to my little girl, Ziyi, who has brought so much laughter and joy to my life in the final period of obtaining a PhD degree.

Last but not least, I would like to thank my grandma, who loved me so much. Her faith in me made me go on, even when the encountered obstacles seemed to be never ending. I know she is looking at me proudly and smiling from heaven.

CHAPTER 1

Introduction

§1.01 THE NATURE OF THE DERIVATIVE ACTION

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

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

It is true that the proper plaintiff principle recognizes the legal entity of the corporation and the importance of business judgment. However, without exceptions, the application of this rule would cause unfairness in some circumstances. Injustice could arise where the majority of a company's shares are controlled by the company's directors or managers. Where these individuals are involved in alleged misconduct, it is most unlikely that the company in this situation would bring litigation.

In fact, the common law in England and Wales and Scotland, from which derivative action originated, has recognized the limitations of the *Foss* rule and developed several exceptions under which shareholders are entitled to sue in their own names. For example, in the case of *Prudential Assurance Co Ltd v. Newman Industries*

1. *Foss v. Harbottle* (1843) 2 Hare 461.

(No2), the court indicated that 'There is no room for the operation of the rule if the alleged wrong is *ultra vires* the corporation, because the majority of members cannot confirm the transaction.'[2] The court further stated that 'there is also no room for the operation of the rule if the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority cannot confirm a transaction which requires the concurrence of a greater majority'.[3] Among these exceptions, a wrongdoer's control might be seen as typical. This means that courts will allow shareholders to bring the litigation when a wrongdoer has sufficient powers to control a company in order to prevent legal action from being commenced in its name.[4]

As a result, exceptions to the proper plaintiff principle have been developed and adopted not just in the UK, but in numerous countries.[5] Derivative actions are a response to the problem of abuse which might be caused by the application of the proper plaintiff principle and allow individual shareholders to sue wrongdoers on behalf of the company. As a consequence, the interests of minority shareholders and the company would be protected. Many countries have either adopted, or are considering the introduction of the statutory derivative action.[6] Indeed, the introduction of statutory derivative actions serves many functions, such as deterring mismanagement.[7] It is also, however, most likely to be abused either in the form of strike suits or shifting corporate governance from directors to shareholders owing to the excessive use of the derivative litigation. Thus, there is a general recognition of the need to balance the interests of minority shareholders and corporate efficiency to craft law that permits minority shareholders to raise derivative actions. The solutions in this respect are quite different across jurisdictions.

§1.02 DERIVATIVE ACTIONS VERSUS OTHER DEVICES DESIGNED TO REDUCE AGENCY COSTS

Since Berle and Means first unveiled the theory of control over the corporate form,[8] the economic term 'agency' has gradually become utilized in legal scholarship.[9] Two forms

2. *Prudential Assurance Co Ltd v. Newman Industries Ltd (No. 2)* [1982] Ch. 204, 210 *per curiam*.
3. *Prudential Assurance Co Ltd v. Newman Industries Ltd (No. 2)* [1982] Ch. 204, 210 *per curiam*.
4. See *Burland v. Earle* [1902] AC 83, 93(PC).
5. Many common law jurisdictions have adopted statutory derivative action as an exception to the proper plaintiff principle. The Canadian have adopted the statutory derivative actions on sections 238-240 of Canada Business Corporations Act, R.S.C.1985. c. C-44. Singapore and New Zealand have also introduced the statutory derivative action respectively. Eventually Australia adopted it in 2000 in the part.2F.1A of its Corporations Act 2001. The US and UK, as the representative countries of the common law jurisdiction, have certainly introduced this statutory rule which will be discussed later.
6. Please refer to n. 5.
7. See E. Ferran, 'Company Law Reform in the UK' (2001) 5 *Singapore J. of Int'l & Comparative L.* 516; J. C. Coffee, 'Privatization and Corporate Governance: The Lessons from Securities Market Failure' (1999) 25 *The J. of Corporation L.* 1.
8. A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (2nd revised edn, Transaction Publishers 1991).
9. For the details of agency cost in China, please see Part 1 of Ch. 2.

of agency costs have been identified: vertical agency cost between shareholders and managers, horizontal agency cost problems between majority shareholders and minority shareholders. For the former form, members of a company do not generally 'control' the company; in its day-to-day operations the board of directors is authorized to run the company, thus accruing agency cost.[10] For the latter, this is normally incurred in the jurisdictions with concentrated ownership as majority shareholders in such jurisdictions have both the ability and incentive to constrain the directors' performance. As such, the managerial agency problem is not a major issue; rather, conflicts between controlling shareholders and minority shareholders are of principle concern.

