubt on the independence or disinterestedness of board of directors; or (2) whether the pleaded facts are sufficient to call into 'reasonable doubt' that the challenged transaction is the result of true business judgment. See *Levine v. Smith*, 591 A.2d 194, 201 (Del. 1991); *Aronson v. Lewis*, 473 A.2d 805, 814-15 (Del. 1984).

65. *Auerbach*, 47 N.Y.2d 619.

66. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788-89 (Del. 1981).

67. *Id.* at 788.

68. *Id.* at 789.

69. See *Kaplan v. Wyatt*, 499 A.2d 1184, 1191-92 (Del. 1985).

70. MODEL BUS. CORP. ACT § 7.44(a)-(b) (2008).

71. MODEL BUS. CORP. ACT §§ 1.43(a)(1), (b)-(c) (2008).

decision made by the board or litigation committee requesting a dismissal.<sup>72</sup>

## 2. *LOCUS STANDI* RULES IN CIVIL LAW JURISDICTIONS

The *locus standi* rules for taking a derivative action in civil law jurisdictions generally turn on minimum shareholding requirements.<sup>73</sup> For example, Germany requires shareholders to hold at least 1% of the overall shares, or 100,000 Euros in nominal capital in order to file a derivative action.<sup>74</sup> Germany's threshold is low in comparison to other countries: some European countries require a minimum of 5% or even 10% of total shares;<sup>75</sup> in Italy, the threshold has been reduced to 2.5% for listed companies.<sup>76</sup> Following the Asian financial crisis, South Korea and Taiwan reduced their threshold from 5% to 0.01% and 3% respectively.<sup>77</sup>

Besides the shareholding requirement, in Germany there are additional prerequisites for a derivative action. First, demand is mandatory, and the merits of a proposed case should be determined before a case is allowed to go to a full trial. Second, shareholders who intend to sue must have acquired their shares before they knew about the complained misconduct. Third, there should be evidence of a serious breach of managerial duties that caused damages to the company. Finally, not only should the shareholders have tried to persuade the board to sue before go-

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72. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.10 (a)(1)-(2) (Proposed Final Draft 1992).

73. There is no such a requirement in Japan, but shareholders should have acquired their shares at least six months before they bring a derivative action. See Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW. U. L. REV. 1436, 1447-48 (1994); Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351, 355 (2001). The derivative action is also available in France and Switzerland, but not based on percentage requirements. See Kristoffel R. Grechenig & Michael Sekyra, *No Derivative Shareholder Suits in Europe - A Model of Percentage Limits, Collusion and Residual Owners*, 3 n.10 (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 32, 2007), available at <http://ssrn.com/abstract=933105>. But see A.J. BOYLE, *MINORITY SHAREHOLDERS' REMEDIES* 45-47 (2002) (showing a different view of the French law).

74. See Noack & Zetzsche, *supra* note 29, at 1042.

75. See Grechenig & Sekyra, *supra* note 73, at 3 (indicating that the share requirements are 10% in Austria, Bulgaria, Hungary, Slovenia and Sweden and 5% in the Czech Republic, Slovakia and Spain).

76. See Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117, 132-33 (2007).

77. See Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory, and Evidence from East Asia*, 29 YALE J. INT'L L. 169, 187 (2004); Joongi Kim, *Recent Amendments to Korea's Commercial Code and Their Effects on International Competition*, 21 U. PA. J. INT'L ECON. L. 273, 294-95 (2000).



ing to court, but there should also be no good reasons for the company to abstain from suing the directors.<sup>78</sup>

#### IV. THE DERIVATIVE ACTION IN CHINA: LAW AND PRACTICE

Chinese companies are required to have both supervisory and managerial boards, but the Chinese system is very different from the German two-tiered board structure. The relationship between the supervisory and managerial boards in China, unlike in Germany, is not hierarchical, and the supervisory board does not have the power to elect or to dismiss managerial directors. In fact, before revision of the 1993 Chinese Company Law in 2005, the supervisory board had little power and played a minimal role in corporate governance.<sup>79</sup> The supervisory board had no right to sue on behalf of the company, and shareholders did not have standing to sue derivatively. Article 111 of the Company Law (1993) provided that:

“Where a resolution adopted by the shareholders’ general meeting or the board of directors violates the relevant national statutes or administrative regulations, or infringes the rights and interests of shareholders, a shareholder is entitled to bring a suit to the People’s Court to enjoin such illegalities or infringements.”

Whether this provision permitted a derivative action was the subject of dispute. The majority view was that the Article did not offer shareholders the standing to sue derivatively, but only permitted them to take personal action to stop a company from implementing illegal resolutions passed by shareholders’ meetings or the board of directors.<sup>80</sup>

Several courts refused to entertain derivative suits filed by minority shareholders, stating that there was no legal basis for derivative action.<sup>81</sup> Nevertheless, out of practical necessity, some derivative suits were allowed. In response to a People’s High Court inquiry concerning the acceptance of a specific case, the Supreme People’s Court in 1994 dictated that, where a company was unable to take an action to redress a wrong, shareholders should be allowed to do so.<sup>82</sup> This is probably the first derivative

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78. See Noack & Zetzsche, *supra* note 29, at 1042 n.43.

79. See Lilian Miles & Zhong Zhang, *Improving Corporate Governance in State-Owned Enterprises in China: Which Way Forward?*, 6 J. J. CORP. L. STUD. 213, 226-77 (2006).

80. See XIAONING LI, *A COMPARATIVE STUDY OF SHAREHOLDERS’ DERIVATIVE ACTIONS* 266-67 (2007).

81. See, e.g., *Zhongtian v. Bichun, et al.*, 24 RENMIN FAYUAN ANLI XUAN 43 (Shanghai Interm People’s Ct. Sept. 16, 1996).

82. See *Zui gao ren min fa yuan guan yu zhong wai he zi jing ying qi ye dui wai fa sheng jing ji he tong jiu fen, kong zhi he ying qi ye de wai fang yu mai fang you li*

case that was permitted in China. The Peoples' High Courts of Zhejiang,<sup>83</sup> Shanghai,<sup>84</sup> Jiangsu<sup>85</sup> and Beijing,<sup>86</sup> in judicial opinions on the application of the Company Law (1993), also instructed lower courts to accept derivative actions. These cases, however, mostly involved limited liability companies, and the derivative action was used to settle disputes between shareholders rather than as a mechanism for minority shareholder protection. As far as listed companies were concerned, there were three attempted cases which were widely reported by the media: one case was dismissed with the explicit holding that there was no legal basis for accepting a derivative action;<sup>87</sup> and while the other two were initially accepted with much media publicity, subsequent developments are unknown.<sup>88</sup> These cases all concerned a

hai guan xi, he ying qi ye de zhong fang ying yi shei de ming yi xiang ren min fa yuan qi su wen ti de fu han [Reply of the Supreme People's Courton When Chinese-Foreign Equity Joint Venture Has an External Controversy over Economic Contract, and the Foreign Side Which Controls the Joint Venture, Has Direct-Interest Relations with the Seller, in Whose Name Shall the Chinese Side of the Joint Venture File a Lawsuit to the People's Court] (promulgated by the Sup. People's Ct., Nov. 4, 1994).