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

Law has an important role to play in reducing these costs. As Kraakman et al have pointed out, carefully designed rules and procedures can enhance disclosure by agents or facilitate enforcement actions brought by principals against negligent or dishonest agents.[12] The derivative action, as one of these rules, can reduce agency costs operating to deter mismanagement by imposing the threat of liability and therefore aligning the interests of managers with those of shareholders.[13] McDonough also recognizes the role of derivative actions and maintains that it, as one way of addressing agency cost, concerns the steps taken on behalf of shareholders in order to redress the imbalance in the modern corporate form between control exercised by managers and shareholders.[14]

Some commentators argue that mechanisms other than derivative action are the rational choice for corporations to diminish agency costs. Agrawal and Knoeber have conducted research into the effects on corporate performance of several alternative mechanisms and their results appear to match up with the notion that different mechanisms of reducing agency costs can complement and substitute for one another.[15] This is also supported by Himmelberg, Hubbard and Palia who state that 'firm

10. See R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 21-23.
11. S. Deakin, E. Ferran and R. C. Nolan, 'Shareholders' Rights and Remedies: An Overview' (1997) 1 *Company Financial and Insolvency Law Review* 162-171.
12. See R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) Ch. 2.
13. A. Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford University Press 2007) 23.
14. D. D. McDonough, 'Proposed New Statutory Derivative Action-Does It Go Far Enough?' (1996) 1 *Bond Law Review* 47.
15. A. Agrawal and C. R. Knoeber, 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders' (1996) 31 *J. of Fin. and Quantitative Analysis* 377.

chooses among alternative mechanisms for minimizing agency costs'.[16] Nevertheless, counter arguments maintain that derivative actions are necessary as a means of dealing with agency costs. As Posner asserts 'the derivative suit is a monument to the problem of agency costs; it would make no sense to allow a shareholder to bypass the corporate management in bringing a suit against an officer if one could be confident that management always acted in the shareholders' interests'.[17] The crux of both these arguments is whether other mechanisms are strong enough to reduce agency costs and hence protect the interests of minority shareholders and the company as a whole.

Given that many countries have adopted or considered introducing statutory derivative actions, it seems clear that other mechanisms alone may not constitute an effective functional substitute to litigation. This part will thus place the system of derivative actions in the context of market mechanisms and legal mechanisms to demonstrate why it has a key role to play in this setting.

[A] Market Mechanisms

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

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

16. There are several strategies which company can choose to reduce agency costs: leverage, increased reliance on outside directors, institutional investors, dividend policy and radical changes in corporate control. See C. P. Himmelberg, R. G. Hubbard, and D. Palia, 'Understanding the Determinants of Managerial Ownership and the Link between Ownership and Performance' (1999) 53 *J. of Fin.l Econ.* 353 382.
17. R. A. Posner, 'Citation Classic - Economic-Analysis of Law' (1985) 49 *Current Contents/Social & Behavioral Sciences* 389.
18. E. Ferran, *Company Law and Corporate Finance* (Oxford University Press 1999) 118-122.

Indeed, these market mechanisms play an important role in enhancing managerial efficiency and accountability from the perspective of the modern economic theory of the corporation.[19] The reason why the USA and UK adopt different attitudes towards derivative actions may be a vivid example to illustrate the role of market mechanism. Miller conducts a comparative study and shows that one reason why the USA and UK adopt different attitudes towards derivative actions is that they have divergent regulations regarding takeovers.[20] In the US, where hostile takeovers are rigorously limited, the derivative action has attained greater prominence as a management control device. In the UK, there is a more vigorous and less regulated takeover market than in the US and thus the operation of derivative action is more restricted. This indicates that in the UK, market forces are a better alternative for reducing agency costs and thus derivative action is not needed.

However, this does not mean the market mechanism can replace the legal method. In fact, the above market mechanisms are not without limits. Recent research implies that extra-legal methods for controlling managerial power are less effective than they might be.[21] Other studies also cast doubt on the mechanism of market for corporate control and identify several drawbacks. First, a takeover can happen to any company regardless of its size though in the real world, it is much easier for large companies to acquire small companies.[22] From this perspective, takeover regulation is irrelevant to the efficiency of management. Second, the cost of takeovers in the change of management is high.[23] Prentice has suggested that either mounting or defending against a takeover involves substantial transaction costs.[24] Furthermore, there is no evidence to prove that firm performance will be improved after a takeover. As Singh and Weisse have noted, the acquiring company is motivated by empire-building considerations rather than improving corporate governance.[25]

Other market mechanisms also have their own disadvantages. For example, the mechanism of labour market for managers may be undermined when managers are at the end of their careers and thus they no longer seek to further their careers. In fact, there is already a vast amount of literature questioning the effectiveness of market

19. F. Easterbrook and D. Fischel, *The Economic Structure of Corporate law* (Harvard University Press Reprint edn 1996); E. F. Fama and M. C. Jensen, Separation of Ownership and Control' (1983) 26 *J. of L. & Econ.* 301.
20. G. Miller, 'Special Symposium Issue: Political Structure and Corporate Governance: Some Points of Contrast between the United States and England' (1998) 51 *Columbia Business Law Review.*
21. S. Deakin, E. Ferran, R. C. Nolan, 'Shareholders' Rights and Remedies: An Overview' (1997) 1 *Company Financial and Insolvency Law Review* 167-169.
22. A. Hughes, 'Merger and Economics Performance in the UK: A Survey of the Empirical Evidence 1950-1990' In Fairburn and J. A. Kay (eds.), *Mergers and Merger Policy* (Oxford University Press 1991).
23. See general: A. T. Peacock and G. Bannock, *Corporate Take Overs and the Public Interest: The Hume Report on Corporate Takeovers* (Elsevier Science Ltd 1991).
24. D. D. Prentice, 'Some Aspects of the Corporate Governance Debate' In D. D. Prentice and P. R. J. Holland (eds.), *Contemporary Issues in Corporate Governance* (Oxford University Press 1993) 37.
25. A. Singh and B. Weisse, 'Corporate Governance, Competition, the New International Financial Architecture and Large Corporations in Emerging Markets' ESRC Centre for Business Research, University of Cambridge Working Paper No. 250, 28.

primacy.[26] The traditional criticism is that such a market may fail to work because of inevitable problems such as informational asymmetry, transaction costs and collective action problems. However, it is not the intention of this book to examine all these problems. The above discussion is to introduce the limits of market mechanism and thus demonstrates the importance of legal methods for reducing agency costs. The details of these market mechanisms in the context of China will be discussed in the next chapter.

[B] Legal Mechanisms

[1] The Strengths of Legal Mechanisms

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

[2] Defects of Legal Mechanisms

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

26. For example, see M. A. Eisenberg, 'The Structure of Corporation Law' (1989) 89 *Columbia Law Review* 1461; J. N. Gordon, 'Corporations, Markets, and Courts' (1991) 91 *Columbia Law Review* 1931.
27. J. P. Humphrey, 'On the Definition and Nature of Law' (1945) 8 *Modern Law Review* 194.
28. For details of one-off misappropriation, please see: Z. Zhang, *The Derivative Action and Good Corporate Governance in China* (Lambert Academic Publishing 2011) 60-66.

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

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

[3] Public or Private Enforcement of Law?

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

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

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

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

§1.08 STRUCTURE

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

CHAPTER 2

The Need of Enhancing Derivative Actions in China

§2.01 DOUBLE AGENCY COSTS IN CHINA

[A] Introduction

The separation of ownership from management is recognized as one of the core structural characteristics of a business corporation.[1] This key distinctive feature is the necessary consequence of rising capital and economic development as the modern economy requires companies to be professionally managed and investors to be free to concentrate on expanding their investments rather than participating in management. However, this separation also means that those who run companies do not own them whilst those who are members of corporations do not control them. Here, agency costs, (derived from economic jargon), may arise where the interests of shareholders and managers are not aligned. It is thus recognized that the central objective of Company Law is to reduce agency costs; good corporate governance would achieve this target.

China has been experiencing unprecedented economic and social development owing to its economic reform and open policy. During this process, the reform of the company – the basic component of the business world – has been and remains a key

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

issue. The significant economic achievements of the recent past could not have been attained without corporation reform, though this also creates a number of difficulties that must be addressed. Prevalent reports of exploitation by majority shareholders and managers have enhanced the view that agency costs in Chinese companies are exceptionally severe. Thus capital market and economic development would be negatively affected if agency costs were not properly addressed.

This part does not aim to examine China's agency costs from an economic perspective as there is already a vast amount of literature which does so.[2] Rather, the purpose is to explore the historical causes and development of Chinese agency costs. Indeed, unusually, there are currently two forms of agency costs prevalent in China: vertical and horizontal. This is a rarity as other countries normally only experience one of the major forms of agency cost. As such, it highlights the need for and value of this part in exploring the causes and development of these two types of agency costs. In discussing this issue, this part will first introduce the theory of and background to agency costs. It will then go on to introduce vertical agency costs, namely the agency problem between shareholders and managers, exploring State-owned Enterprises (SOEs) reform and the development of insider control. The third section will address horizontal agency costs, namely the agency problem between majority shareholders and minority shareholders. This part concludes that the severe agency costs in China undoubtedly generate need for the establishment of strong protective methods for minority shareholders. Further, mechanisms to reduce agency costs cannot be properly established without acknowledging these double agency costs in China.

[B] Background to Agency Costs

Since Berle and Means first unveiled the theory of control over the corporate form,[3] the economic term 'agency' has gradually become utilized in legal scholarship. In *The Modern Corporation and Private Property* they highlighted that those who control large public companies do not necessarily have substantial ownership interests in them, while conversely, those who own such corporations do not manage them.[4] This separation of ownership from management is justified on several counts. First, management/control of a company is vested in its board of directors. As a corporation itself is a non-natural person, it is incapable of expressing its will and conducting business without human mediation. Since it is impossible for all the shareholders to

2. For example, see: X. Wang, 'A Study on the Factors Affecting the Agency Cost of SOEs' (2008) 5 *Economic Survey* 101-107; J. Chen, 'The Empirical Analysis of Affection from Executive Compensation to Agency Costs in Family Business' (2010) 32 *Economic Management* 72-77; J. Lv and H. Den, 'Effect of Ownership Governance Structure of Listed Company on the Agency Cost on the Condition of Full-Circulation – Based on the Empirical Data of Manufacture Listed Company from the SMEs Board' (2010) 11 *China Soft Science magazine* 136-143.
3. A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (2nd revised edn, Transaction Publishers, 1991).
4. See also P. Redmond, *Companies and Securities Law: Commentary and Materials* (3rd edn, Law Book Co 2000) 181.

run the company, particularly when shares are widely distributed, it becomes necessary to delegate management to the board of directors in order to make the company work in reality. Second, the rapid development of the capital market signifies that the profits of a company do not depend on investor energy and initiative but on management. Formerly, investment in property tied a person to that property. However, the modern capital market renders property less concerned with investors, allowing them to invest in various companies without worrying about the actual status of their property. In this sense, a shareholder in a listed company has now ceased to be a quasi-partner and has become a mere supplier of capital.[5] Third, the separation of ownership from management also creates opportunities for professional managers to run companies and thus increase their benefits. In the modern economy, a company must respond quickly to market reactions, taking decisive measures by which to compete; without professional management a company is unlikely to achieve a competitive advantage. The employment of professional persons with managerial skills is therefore both important and necessary, even if they are not themselves members of the company. Fourth, this separation also benefits investors themselves. Shareholders would barely have the time or energy to look for other investments if they had to participate in the management of every venture. Indeed, it is almost impossible for an individual shareholder with a large portfolio personally to manage every company in which he or she holds shares. In allowing investors to focus on investments, separation therefore expands the capital market and the economy.