83. Guanyu Gongsifa Shiyong Ruogan Yinan Wenti de Lijie [Understandings on Several Difficult Issues Regarding the Application of Company Law], 2004 ZHEJIANG SHENG GAOJI RENMIN FAYUAN MINSHI SHENPAN DI'ER TING 294 (No. 2 Civil Division of the High People's Court of Zhejiang Province) (China), available at <http://www.gudonglawyer.org.cn/ShowArticle.shtml?ID=2009122810182118074.htm>.

84. Guanyu Shenli Sheji Gongsu Susong Anjian Ruogan Wenti de Chuli Yijian (Yi) [Opinions on Adjudicating Cases Regarding Corporate Litigation (No. 1)], 2003 SHANGHAI SHI GAOJI RENMIN FAYUAN MINSHI SHENPAN DI'ER TING (No. 2 Civil Division of the High People's Court of Shanghai), available at <http://www.gglsw.cn/flwk/zhidaowenjian/4576.html>.

85. Guanyu shenli Shiyong Gongsifa Anjian Ruogan Wenti de Yijian (Shixing) [Opinions on Several Issues on Adjudicating Cases Applying Company Law (Trial Implementation)], JIANGSU SHENG GAOJI RENMIN FAYUAN, at art. 17 (the High People's Court of Zhejiang Province June 3, 2003), available at <http://law.chinalawinfo.com/newlaw2002/SLC/slc.asp?db=lar&gid=16826048>.

86. Guanyu Shenli Gongsu Jiufen Anjian Ruogan Wenti de Zhidao Yijian (Shixing) [Guiding Opinions on Several Issues on Adjudicating Corporate Dispute Cases (Trial Implementation)], BEIJING SHI GAOJI RENMIN FAYUAN at art. 1(8) (the High People's Court of Beijing Feb. 2004), available at <http://law.chinalawinfo.com/Newlaw2002/SLC/slc.asp?db=lar&gid=16830043>.

87. See *Mr. Shao v. Zhao Xinxian*, cited in Fidy Xiangxing Hong & S.H. Goo, *Derivative Action in China: Problems and Prospects*, 4 J. B. L. 376 (2009).

88. These two cases involved Henan Lianhua Weijing (600186) and Shenzhen Xingdu Hotel (000033). See *Shou Li Shangshi Gongsu Gudong Daibiao Susong An (First Lawsuit on Behalf of Shareholders of Listed Companies)*, SHU WANG (CENTURY NETWORK), June 23, 2003, available at <http://www.21cbh.com/HTML/2003-6-23/10363.html>; Henan Lianhua Weijing Gufen you Xian Gong Si Dong Shi Hui Guan yu Liu Tong Gugu Dong Su Song Shi Xiang de Shui Ming de Chengqing Gong Gao (Henan Lotus Gourmet Powder Co., Ltd. Board of Directors of the Outstanding Shares of Shareholder Litigation Matters for the Clarification Announcement), *Lianhua Weijing (600186) Gong Gao Zhengwen (Lotus Gourmet Powder (600186) Notice Text)*, IFENG (Jul. 23, 2004), available at <http://app.finance.ifeng.com/data/stock/ggzp.php?id=12504159&symbol=600186>.

serious corporate governance problem plaguing listed companies in China: the misappropriation of corporate funds by controlling shareholders.<sup>89</sup>

In short, before the Company Law (1993) was revised in 2005, the supervisory board in China did not have the power to take legal action on behalf of the company. Minority shareholders' attempts to bring derivative actions against misbehaving managers and controlling shareholders of listed companies were unsuccessful, although some derivative suits involving limited liability companies were permitted out of practical necessity. The deficiencies of the old company law were criticized as leaving minority shareholders in China powerless, and repeated calls were made to introduce the derivative action.<sup>90</sup> This was done in 2005 when the Company Law (1993) was extensively amended.

The Chinese derivative action introduced by the Company Law 2005 exhibits some salient "Chinese characteristics". First, with respect to the minimum shareholding requirement, a distinction has been drawn between limited liability companies and joint stock limited companies. For joint stock companies, only shareholders who individually or collectively own at least 1% shares of the company are qualified to bring suit.<sup>91</sup> No such restriction exists for limited liability companies. Furthermore, unlike the German derivative action, the law in China does not provide a monetary threshold figure. Second, shares must have been held continuously for at least 180 days before shareholders can initiate an action.<sup>92</sup> Third, shareholders must make a written request asking the company to bring suit, and only if the demand has been refused or the company has failed to act within 30 days of the demand, can the shareholders take the legal action themselves. Request is made to the supervisory board where members of the managerial board are the intended defendants, and *vice versa*.<sup>93</sup> Fourth, qualified shareholders can take actions against persons other than directors who have infringed the rights of, and caused damages to, the company.<sup>94</sup> This means that, not only can the derivative action be used to target miscre-

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89. See generally Guohua Jiang et al., *Tunnelling in China: The Remarkable Case of Inter-Corporate Loans (2008)*, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1154314](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1154314); LIH GAO & GERHARD KLING, *Corporate Governance and Tunneling: Empirical Evidence from China*, 16 PAC. BASIN FIN. J. 591 (2008) (discussing asset appropriation by principal shareholders of Chinese corporations).

90. See Deng, *supra* note 4.

91. See Company Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005), art. 152(1) (China).

92. *Id.*

93. *Id.* at 152(2).

94. *Id.* at 152(3).

ant controlling shareholders, but minority shareholders can challenge a company's decision not to litigate an ordinary commercial dispute and take action themselves. Finally, shareholders need not obtain permission from the court to file a derivative action. The absence of such a requirement is conspicuous when the Chinese approach is compared with other countries where derivative actions are allowed.

After the new law came into effect on January 1, 2006, derivative actions increased.<sup>95</sup> Some of the claims in these cases were for hundreds of millions of Renminbi (RMB). However, most of these actions have involved limited liability companies.<sup>96</sup> As far as listed companies are concerned, only one derivative action has ever been brought by shareholders and accepted by the courts.<sup>97</sup> Even this suit was not a typical derivative action for minority shareholder protection, because the action was taken against a former controlling shareholder. The legal basis of the action is also dubious, since the company itself had already brought an action against the former controlling shareholder on the same ground;<sup>98</sup> The derivative action was brought with support from the current controlling shareholder to put pressure on the former controlling shareholder regarding a separate legal action concerning the legality of the current controlling shareholder's takeover of the company.<sup>99</sup> There have been two other cases

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95. See Fidy Xiangxing Hong & S.H. Goo, *Derivative Actions in China: Problems and Prospects*, 2009 J. BUS. L. 376, 387 (2009).