Whilst the separation of ownership from management can ultimately increase company benefits and promote the capital market, this separation can also create conflicts, referred to by economists as 'agency problems', when the interests of managers and shareholders are not aligned.[6] No agency problems arise if an 'agent' acts in the interests of their 'principal', though this is rare without proper legal and extra-legal constrain. Crucially, agents normally have better access to information than principals, making it difficult for principals to ensure that agents are acting in their interests.[7] Here, agents may be encouraged to pursue their own interests over their principals, leading them to act opportunistically by taking advantage of their powers. Such abuse of power would undoubtedly affect an agent's management performance, thereby reducing the principal's confidence. Such divergence of interests generates both monitoring cost for principals wishing to police agent performance, and bonding costs for agents to assure principals that their interests are being pursued.[8] Given the

5. R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 46.
6. See, e.g., S. Ross, 'The Economics Theory of Agency: The Principal's Problem' (1973) 63 *American Economic Review* 134.
7. R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 35.
8. M. Jensen and W. Meckling, 'The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *J. of Fin. Econ.* 305; I. Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales L. J.* 151.

risks borne by principals, it is argued that one of the functions of corporate law is to control conflicts between the various interests of company constituencies to reduce these agency costs.[9]

Three agency problems have been identified in business firms: vertical agency problems between shareholders and managers, horizontal agency problems between majority shareholders and minority shareholders, and agency problems between a firm itself and the other parties with whom that firm contracts.[10] As the latter agency problem does not constitute an agency cost internally within the company and is therefore beyond the scope of Company Law,[11] it will not be addressed in this chapter. Concerning the first two agency problems, various studies have identified a relationship between ownership structure and agency cost.[12] In jurisdictions where share ownership is dispersed, such as the UK and the USA, managerial agency costs are generally much more serious. That is because managers have much greater power to control a company as scattered shareholders mean that no blockholders are able to monitor management.[13] Conversely, for those jurisdictions with concentrated ownership, such as Germany, the managerial agency problem is not a major issue; rather, conflicts between controlling shareholders and non-controlling shareholders are of principal concern.[14] In these ownership-concentrated countries, majority shareholders have both the ability and incentive to constrain the directors' performance. At the same time, agency problems between majority and minority shareholders are created as the former can impose their influence on the company to benefit themselves at the expense of the latter. Although these two types of agency problems can coexist, they are usually mutually exclusive as countries generally have dispersed ownership or concentrated

9. R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 35.
10. R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 36.
11. The agency problem between a company and a third party with whom the company contracts can be treated as a dispute between two parties and thus is regulated by other laws, such as contract law and tort law.
12. See E. Berglöf, 'A Note on the Typology of Financial Systems'. In K. Hopt and E. Wymeersch (eds.), *Comparative Corporate Governance: Essays and Materials* (Walter de Gruyter 1997) 151-164; J. Armour, S.Deakin and S. Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41 *British J. of Industrial Relations* 531, 533; B. Cheffins, 'Putting Britain on the Roe Map: The Emergence of the Berle–Means Corporation in the United Kingdom' In J. McCahery and L. Renneboog (eds.), *Convergence and Diversity in Corporate Governance Regimes and Capital Markets* (Oxford University Press 2002) 147-170.
13. See R. L. Porta, F. Lopez-De-Silanes, A. Shleifer and R. Vishny, 'Corporate Ownership around the World' (1999) 54 *J. of Fin.* 475; M. Aoki, 'Controlling Insider Control: Issues of Corporate Governance in Transition Economies' In M. Aoki and H. Kim (eds.), *Corporate Governance in Transition Economy, Insider Control and the Role of Bank* (EDI Development Studies 1996) 5.
14. See B. Cheffins, 'Putting Britain on the Roe Map: the Emergence of the Berle–Means Corporation in the United Kingdom' In J. McCahery and L. Renneboog (eds.), *Convergence and Diversity in Corporate Governance Regimes and Capital Markets* (Oxford University Press 2002) 147-170; For more discussion on this, please see: R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 29-32.

ownership structures. However, this is not the case in China owing to its special policy on SOEs, discussed in the next part.

[C] Vertical Agency Costs between Shareholders and Managers

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

[1] The SOE Reform

Following the opening up policy of 1978, SOE reform was recognized increasingly to be extremely important to the Chinese economy. The tax system at that time was very simple and financial revenue was limited, as the primary source of public revenue was SOE profits.[15] Unfortunately, SOEs suffered from chronic inefficiency and low productivity, incurring numerous debts and losses.[16] Fears about the ever-deteriorating performance of SOEs threatening the nation's entire economy were growing and a consensus reached for reform. Initial reform separated ownership and management proclaiming that SOEs should become independent entities and thus be responsible for their own profits and losses.[17] Levels of government interference were thereby reduced. However, this reform was not implemented effectively owing to the mixed political climate of that time. Fears about the peaceful infiltration of Western ideology and structuralism remained widespread owing to the cold war. Therefore SOE ownership stayed with government, rather than SOEs themselves. In 1988, state administration was spilt from SOE management in a bid to improve SOE performance, using a contract system. This system required SEO directors to sign contracts with their supervisory authorities to set performance targets; this initiative turned out to be another failure.

Concern about the inefficiency of SOEs remained ongoing and the collapse of the Soviet Union intensified the anxiety that economic failure would lead to a breakdown of the political system. Therefore, following Deng Xiaoping's southern tour speech, the

15. Z. Lin, 'Recent Development of Tax System Reforms in China: Challenges and Responses' (2001) 27 *Int'l Tax J.* 92-93.
16. W. W. Wang, 'Reforming State Enterprises in China: The Case for Redefining Enterprises Operating Rights' (1992) 6 *J. of Chinese L.* 89, 131.
17. Zhonggong Zhongyang Guanyu jingji Tizhi Gaige de Jueding [Decisions of the CPC Central Committee on the Economic Structure Reform], adopted by the Third Plenary Session of the CPC Twelfth National Congress on 20 Oct. 1984.

socialist market economy was established and SOE-oriented reform was launched. The target for SOEs was to establish a modern enterprise system; that, according to the 1993 Decision, would 'clarify property rights, designate authorities and responsibilities, separate government and enterprise functions and establish scientific management'.[18] The principal approach in achieving this objective was to sever government intervention from company management by corporatizing SOEs, thus releasing the government from its unlimited responsibility. It anticipated SOEs could thereby plan their own productivity in line with market demand and raise funds through capital markets to expand their business. Indeed, corporatization did improve efficiency and significantly increased overall value.[19]

While the separation of ownership and management was a solution to prevalent problems, it also raised fundamental issues where discretion and power could be abused by managers, incurring managerial agency costs. This was particularly so in China, which then lacked an efficient system to supervise management conduct and protect the interests of shareholders, and indeed still does. In recent years, news of SOEs losses occasioned by mismanagement has been widely reported. A notorious example was the China Aviation Oil (Singapore) Corporation (CAO) scandal. CAO announced a USD 550 million loss in oil derivatives trading, exceeding the company's registered capital of USD 549 million, owing to poor management. This scandal, as Jackson highlights, revealed internal control failures at virtually every level of management.[20] Moreover, CEO, Chen Jiulin, who was subsequently imprisoned, had been receiving the highest salary of any chief executive in the country.[21] Another example was the scandal of the China National Cotton Reserves Corporation (CNCRC), which is also an SOE. It was reported that CNCRC had lost almost RMB 1,000 million making false bets on prices after failing to sell its expensive cotton stocks when prices plunged. Reports also indicated that the cotton speculative trading decisions were being made by only a few executives rather than a formal decision-making procedure.[22] Investigations conducted by the Key Laboratory for Management, the Decision and Information Centre and the Virtual Economy and Finance Research Centre have found that lack of accountability of managers to shareholders (namely the government), poor corporate governance and the ineffectiveness of binding mechanisms, led to this tragic loss.[23] The above facts, which are only a part of the whole picture, vividly illustrate the negative

18. Zhonggong Zhongyang Guanyu Jianshe Shehui Zhuyi Shichang Jingji Tizhi Ruogan Wenti de Jueding [Decisions of the CPC Central Committee on Some Issues Concerning the Establishment of a Socialist Market Economy System], adopted by the Third Plenary Session of the CPC Fourteenth National Congress on 14 Nov. 1993.
19. Q. Ye, 'Xinzhongguo Chengli 60 Zhounian lai Woguo Guoyouqiye Gaige de Licheng yu Chengxiao' [The Historical Development of SOEs Reform after the Establishment of PRC] (2009) 67 *Jingji Yanjiu Cankao* [Review of Economic Research] 10-25.
20. K. T. Jackson, 'The China Aviation Oil Scandal' In S. Matulich and D. M. Currie (eds.), *Handbook of Frauds, Scams and Swindles: Ethical Failures in Leadership* (CPC Press 2008) 151-160.
21. China Daily News <http://www.chinadaily.com.cn/english/doc/2004-12/23/content_402605.htm> [lasted visited 29 Apr. 2014].
22. Sohu news <http://news.sohu.com/20050113/n223916814.shtml> [lasted visited 29 Apr. 2014].
23. Available at <http://madis.iss.ac.cn/dct/page/65574> [lasted visited 29 Apr. 2014].

implications of SOE reform, despite its improvement of SOE performance in general. Furthermore, SOE reform in the absence of a legal system and other binding mechanisms inevitably induces insider control problems in China.

[2] Insider Control

The insider control problem accompanies the evolution of SOE reform in China. Before exploring this problem, some conceptual issues should be clarified. Owing to the socialist nature of the market, SOEs are managed or controlled by different levels of organ. At least six strata can be identified in practice: central government leadership, local state government,[24] relevant central ministries, local organs supervising SOEs, managers and workers.[25] Within this framework, SOE insiders are managers and workers while all other organs are outsiders. Although workers are regarded as insiders, their ability to participate in the management of SOEs is strictly limited. This seems absurd given the Chinese government's declaration that the PRC was established under the leadership of the working class, whilst trade unions now serve a mere decorative function within SOEs without any practical input. From this perspective, there is in fact only one effective insider organ within an SOE: management. For outsiders, some government agency reform has taken place. During the planned economy era, SOEs were controlled by central government, or local governments delegated or authorized by the central state. With the initiation of the market economy, control rights were first transferred from central government to the Commission for Managing State Properties, and then to the Ministry of Personnel. The most recent supervising agency is the State-owned Assets Supervision and Administration Commission of the State Council (SASAC).[26]