96. See Guo Hengzhong, *Guonei Suopei e Zuoda de Gudong Paishen Susong An Yishen Panjue (A Derivative Action with the highest Claim Value so Far in the Country Adjudicated in the First Instance)*, FAZHI RIBAO (LEGAL DAILY), Apr. 22 2007. In another derivative action, a listed company was a defendant because it was accused of inflicting injury, but not because its own interests were injured. See Li Jianping, *Gongsifa Xiuding Hou Guonei Zuoda Biaodi Gudong Daibiao Susong An Shilu (Witnessing a Shareholder Derivative Action with the Highest Claim Value in the Country since the Company Law was Revised)*, FAZHI RIBAO (LEGAL DAILY), Jan. 11, 2008.

97. There are numerous websites providing information and covering news about listed companies in China. Litigation involving listed companies, especially securities actions and derivative suits which have implications for corporate governance and investor protection, attracts wide media attention. According to this author's online research, only one derivative action has been brought by shareholders and accepted by the courts since the new company law came into effect. This finding has been confirmed by a report of the CHINA SECURITIES JOURNAL. See 2009 Nian Zhenquan Shichang Shida Dianxing Anli Pandian (*Stocktaking of Ten Major and Typical Cases Concerning the Securities Market in 2009*), ZHONGGUO ZHENQUAN BAO (CHINA SECURITIES JOURNAL), Mar. 15, 2010.

98. *Id.*

99. See Zhuoming Wang, *San'an 'Jingqi' (Astonished at 'Three Cases')*, 21ST CENTURY BUSINESS HERALD, Dec. 11, 2009, available at [http://www.21cbh.com/HTML/2009-12-11/157391\\_3.html](http://www.21cbh.com/HTML/2009-12-11/157391_3.html).

involving listed companies brought by minority shareholders.<sup>100</sup> These cases, however, are not derivative but direct suits based on Article 22 of the new Company Law, which allows shareholders to take direct actions against a company to revoke unlawful resolutions adopted by shareholders' meetings or the board of directors.<sup>101</sup>

## V. NO DERIVATIVE ACTION IN CHINA AND THE MINIMUM SHAREHOLDING REQUIREMENT

### 1. THE MINIMUM SHAREHOLDING REQUIREMENT AS A BARRIER TO DERIVATIVE ACTIONS

Why has there only been one derivative action involving a listed company in China, despite extensive reports of the abuse of power by controlling shareholders and corporate managers? It would appear that the 1% minimum shareholding requirement is a major obstacle. Compared with some European countries and Taiwan, requiring those bringing the derivative suit to hold only 1% is fairly low. However, as far as listed companies are concerned, such a figure is still substantial. Institutional investors and other non-institutional block-holders could qualify, but individual minority shareholders may practically be excluded by the requirement.

In a study of the role of institutional shareholders in listed companies' non-tradable share reform,<sup>102</sup> it was found that, among 811 non-financial firms which had completed the non-tradable share reform before December 31, 2008, the average number institutional shareholders with holdings in a company was 7.846%, and the average holdings of institutional shareholders in a firm constituted 10.855% of the equity. This indicates that the average shareholding of one institutional shareholder in a firm was approximately 1.4%.<sup>103</sup> Individual minority shareholders, on the other hand, are unlikely to meet the entry-level

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100. Minority shareholder plaintiffs in *Zhang Qiuju v. Sinopec Wuhan Petroleum Group Co. Ltd* [2007] and *Chen Dongmei v. Sinopec Shandong Taisan Petroleum Co. Ltd* [2007 Taisan minchuzhi No. 594] have both lost their cases. See Gu Min Qisu "Swu Shiyou" Dongshihui Jueyi Wuxiao: "Mayi" yu "Daxiang" De Kang Zheng (Shareholders Sue "S Wu Oil" Board, Resolution Null and Void: "Ants" and "Elephant" In Protest?), FAZHONG WANG (LEGALDAILY), Mar. 18, 2007, available at [http://www.legaldaily.com.cn/bm/content/2007-03/18/content\\_561971.htm](http://www.legaldaily.com.cn/bm/content/2007-03/18/content_561971.htm).

101. Company Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005), art. 22 (China).

102. For more information on non-tradable share reform, see STEPHEN GREEN, *supra* note 15.

103. See Yamin Zeng & Junsheng Zhang, *The Dark Side of Institutional Shareholders Activism in Emerging Markets: Evidence from China's Non-Tradable Share Reform* tbl.4 (Apr. 2, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1372428](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1372428).

requirement. According to a survey conducted by the China Securities Investment Protection Fund Corporation at the end of 2008, individual investors whose stock holdings were 100,000 RMB or less accounted for 68.69% of investors, and those whose stock holdings were 300,000 RMB or less constituted 88.08% of investors.<sup>104</sup> Meanwhile, the minimum share capital requirement for a listed company is 30 million RMB.<sup>105</sup> At the end of 2008, the weighted average price in the Shenzhen Stock Exchange was 7.01 RMB per share, while the weighted average price in the Shanghai Stock Exchange was 6.31 RMB.<sup>106</sup> Thus, for the 88.08% of individual investors with investments up to 300,000 RMB, even if they invested all their money in only one company with the smallest amount of share capital, they would only own approximately 0.15% of the total shares. In theory, individual shareholders can aggregate their shares to meet the 1% shareholding requirement; in reality, however, the cost of coordination amongst individual shareholders to take an action would be prohibitive.<sup>107</sup> The fact that there are few collective actions in other countries is evident.

Therefore, those who may bring derivative actions are frequently institutional shareholders or non-institutional block-holders.<sup>108</sup> However, in the case of non-institutional block-holders, they may be aligned with controlling shareholders and complicit in the wrongdoing, or may be easily bought off.<sup>109</sup> Moreover, in China many of these block-holders themselves are SOEs or other government-controlled entities brought into a corporation's equity structure during the restructuring of a traditional SOE for listing. These block-holders and the controlling shareholders are both ultimately controlled by the government.<sup>110</sup> Thus, it is doubtful that these block-holders will bring litigation against controlling shareholders or managers. There-

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104. CHINA SECURITIES INVESTMENT PROTECTION FUND CORPORATION, 2007-2008 SUMMARY OF THE PRIVATE SECURITIES INVESTOR SURVEY (2009), <http://www.sipf.com.cn/dczx/dccg/10/1144.shtml>.

105. Securities Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005), art. 50(2) (China).

106. See CHINA CENTER FOR MARKET VALUE MANAGEMENT, 2008 MARKET VALUE MANAGEMENT REPORT FOR LISTED COMPANIES OF CHINA (2009), available at <http://stock.hexun.com/2009-02-19/114683077.html>.

107. See Hong & Goo, *supra* note 95, at 388-90.

108. Those bringing the derivative action are block-holders, but not institutional investors. Block-holders are shareholders with a large amount of a company's shares and often able to influence the company's decisions with the voting rights awarded with their holdings; institutional investors are entities, such as mutual funds, pension funds, hedge funds, insurance companies and investment banks, which pool large sums of money and invest those sums in corporations.

109. See Grechenig & Sekyra, *supra* note 73.

110. See Zhang, *supra* note 3.

fore, concerning listed companies, institutional shareholders are the only potential candidates for bringing derivative actions. Nevertheless, the question remains whether institutional shareholders have appropriate incentives to pursue derivative actions against corporate managers or controlling shareholders. The objective evidence thus far would indicate that the answer is no.

This outcome is not exceptional. Continental Europe has had very much the same experience. Despite the availability to minority shareholders of the derivative action, there have been hardly any derivative suits in Europe,<sup>111</sup> which may be attributed to the shareholding requirements for taking derivative actions.<sup>112</sup>

The experience of securities class action reform in America is also revealing. There were complaints in America that securities class actions were “lawyer-driven” and abused by plaintiffs’ attorneys, who were not acting in the best interests of their clients. One solution was to enlist institutional shareholders to play a bigger role in these actions.<sup>113</sup> In 1995, Congress passed the Private Securities Litigation Reform Act, which provided that the court should publish a notice within 20 days of receiving a suit inviting class members to apply to be the suit’s lead plaintiff.<sup>114</sup> The Act also requires that within the next 90 days, the court must appoint a lead plaintiff out of those who have applied,<sup>115</sup> primarily determined by who “has the largest financial interest” in the action.<sup>116</sup> This is inevitably an institutional investor. However, empirical evidence underscores the reluctance of institutional investors to assume the role of lead plaintiff, especially in smaller cases. Up until 2001, institutions appeared as the lead plaintiff in only 5%-10% of all securities class actions.<sup>117</sup> Instead of an institutional investor, a securities class suit’s represen-

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111. *Id.* at 2.

112. *Id.* at 3. Another commonly cited reason is the rule on litigation funding. See Baums and Scott, *supra* note 22, at 53.

113. See generally Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 *YALE L. J.* 2503 (1995) (advocating for a greater role for institutional investors in securities class actions).

114. 15 U.S.C. §78u-4(a)(3)(A)(i) (2010).

115. 15 U.S.C., s. 78u-4(a)(3)(B)(i).

116. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2010).

117. See James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter?: An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 *COLUM. L. REV.* 1587, 1590 (2006). See generally James D. Cox & Randall S. Thomas, *Leaving Money On the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80 *WASH. U. L. Q.* 855 (2002) (finding that many institutional investors often fail to file claims in securities fraud class actions). There are studies finding institutions are getting involved more frequently in recent years. For example, see ELLEN M. RYAN & LAURA E. SIMMONS, *POST-REFORM ACT SECURITIES SETTLEMENTS: 2005 REVIEW AND ANALYSIS* 9 (2005) (finding that about 35% of all post-Reform Act settlements have involved institutions serving as lead plaintiffs); ELLEN M.

tative is "far more likely to be an aggregation of non-financial institutional investors or even a single individual."<sup>118</sup>

The disincentives for institutional investors to attempt to participate in corporate governance, and the difficulties of doing so, are well recorded:<sup>119</sup> liquidity is a significant concern when embarking upon prolonged legal actions; free-riding may occur by fellow investors, which may also include peer institutions; there may be a deficit of information and personnel necessary for conducting complex and time-consuming litigation; and the institutional investor may believe that their bottom line would be better affected by focusing on successful investing, rather than becoming mired in litigation.<sup>120</sup> Institutions may similarly be unwilling to bring litigation because they do not want to reveal their business practices or jeopardize their relationship with the defendant. In addition, many institutional investors simply do not want to acquire a reputation of being antagonistic.<sup>121</sup> Moreover, it is argued that there is only a thin social divide between managers of financial institutions and executives of industrial firms.<sup>122</sup> Furthermore, institutional investors may be influenced by controlling shareholders and managers.<sup>123</sup> All of these factors militate against institutional shareholders' deciding to take legal action against corporate managers or controlling shareholders; but in the distinct context in which Chinese institutional investors operate, there are further disincentives, such as highly concentrated state ownership in listed companies, an immature regulatory environment, inadequate transparency and disclosure of

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RYAN & LAURA E. SIMMONS, SECURITIES CLASS ACTION SETTLEMENTS: 2007 REVIEW AND ANALYSIS 10 (2008) (finding that the figure in 2007 was roughly 60%).

118. See Cox & Thomas, *supra* note 117, at 1590.

119. See, e.g., John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1278-86 (1991); Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994); Stephen M. Bainbridge, *SHAREHOLDER ACTIVISM AND INSTITUTIONAL INVESTORS*, (UCLA Sch. Of Law & Econ. Research Paper Series No. 05-20, 2005). For the legal obstacles for institutional shareholder activism in the U.K., see Gerard McCormack, *Institutional Shareholders and the Promotion of Good Corporate Governance*, in *THE REALM OF COMPANY LAW: A COLLECTION OF PAPERS IN HONOUR OF PROF. LEONARD SEALY* 131 (Barry A.K. Rider ed., 1998).

120. See Cox & Thomas, *supra* note 117, at 1605-10.

121. James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions To Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 441 (2005).

122. *Id.* at 427-28.

123. See Grechenig & Sekyra, *supra* note 73, at 3.



financial information, and weak corporate governance within institutions themselves.<sup>124</sup>

As such, the lack of derivative suits in China may be first of all attributed to the 1% minimum shareholding requirement. As a result of the shareholding requirement, individual minority shareholders are excluded and only institutional investors and other non-controlling block-holders may bring derivative suits. Such investors, however, do not have the incentive to challenge the controlling shareholders or the management of the companies. Arguably, if a minimum ownership requirement is instituted so as to exclude individual minority shareholders from being qualified to take derivative actions, the policy goal of making derivative action an important corporate governance tool is effectively undermined.

## 2. A REDUCED THRESHOLD FIGURE?

Minimum shareholding requirements are generally justified as being means by which frivolous lawsuits may be prevented. Small shareholders bear only a small portion of the cost arising from derivative litigation, so the cost of litigation does not serve as a disincentive to bringing unmeritorious suits.<sup>125</sup> The minimum shareholding requirement removes from those shareholders with the strongest incentive to bring frivolous suits the ability to do so. If the failure of the Chinese derivative action to serve as a check to abusive corporate governance is due to the fact that the 1% figure is too high, then reducing that threshold seems to be the clear solution. However, it is difficult to determine to what extent the threshold should be reduced to enable individual minority shareholders to bring suit, while still preventing frivolous actions.

It is impossible to set a universally appropriate threshold figure, and any fixed percentage or amount of monetary value is arbitrary. It is by no means clear that a shareholder owning 0.9% of a company will sue with a malicious motivation but a shareholder owning 1% will not; the cost-benefit analysis of pursuing a frivolous suit varies from case to case.<sup>126</sup> Moreover, frivolous lit-

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124. See Rongli Yuan et al., *The Role of Financial Institutions in the Corporate Governance of Listed Chinese Companies*, 20 *BRIT. J. MGMT.* 562, 576-77 (2009).