Having clarified the concepts of insider and outsider in China, the notion of insider controls must now be addressed. 'Control' in corporations means the right and power to make decisions about important issues like business strategy, dividend distribution and personnel arrangements. According to Aoki's theories of the firm,[27] the concept of insider control in China is quite different from other jurisdictions. In Japan, insider control normally refers to controlling shareholders and affiliated companies in a business group (*keiretsu*), with the labour unions taking second place. Under an Anglo-Saxon company model, the power of labour unions is relatively weak

24. Strictly speaking, not only the government, central or local, controls the SOEs, but importantly, the Party. It is common sense, particularly in Western countries, for the Party and the state to be different entities. In China, however, there is no need to separate the concepts of party and state as they are intermingled. This is confirmed by the Constitution in stating that 'the State should be led by Chinese Communist Party'.
25. K. Lee and D. Hahn, 'From Insider-Outsider Collusion to Insider Control in China's SOEs' (2004) 40 *Issues & Studies* 1-45.
26. The SASAC has central and local agencies which supervises central SOEs and local SOEs respectively.
27. M. Aoki, 'The Japanese Firms in Transition' In K. Yamamura and Y. Yasuda (eds.), *The Political Economy of Japan* (Stanford University Press 1987) 263-88; M. Aoki, 'Towards an Economic Model of the Japanese Firms' (1990) 28 *J. of Econ. Literature* 1-27.

costs with the ineffectiveness of market forces and legal mechanisms in China reveals the fact that derivative action is strongly needed to provide protection for Chinese minority shareholders.

Since it is now clear that derivative action should play an important role in constraining managers and controlling shareholders, another question arises as to whether the new statutory derivative action has functionally worked. It cannot be denied that the adoption of a derivative action system is a step forward in the development of China's Company Law, but the built-in defects in this new institution may discourage shareholders from initiating litigation to protect themselves; they may also provide an excuse for the courts to evade hearing derivative actions. The near absence of cases in JSCs has shown that the system of derivative actions is simply not working, regardless of the reasons behind this absence, speculated on above. Furthermore, various cases in limited liability companies also demonstrate the fact that the vagueness and defects of the law lead to the chaos and unsystematic judicial practice. In sum, China's mechanism for derivative actions, which ought to play a key role in reducing agency costs, remains insufficient to support accountability for managers and controlling shareholders. In view of this, it is necessary to examine derivative actions in the UK and US. Suggestions from these two jurisdictions may possibly be borrowed to improve the system of derivative actions in China.

CHAPTER 4
Comparative Analysis

§4.01 WHY DERIVATIVE ACTIONS CAN BE ENCOURAGED

As discussed in previous chapters, there are double agency costs in China and thus minority shareholders risk exploitation by both majority shareholders and managers. To reduce these agency costs, legal mechanisms and market forces have been examined and found to be ineffective in constraining the misbehaviour of majority shareholders and managers for a number of reasons. Derivative actions, as one legal mechanism for protecting the interests of minority shareholders, should therefore have a key role to play. In light of the inherent defects in the new statutory derivative actions regime in China, it is submitted that restrictions on derivative actions should be relaxed and shareholders are encouraged to raise proceedings. However, the foregoing discussion only addresses why derivative actions should play a significant role in monitoring management; it does not address why shareholders can be encouraged to exercise this right.

In fact, this touches the stone of legal transplant theory. As discussed in Chapter 1, there are basically two arguments for legal transplant: voluntary transplant and contextualist or culturalist theory. The former theory generally believes that legal transplant is socially easy while the latter recognizes that the social context of the recipient country should be noted that. In addition to the demonstration of why legal transplant is possible in China which has been discussed in Chapter 1, this book argues that the social context is not unimportant for legal transplant. With regard to derivative action, there are two factors which should be noted when attempting to improve derivative actions. As such, this part will examine why litigation can be developed on Chinese soil, mainly from the perspective of culture and the judiciary.

[A] Culture

It is recognized that culture can deeply affect the means of resolving disputes.[1] Indeed, choice of means for dispute resolution is strongly influenced by the peculiarities of traditional culture. As Chen argues, the means adopted by a society to resolve disputes depends on its available resources, cultural inclinations and philosophic leanings.[2] From this theoretical perspective, it is argued that Chinese culture is not suited to encouraging litigation. It is well known that Confucian ethics are strongly rooted in Chinese culture and that the core principle of these ethics is the belief that harmony among persons must be achieved.[3] Five cardinal relationships that must be honoured to achieve a stable social order are identified in Confucian ethics: father and son, ruler and subject, husband and wife, elder and younger brother, and friend and friend. Confucianism believes that although such relationships can be achieved by resorting to the law, their stability cannot last for a long time as the law cannot deliver kindness, humanity, compassion and benevolence. In the Analects of Confucius, it is clearly stated that:

> I can hear a court case as well as anyone. But we need to make a world where there is no reason for a court case. If you use government to show them the way and punishment to keep them true, the people will grow evasive and lose all remorse. But if you use integrity to show them the way and ritual to keep them true, they will cultivate remorse and always see deeply into things.[4]

The influence of this Confucian culture means that Chinese people are not willing to resolve their disputes in courts. Instead, they might choose a means of settling disputes privately. In light of this, it is argued that court-based dispute resolution would not be popular in China and thus shareholder litigation would not be aggressively used.