125. See text accompanying *supra* note 33.

126. This is a simplified example which does not bring plaintiffs' lawyer into play. In the US where derivative actions are said to be lawyer-driven, the strategy of a minimum shareholding requirement would be even more irrational because lawyers do not necessarily hold shares in the companies. See John C. Coffee, *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is Not Working*, 42 *MD. L. REV.* 215, 233 (1983); John C. Coffee, *Understanding the Plain-*

igation is not driven solely by perceived financial benefits.<sup>127</sup> Thus imposing a percentage threshold, although high, may still be ineffective in filtering out frivolous actions that are not grounded in the shareholders personal financial gain.<sup>128</sup>

When considering the adoption of a minimum shareholding strategy, it is inappropriate to only consider the need to sift out frivolous litigation; it is also important to ensure that meritorious suits are not blocked. The assumption that a shareholder with ownership of a smaller share would have a stronger incentive to sue frivolously is not always true. It is possible that, although a minority shareholder owns a very small number of shares, they may still act in the best interests of the company. In light of this, the rationale underpinning the minimum shareholding strategy is flawed because the minimum shareholder requirement “throws the baby out with the bath water.” A fixed threshold figure could be set to a very low level, as in South Korea where the threshold is 0.01% for listed companies, yet some shareholders who wish to act for the benefit of the company may still be excluded.

Reform proposals invariably suggest the reduction of threshold figures.<sup>129</sup> Such reductions have occurred in European countries such as Germany and Italy,<sup>130</sup> as well as Asian countries such as South Korea and Taiwan.<sup>131</sup> Similarly, it is suggested that China lower its 1% figure,<sup>132</sup> but as noted above, it is impossible to determine how low the figure should be. It is proposed that the shareholding requirement be only reasonably higher than the average holdings of tradable shares of the average retail shareholder.<sup>133</sup> Aside from the ambiguity of “reasonably higher” and the difficulty associated with ascertaining the average holdings of a retail shareholder, it is difficult to rationalize why that percentage should become the threshold figure.

A concern with low threshold figures is the potential danger to the company. According to China Securities Depository and Clearing Corporation Limited, by 2008, more than 120 million individuals opened an A-share investment account and, about 46

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*tiffs' Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 691-92 (1986).

127. See *supra* text accompanying notes 30, 31 and 32.

128. See HIRT, *supra* note 23, at 308.

129. See Klaus J. Hopt, *Shareholder Rights and Remedies: A View from Germany and the Continent*, 2 COMPANY FIN. & INSOLVENCY L. REV. 261 (1997).

130. See Roberto Ulissi, *Company Law Reform in Italy: An Overview of Current Initiatives 8-9* (OECD Conference Paper, 2000), available at <http://www.oecd.org/dataoecd/21/32/1857507.pdf>.

131. See Milhaupt, *supra* note 77, at 186.

132. Hong & Goo, *supra* note 87, at 390.

133. *Id.*

million of them actually owned A-shares.<sup>134</sup> If the average individual investor was able to bring derivative actions without any other prerequisites stipulated, there would be 23 million potential candidates for bringing derivative actions, many of which would be detrimental to the interest of companies. This is especially true given that the current Chinese legislation does not provide for a permission procedure where judges have discretion on whether a suit may go forward, and a derivative action can be brought against persons other than the controlling shareholder and management without additional requirements being met.<sup>135</sup> An additional requirement for court permission, such as that of Germany, could in theory address this concern, but this begs the question of why a minimum shareholding requirement is still needed when a permission procedure is in place.

In conclusion, the strategy of imposing a minimum shareholding requirement is fundamentally flawed. It is impossible to set a threshold figure that is universally effective in filtering out frivolous lawsuits while allowing meritorious actions. Any figure is arbitrary, over-inclusive, and under-inclusive. In the case that lawsuits are brought for non-financial considerations, a minimum shareholding requirement is irrelevant. It is impossible to ascertain to what extent the Chinese shareholding requirement should be reduced; on the other hand, there is the legitimate concern that any reduced threshold figure may be too low.

## VI. REFORMING THE LAW: IS A PERMISSION PROCEDURE, WITH JUDGES IN CONTROL, THE RIGHT SOLUTION?

If a minimum shareholding requirement is inherently flawed and unfeasible, the better solution may be to abolish the requirement altogether and instead introduce an alternate strategy. This section evaluates whether a *locus standi* rule without a minimum shareholding requirement can work effectively in China.

Generally, two approaches have been pursued. In the first approach, the courts assess whether a proposed action is in the best interest of the company, and decide accordingly whether the action should be allowed to proceed. In the second, the courts review the assessment made by disinterested directors on behalf

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134. See CHINA SECURITIES DEPOSITORY AND CLEARING CORPORATION LIMITED, CHINA SECURITIES REGISTRATION AND SETTLEMENT STATISTICAL YEARBOOK 17 (2008), available at [http://www.chinaclear.cn/main/03/0305/0305\\_1.html](http://www.chinaclear.cn/main/03/0305/0305_1.html). A-shares refers to shares listed domestically on Shanghai or Shenzhen Stock Exchange and denominated in Renminbi. Besides A-shares, another type of shares, B-shares, is listed domestically but denominated in foreign currencies.

135. See Company Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005), art. 152(3) (China).

of the company. Hence, the first question to be considered is who, the court or the company, should be empowered to assess whether a proposed action is in the interest of the company.

### 1. WHO SHOULD HAVE THE MANDATE TO ASSESS A PROPOSED ACTION?

There has actually been a debate on this question in common law countries. The debate over who should assess whether a derivative action should be pursued invokes both doctrinal and practical considerations.

First, if companies are regarded as having independent personality, it is argued, they should have the prerogative to decide whether or not seek redress for an injury they receive.<sup>136</sup> There is no difference when it comes to the derivative action. The decision whether to pursue a derivative action is similar to many encountered in the life of a business, involving the application of “the company’s resources to run a risk against expected return.”<sup>137</sup> In essence, a litigation decision is an investment decision for the company; as such, the company’s autonomy should not be impugned.

On the other hand, it is argued that, in the context of derivative action, a company has become effectively unable to function as an entity separate from its members, as wrongdoers have used the company as a vehicle for their own interests and disabled it from conducting litigation for itself.<sup>138</sup> As such, the independent personality of the company is no longer extant and, because no disinterested decision-making body exists within the company, it becomes necessary for others to decide whether or not an action is in its best interests.<sup>139</sup>

Second, it is suggested that companies are in a better position than the courts to assess whether or not litigation is in their best interests. Because such a decision may involve an assessment of business decisions made by corporate managers, it requires specific knowledge, experience and business expertise, which judges may not have.<sup>140</sup> Moreover, directors are arguably in a far better position than courts to verify the alleged wrongdo-

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136. See HIRT, *supra* note 23, at 246.

137. See Hans C. Hirt, *Ratification of Breaches of Directors’ Duties: The Implications of the Reform Proposal Regarding the Availability of Derivative Actions*, 25 CO. LAW. 197, 210 (2004).

138. See Christopher Hale, *What’s Right with the Rule in Foss v. Harbottle?*, 2 COMPANY FIN. & INSOLVENCY L. REV. 219 (1997).

139. *Id.* See also Reisberg (2006), *supra* note 9, at 75.

140. See Michael Bradley & Daniel R. Fischel, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 273 (1986).

ings and to evaluate the benefits and cost of a proposed action, simply because they have a better understanding of the company's operations.<sup>141</sup> Since reasonable people may differ in their judgement of the merits of a case, the assessment of whether or not litigation is in the company's best interests generally ought to be carried out by an internal body of the company, ideally representing the shareholders as a whole.<sup>142</sup>

However, counter arguments indicate that decisions regarding whether a derivative action should be commenced may just as easily be characterized as legal, not business, decisions.<sup>143</sup> Such decisions are viewed as "not managerial decisions and do not require business specialists or those with an intimate knowledge of the company."<sup>144</sup> The "talents that a court is generally thought to lack—business intuition, a feel for the marketplace, and the ability to trade off risk for return—are not here called for to the same degree."<sup>145</sup> To the extent that the decision whether or not to pursue litigation hinges on an appraisal of the merits of the litigation, "the court's perspective and expertise are can be viewed as superior to the boards."<sup>146</sup>

Third, it is argued that by leaving the decision of whether to pursue litigation with the company may save time and expense. By allowing a company to make its own assessment, there will often be less resources *expended* by all parties involved in the process, and directors may avoid being caught up in long and cumbersome lawsuits.<sup>147</sup> On the contrary, it is contended that such an arrangement means a duplication of work and costs.<sup>148</sup> The company has to incur potentially significant costs when investigating the desirability of an action.<sup>149</sup> Subsequently, costs

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141. *Id.* See also James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L. J. 959, 960 (1982); R. Smith, *Shareholders' Derivative Suits and Shareholders' Welfare: An Evaluation and Proposal*, 77 NW. U. L. REV. 856, 904-05 (1983).

142. See HIRT, *supra* note 23, at 245-47.

143. See M. A. Maloney, *Whither the Statutory Derivative Action?*, 64 LA REVUE DU BARREAU CANADIEN [CAN. B. REV.] 309 (1986) (Can.). The author based his argument on the view that such decisions should rest entirely upon the severity of the breach of duty and the possibility of the success of a proposed action rather than the calculations of the costs and benefits of the action.

144. *Id.* at 337.

145. See John C. Coffee & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 282-83 (1981).

146. *Id.* at 282. See also Tamar Frankel & Wayne M. Barsky, *The Power Struggle between Shareholders and Directors: The Demand Requirement in Derivative Suits*, 12 HOFSTRA L. REV. 39, 54-55 (1983).

147. See Bradley & Fischel, *supra* note 140, at 273; Cox, *supra* note 141 at 960.

148. Ramsay, *supra* note 20 at 173.

149. For example, in one case, a company's special litigation committee interviewed 70 witnesses in conducting its investigation and produced an 1100 page's

arise again when a court reviews the assessment made by the company. Such judicial review may be no easier than a direct assessment of the merits of the case.<sup>150</sup> In fact it was said that the issues involved in the judicial review of a recommendation made by the company might be “as difficult as the issues raised by the underlying claims and could easily require the development and presentation of extensive evidence.”<sup>151</sup> If the court in the end decides to reject the company’s assessment, it has to conduct its own evaluation, resulting in duplication of work and wasted costs.<sup>152</sup>

## 2. WHY THE PERMISSION PROCEDURE MAY NOT WORK IN CHINA

### a. *Broad Judicial Discretion and the Nature of the Permission Procedure*

While the respective merits of the two approaches described above are hotly debated in common law countries, the critical issue for our purposes is whether either of these two strategies can work effectively in China. Although the tasks that the courts are required to perform are different, these two strategies are in fact alike in the broad discretion that judges are offered.

The approach to the statutory derivative action generally adopted by Commonwealth countries gives broad discretion for judges in determining the admissibility of a derivative action. The ultimate test, that an action should be in the best interests of the company, is vague, and the statutory framework generally does not provide specific rules on how this test should be performed. Although the courts in New Zealand are instructed to consider “the likelihood of the proceeding succeeding” and “the costs of the proceedings in relation to the relief likely to be obtained,” it is nevertheless unclear how to determine an action’s

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report, the conclusion of which was nevertheless rejected by the court. See Jeremy J. Kobeski, *In re Oracle Corporation Derivative Litigation: Has a New Species of Director Independence Been Uncovered?*, 29 DEL. J. CORP. L. 849, 858-59 (2004). In the U.S., such costs are not recoverable from the plaintiff even if the court dismisses the case in accordance with the company’s recommendation. This may also be true in England, if the company is only a nominal defendant. See *Re a Company* (No.001126 of 1992) [1993] B.C.C. 325; *Harley Street Capital Ltd. v. Tchigirinsky*, [2005] EWHC (Ch.) 1897 (Eng.).

150. See L. S. Sealy, *The Rule in Foss v. Harbottle: The Australian Experience*, 10 CO. LAW. 52, 54-55 (1989).

151. See Gevurtz, *supra* note 30, at 281.

152. See Gregory V. Varallo et al., *From Kahn to Carlton: Recent Developments in Special Committee Practice*, 53 BUS. LAW 397, 403 n.23 (1998). For examples of cases in which courts have rejected SLC recommendations, see *Lewis v. Fuqua*, 502 A.2d 962 (Del. Ch. 1985) and *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003).

probability of success and to estimate the cost and relief from the action.<sup>153</sup> In England, the Companies Act 2006 provides that an application for a derivative action must be dismissed if the application and evidence filed do not constitute a *prima facie* case.<sup>154</sup> However, this test is presumably the same as that provided for striking a case in the U.K. Civil Procedure Rules, and gives no greater insight into how to assess the probability of success of a proposed action.<sup>155</sup>

The laws of different countries stipulate other factors that the courts can take into account in reaching a decision; however, these statutes nevertheless remain non-exhaustive and inconclusive.<sup>156</sup> For example, in both Australia and Canada, the courts are asked to take shareholders' ratification of a challenged wrong into account, but ratification is not a bar to derivative actions.<sup>157</sup> Similarly, the courts are not obliged to adhere to a board's decision not to sue,<sup>158</sup> although in England the company's decision not to sue is a factor that courts *must* take into account.<sup>159</sup> Moreover, the statutes do not provide guidance on how the courts should weigh different factors. Indeed, when commenting on the Law Commission of England and Wales's recommendations on the reformation of the derivative action prior to the Companies Act 2006, scholars observed that the approach underlying the proposed statutory derivative action is to substitute judicial discretion for the traditional common law rules developed after *Foss v. Harbottle*.<sup>160</sup> This observation regarding the statutory derivative action enacted in other Commonwealth countries is also supported by the English Law Commission's recommendations that were derived from these other Commonwealth countries. In America, the courts must review the independence of corporate directors who recommend terminating a proposed action, but

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153. See Companies Act 1993 § 165(2)(a)-(b) (N.Z.).

154. See Companies Act, 2006, c. 46, 261(2) (U.K.).

155. See Civil Procedure Rules, 1998, S.I. 1998/3132, r. 3.4 (U.K.). The Law Commission explicitly opposed a threshold test of the probability of success. See Law Commission, *supra* note 41, at para. 16.22.