However, this book opposes the above arguments for the following reasons:

First, while Confucian culture is widely known in traditional China, another school of Chinese thought, the Legalists, has been intentionally or unintentionally neglected in the debate. This school of thought believes that a nation's cohesion can be secured by the application of strict legislation as well as harsh and draconian punishment.[5] The application of this school of thought was exemplified by the first emperor of unified China, Qin Shi Huang, who organized the construction of the Great Wall and who also emphasized the necessity of using cruel punishment for those who dared to show even the slightest resistance. Throughout the history of China, the

1. C. D. Vera, 'Arbitrating Harmony: "Med-Arb" and the Confluence of Culture and Rule of Law in the Resolution of International Commercial Disputes in China' (2004) 18 *Colum. J. of Asian L.* 149-194.
2. G. B. Chen, *Law without Lawyers, Justice without Courts: On Traditional Chinese Mediation* (Ashgate Publishing 2002) 1.
3. U. M. Lauchli, 'Cross-Cultural Negotiations, with a Special Focus on ADR with the Chinese' (2000) 26 *William Mitchell Law Review* 1045, 1062.
4. Confucius as quoted in U. M. Lauchli, 'Cross-Cultural Negotiations, with a Special Focus on ADR with the Chinese' (2000) 26 *William Mitchell Law Review* 1059.
5. X. Ren, *Tradition of the Law and Law of the Tradition: Law, State, and Social Control in China* (Praeger Publisher 1997) 21.

Legalist school has been accompanied by the Confucian school. Its main belief of adopting strict laws to secure social stability has undoubtedly had an influence on Chinese dispute resolution. Therefore, Confucianism is not the only traditional culture to affect methods for resolving disputes; another traditional counter-culture has encouraged people to use law to resolve disputes.

Second, even though Confucianism has had much more influence than the Legalist school on Chinese culture, its ability to play a significant role in litigation is highly doubtful given China's increasing economic and social development. Unlike China's ancient society, the country is now experiencing a fast economic miracle, leading to transformation in almost every aspect of the nation's being. Consequently, a commercial culture is gradually becoming established. One of the core principles in commercial culture is that everyone should be held accountable for his or her behaviour. For example, anyone who fails to perform obligations under a contract should be held responsible for that failure and thus be prepared to be sued if they do not redress the damage caused by their non-compliance. Therefore, in commercial culture it is normal, or at least not unusual, to resolve disputes by bringing litigation. Another factor that encourages litigation as a result of commercial culture is that people are not afraid to do business with strangers. This inevitably leads to the phenomenon that one party would not hesitate to initiate an action against another if they have violated an agreement. This is particularly true in China as Chinese people are not willing to raise actions against those they are familiar with, owing to the need to 'face'[6] and '*renqing*'.[7]

Third, empirical studies have shown that Confucianism may not have any bearing on private shareholder litigation. For example, in Japan, which was and still is dominated by Confucian culture, only twenty derivative lawsuits were raised in the first thirty-five years after the introduction of derivative actions. It was argued that Japanese shareholders would forgo bringing derivative suits for financial gains owing to the cultural obsession with maintaining social harmony.[8] However, this argument lost its ground as the number of derivative actions being raised started to rise in 1980s. After litigation cost reforms in 1993, the number of derivative actions being brought rose rapidly, peaking in 1999 with ninety-five new actions filed and a total of 222 actions pending.[9] This fact strongly refutes the argument that Japan's culture was solely responsible for low litigation rates. Mark Ramseyer has even claimed that the

6. 'Face' is similar to 'honour', which is defined by 'one's accumulated moral and social prestige in the eyes of the community'. See C. Hutu, *China – Its People, Its Society, Its Culture* (HRAF Press 1960) 493.
7. '*Renqing*' is equivalent to 'personal goodwill' as it relates to the imperative that one party grant a favour to another party based on the nature of their relationship. The closer the relationship is, the greater the expectation and obligation of fulfilling one's renqing with the other. See C. D. Vera, 'Arbitrating Harmony: "Med-Arb" and the Confluence of Culture and Rule of Law in the Resolution of International Commercial Disputes in China' (2004) 18 *Colum. J. of Asian L.* 149-194.
8. M. West, 'The Pricing of Shareholder Derivative Actions in Japan and the United States' (1994) 4 *Northwestern University Law Review* 1436-507; T. Ginsburgh and G. Hoetker, 'The Unreluctant Litigant? An Empirical Analysis of Japan's Turn to Litigation' (2006) 35 *J. of Legal Studies* 33.
9. D. W. Puchniak and M. Nakahigashi, 'Japan's Love for Derivative Actions: Irrational Behaviour and Non-Economic Motives as Rational Explanations for Shareholder Litigation' (2012) 45 *Vanderbilt J. of Transnational L. Vol.* 1-82.

cultural theory was little more than a tautology.[10] In China, the increasing amount of litigation being engaged in also shows that Confucian culture may have less influence on private litigation than expected. After the Cultural Revolution, litigation actions rose significantly from 613,272 cases in 1979 to 7,462,488 cases in 2009. Civil litigation constituted 51.9% of these actions in 1979, rising to 86.2% in 2009.[11] In the first half of 2012, the number of private lending cases alone was 376,000, an increase of 24.78% compared with the same period for 2011.[12] The boom in commercial suits reveals that the influence of Confucian culture, which discourages litigation, is declining.