156. See PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLE OF MODERN COMPANY LAW 614-23 (8th ed. 2008).

157. See *Corporations Act*, 2001 (Cth) s 239 (Austl.); Canada Business Corporations Act, R.S.C. 1985, c. C-44 § 242(2)(1) (Can.). In England, an effective ratification is a bar to derivative action. See Companies Act, 2006, c. 46, § 263(2)(b)-(c) (U.K.).

158. In Australia, a derivative action is presumed not to be in the company's interests if the board decides not to sue as long as certain requirements are met. See *Corporations Act*, 2001 (Cth) s 237(3) (Austl.).

159. See Companies Act, 2006, c.46, § 263(3)(e) (U.K.).

160. See DAVIES, *supra* note 156, at 614-15; David Neuberger, *Company Law Reform: The Role of the Courts*, in THE REFORM OF UNITED KINGDOM COMPANY LAW 59, 74 (John de Lacy ed., 2002).

this has proved to be a difficult endeavour.<sup>161</sup> Arguably, the difficulty in ascertaining independence is no less than that of determining whether pursuit of the action is in the best interests of the company.<sup>162</sup> Moreover there exists an inherent dilemma in the derivative action where directors are involve in the process of deciding whether to sue themselves makes it impractical to determine the independence of corporate directors.<sup>163</sup> Although the American special litigation committee is typically comprised of directors who are financially disinterested in an accused transaction, they may still have other conflicts of interest. They may have been nominated or elected to the board by interested persons, appointed to the committee by interested persons, taken part in the approval of the challenged transaction, or otherwise been named as defendants in the action. As a result, their independence can be called into question. The difficulty determining directors' independence is again illustrated by two relatively recent Delaware derivative suits, *In re Oracle Corporation Derivative Litigation*<sup>164</sup> and *Beam v. Stewart*,<sup>165</sup> where novel questions concerning a director's independence had to be answered: could independence be compromised by friendship, and what other factors need to be taken into consideration aside from financial relationship, familial ties, domination and control, and so forth?

Another concern is that company directors are "structurally biased."<sup>166</sup> The fact that special litigation committees in the U.S. rarely recommend continuing an action in its original form suggests that such concerns over directors' independence should not be lightly dismissed.<sup>167</sup> Some commentators in the U.S. see the institution of the litigation committee as tolling the death knell

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161. See Harvey Gelb, *Corporate Governance and the Independence Myth*, 6 WYO. L. REV. 129, 131 (2003); Kobeski, *supra* note 149, at 281.

162. See Gevurtz, *supra* note 30, at 281.

163. See Gevurtz, *supra* note 30, at 281 (arguing that the extensive adjudication required to determine independence would defeat the whole purpose of allowing the board to terminate litigation harmful to the corporation).

164. *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003).

165. See *id.*; *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040 (Del. 2004).

166. See Mark A. Underberg, Note, *The Business Judgement Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 601-02 (1980); James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 84-85 (1985); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 821, 849-51 (2004); Rachel A. Fink, *Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate 'Rubber-Stamping' Boards*, 79 S. CAL. L. REV. 455, 465-69 (2006).

167. See Cox, *supra* note 141, at 963; Deborah A. DeMott, *Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions*, 11 SYDNEY L. REV. 259, 275-79 (1987).



for the derivative action.<sup>168</sup> They argue that only with judicial innovation under wide discretion has the derivative action survived like “a cat with nine lives.”<sup>169</sup>

Two other issues that courts have to consider when reviewing a recommendation to terminate an action include the good faith of the disinterested directors in making such a recommendation, and the adequacy of investigation by the directors. “Good faith” is a very broad legal concept open to different interpretations. For example, the test of “good faith” in Australia has been criticized as a rhetorical device that is “replete with uncertainty in conception and highly unworkable in practice.”<sup>170</sup> It is even more difficult to provide a clear-cut threshold test on adequacy of investigation, and judges have to be entrusted with open-ended discretion.

Broad discretion is present in both the strategies adopted by Commonwealth countries and America. This is not surprising upon closer examination of the nature of the permission procedure in the derivative action. To assess the desirability of a proposed action, the courts have to determine the probability that the underlying claim will succeed; in the court’s eye only when an action is successful can it bring benefits to the company. In ordinary litigation, judges make decisions based on evidence following a full trial. The procedures for granting of permission to pursue a derivative action is not allowed to escalate into even a “mini trial,”<sup>171</sup> let alone a full trial. This means that judges have to determine the probability of success of an underlying claim with access to very limited and unverified evidence. It is thus impossible to specify how the courts should determine the probability of success of a proposed action based on evidence. The English Law Commission explicitly rejected stipulating a threshold test of the probability of success because such a test would lead to extensive discovery, and trial of evidence, which would defeat the permission procedure’s goal of avoiding the costs of frivolous lawsuits.<sup>172</sup> Although the law in New Zealand states that the courts should consider “the likelihood of the proceeding’s succeeding,”<sup>173</sup> it nevertheless is not for the courts “to

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168. See Coffee & Schwartz, *supra* note 145, at 323; Cox, *supra* note 141, at 997; G. W. Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Action?*, 75 NW. U. L. REV. 96, 109 (1980); M. I. Steinberg, *The Use of Special Litigation Committees to Terminate Shareholder Derivative Suits*, 35 U. MIAMI L. REV. 1, 2 (1980).

169. See Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1749 (2004).

170. See Keay & Louhrey, *supra* note 50, at 485.

171. See LAW COMMISSION, *supra* note 41, at para. 16.22.

172. *Id.*

173. See Companies Act 1993 § 165(2)(a) (N.Z.).

conduct an interim trial on the merits of the claim.”<sup>174</sup> If the success of a case cannot be determined based upon evidence, legislation can only provide some factors for judges to consider. However, a case’s probability of success cannot be concretely ascertained just by a consideration of these factors. Judges must thus be offered wide discretion and trusted to make sound judgements.

Another difficulty facing judges administering the permission procedure is that they have to assess the negative impact that an action would cause on the company, before such impacts have materialized. In other words, the courts have to speculate on the probability of occurrence of such impacts and the magnitudes. This is very different from ordinary litigation, where existing damages are assessed based upon evidence, and again calls for judicial discretion. Although American judges, in principle, do not assess the desirability of a proposed action directly, they still must do so indirectly when screening actions on the probability of success and the negative impacts of an action.

In summary, the permission procedure is called for the merits of a claim to be assessed before trial and before the impacts of the litigation is felt. In view of this, it is not surprising that wide judicial discretion is present in both the strategies adopted by Commonwealth countries and America. When evidence is limited and a trial is not allowed it is unfeasible to lay down accurate, definite, and detailed rules concerning how to assess the desirability of a proposed action.

*b. Why the Permission Procedure may not Work in China*

If China decides to abandon the minimum shareholding requirement and introduce the permission procedure, judicial discretion is unavoidable. The factors listed in the legislation of Commonwealth countries can be transplanted to China, but it is doubtful that China would be able to articulate an effective test of directorial independence and good faith, or be able to provide a specific threshold test on the adequacy of investigation. In China, because of the prevalence of concentrated ownership structure, the controlling shareholders in listed companies hold a monopoly on choosing who can become the independent directors of the company. Hence the independence of directors is cast into greater doubt.<sup>175</sup> If China ultimately decides to adopt the

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174. See Matthew Berkahn, *The Derivative Action in Australia and New Zealand: Will the Statutory Provisions Improve Shareholders’ Enforcement Rights?*, 10 BOND L. REV. 74, 95 (1998) (citing *Vrij v Boyle* [1995] 3 NZLR 763, 765 (H.C.)).

175. See Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 36 DEL. J. CORP. L. 125, 195 (2006); Sibao Shen & Jing Jia, *Will the Inde-*

American strategy, wide judicial discretion is necessary in order to enable judges to innovate and respond to new circumstances concerning a director independence; otherwise, the derivative action would not survive for long.

Broad judicial discretion is generally not a serious problem in jurisdictions where the judiciary is well respected, judges are highly skilled and experienced, and case law is available for guidance. However, this is not the case in China. First, judges in China are widely criticized for their low-level professional training and lack of experience.<sup>176</sup> Judges in China are not experienced lawyers but instead are new graduates from law schools; a vast number of judges do not even have formal legal education.<sup>177</sup> As a result, the overall competence of the judiciary is low.<sup>178</sup> Empirical studies indicate that judges handling “economic cases” are a particular concern.<sup>179</sup> In light of the complexity of the derivative action, the concept that many judges in China may not have the skills to handle such cases is a troubling possibility.

Second, it is well known that the judiciary is under tight government control with little independence and that it ranks low in the Chinese political and bureaucratic hierarchy.<sup>180</sup> Government control is especially pronounced with respect to politically sensitive cases and cases considered to be economically or socially important.<sup>181</sup> A substantial majority of listed companies are nationally or locally dominant in their sectors, or affiliated with the government at different levels. Given that these companies provide jobs, are a major source of tax revenue, and a majority of their shares are controlled by the state, they are quite significant for the government. Moreover, procedural rules in China require a plaintiff to sue where the defendant is domiciled.<sup>182</sup> This means that the courts where listed companies reside usually have jurisdiction over cases involving those companies. Thus, local

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*pendent Director Institution Work in China?*, 27 *LOY. L.A. INT'L. & COMP. L. REV.* 223, 232 (2005).

176. See Donald C. Clarke, *Empirical Research in Chinese Law*, in *BEYOND COMMON KNOWLEDGE: EMPIRICAL APPROACHES TO THE RULE OF LAW* 164, 175-77 (Erik Jensen & Thomas Heller eds., 2003).

177. *Id.*

178. See PIERENBOOM, *supra* note 10, at 290.

179. See Hualing Fu, *Putting China's Judiciary into Perspective: Is it Independent, Competent and Fair?*, in *BEYOND COMMON KNOWLEDGE: EMPIRICAL APPROACHES TO THE RULE OF LAW* 193, 210 (Erik Jensen & Thomas Heller eds., 2003).

180. Stanley Lubman, *Bird in a Cage: Chinese Law Reform after Twenty Years*, 20 *Nw. J. INT'L L. & BUS.* 383 (2000).

181. See Fu, *supra* note 179, at 204.

182. See *Minshi Susongfa* (民事诉讼法) [Civil Procedure Law] (promulgated by the Standing Comm. Nat'l People's Cong. Apr. 9, 1991, effective Apr. 9, 1991) art. 22 (China).

protectionism becomes critical and local courts are unlikely to be unbiased in adjudicating cases involving these companies or to deliver effective protection for minority shareholders.<sup>183</sup>

Third, judicial corruption is rampant in China.<sup>184</sup> As such, it is doubtful that judicial discretion will be independently exercised. Furthermore, broad discretion would likely lead to judicial abuse of power. As a result, shareholder derivative actions would likely fail to address the grievances of minority shareholders.

Lastly, precedents in China are not law and there is no compilation of law reports.<sup>185</sup> Hence, judges cannot resort to case law for guidance. Accordingly, the problem caused by judicial incompetence is further exacerbated.

As noted above, the judiciary in China does not command high regard from the general public. The system is unreliable for resolving even ordinary disputes and enforcing relatively clear-cut rules.<sup>186</sup> It is doubtful that the system is currently able to effectively handle derivative lawsuits, which are complex and entail wide judicial discretion. It is unrealistic that the derivative action may be an effective tool for corporate governance where the judiciary is in such a state. It is rightly pointed out by a scholar of Chinese law, Donald C. Clarke, that it would be unwise "to give the Chinese judiciary an important role to play in the development of Chinese corporate governance norms," given "[the judiciary's] low level of education and vulnerability to corruption and political pressure."<sup>187</sup>

## VII. CONCLUSION

There is high hope that the derivative action will help improve corporate governance in China. In reality, however, since the derivative action became available on January 1, 2006, only one derivative suit has been brought. This is in large part because the 1% shareholding requirement is a major barrier to derivative suits. It excludes individual minority shareholders; and despite the fact that institutional shareholders and other non-controlling block-holders may be able to bring derivative suits,

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183. See Clarke, *supra* note 12, at 182.

184. See *supra* note 10.

185. See Clarke, *supra* note 12, at 182 (stating that "Chinese legal theory has traditionally been resolutely against the development of any kind of case law by courts – the pupil in this case surpassing the teacher, the civil law system of Europe, in adherence to this dogma").

186. See Lieberman, *supra* note 10, at 33 (stating that "China's courts are still some way from being effective adjudicators of private rights or even a primary mechanism for resolving individual grievances").

187. See Clarke, *supra* note 12, at 183.

they are nonetheless disincentivized from pursuing such actions against controlling shareholders and management. Nevertheless, it is unfeasible to establish and reduce the threshold figure to an appropriate level. As such, the minimum shareholding requirement as a mechanism for screening out frivolous litigation is inherently flawed.

On the other hand, a strategy based upon judicial control, where judges are entrusted with broad discretion in deciding the admissibility of a derivative action, would be similarly ineffective in China given the current condition of the Chinese judicial system. Such a strategy requires judges to be highly skilled and experienced, and a judicial system that is well respected and trusted; neither of these traits define the Chinese system. Under current conditions, it is unlikely that judges would exercise their discretion appropriately and handle derivative suits independently. It is unrealistic to expect that the derivative action can play an important role in corporate governance where the judicial system is in such a state of affairs.

This paper offers support for the view that the private enforcement of law cannot currently play a significant role in corporate governance in China, and presents a case study of why this is the case. The findings in this paper and the experience of China leave some interesting questions. First, whether and how corporate governance can be improved where the judicial system is weak? Second, whether private enforcement is essential to investor protection and stock market development? Finally, how the stock market in China grew to its current size, considering that investor protection has been exceedingly weak due to the failure of both the private and public enforcement of law? These questions are ripe subjects for further research.