The influence of culture on litigation is not unilateral. Instead, there is an interaction between culture and derivative action. As discussed above, commercial culture, which has been promoted by China's economic development, indicates that people would not hesitate to bring an action against others if it is necessary to do so. As such, the establishment of this culture would encourage the use of derivative actions. However, the strengthening of derivative actions has the capacity to assist in the evolution of commercial culture in China. The main purpose of derivative actions is to protect the interests of minority shareholders and the company from being exploited by directors or controlling shareholders. It can thus be regarded as a means of tackling corporate corruption and wrongdoing. From this perspective, derivative actions harbour the transformative potential of fostering a particular conception of a free commercial culture. As a result, the active use of derivative actions can have a positive impact on promoting commercial culture, which would be beneficial to derivative actions themselves in return.

[B] The Judiciary

Another argument seeks to posit that China's current judiciary may not be able to deal with the increasing volume of litigation, especially derivative actions needing specialist securities knowledge. This is true to some extent as the competence of Chinese judges has been criticized for a long time owing to an earlier policy permitting retired military officers to work as judicial authorities. As a result of this policy, many judges lacked legal knowledge as they had little or no legal education. However, the situation has been changing in recent years making the judiciary capable of dealing with derivative action cases for the reasons outlined below.

First, Chinese judges are becoming increasingly competent. A new Judges Law[13] has replaced the previous policy and stipulates the need for qualifications for becoming a judge. For example, it requires an academic degree and work experience. Furthermore, entry-level judges are to be selected from individuals who not only meet the

10. J. M. Ramseyer, 'The Costs of the Consensual Myth: Antitrust Enforcement and Institutional Barriers to Litigation in Japan' (1985) 94 *Yale L. J.* 604-607.
11. J. Zhu, Zhongguo Jin 30 nian lai Susong Anjian Shuliang Fenxi [Quantity Analysis on the Chinese Lawsuits for the Past 30 Years] *Fazhi Ribao* [Legal Daily News] 18 Jan. 2012.
12. *Ibid.*
13. The Judges Law of the People's Republic of China (hereinafter Judges Law) was first enacted in 1995 and then revised in 2001.

basic requirements,[14] but have also passed a National Judicial Examination (Bar Exam).[15] The bar exam in China is known to be 'the most difficult exam in the world' because of its low pass rate. With these strict requirements, it is believed that Chinese judges will become increasingly competent.

Second, it is argued that if shareholders are encouraged to raise litigation, the courts will be heavily burdened in light of the prevailing exploitation of minority shareholder interests. Indeed, derivative actions may rise sharply if unnecessary restrictions are removed and shareholders are given strong incentives to exercise their right to take derivative action. However, there are sufficient judicial resources to deal with this increase in shareholder litigation as judges have risen in number from 130,000 in 1991 to 250,000 in 2010. This has created the availability of approximately one judge to every 48,000 people – a ratio that is much higher than in other jurisdictions. Although it is argued that some judges do not engage in the business of rendering judgment as they are responsible for administrative affairs, one of the tendencies of modern judicial reform in China is a reduction in the number of administrative judges. In addition, every year courts are recruiting increasingly qualified people to engage in judgment business with the retirement of non-competent judges who have no or little legal training. As a consequence, it can be expected that the judiciary would have little difficulty in dealing with the increase in such cases.

Third, the courts are now more willing to accept shareholder litigation. Traditionally, courts have been unfriendly to private securities litigation. As early as 1996, shareholders repeatedly attempted to file suits with the courts, without one case being accepted.[16] One example can vividly illustrate the unfortunate situation at that time. A company shareholder brought an action after the company's Chairman was sentenced to prison for committing financial fraud. However, the shareholder's application was refused by the court despite the clear evidence of wrongdoing, demonstrated by the chairman's criminal conviction.[17] This position continued even after the enactment of China's securities law in 1998. In the face of this situation, the SPC surprisingly issued a report in 2001 stating that all lower courts should refuse to hear private securities litigation cases. However, this prohibition was suddenly changed in 2002 as the SPC lifted the restriction on accepting cases, though the only available cause of action was limited to false disclosure. After specific rules for handling private securities cases were issued by the SPC, the courts started to accept such litigations. Although the limited availability of civil remedies continues to be criticized, it is apparent that the attitude of the courts towards shareholder litigation has changed in a direction that is increasingly

14. For example, a person who wants to be a judge in a High Court must have engaged in the legal work for at least three years in the cases of a law student from colleges or universities or from non-law graduate of colleges or universities but possessing the professional knowledge of law. See Art. 9 of Judges Law.
15. See Art. 12 of the Judges Law.
16. See: W. Hutchens, 'Private Securities in China: Material Disclosure about China's Legal System?' (2003) 24 *U. of Penn. J. of Int'l Econ.* 599-689.
17. C. E. Walter and F. J. T. Howie, *Privatizing China* (2nd edn, John Wiley & Sons (Asia) Pte Ltd 2006) 61.

friendly towards shareholders. With the increasing awareness of the need to protect investors, Chinese courts can be expected to be more open to shareholder litigation.

[C] Summary

The previous chapters attempt to demonstrate that derivative actions should be actively used and shareholders should be strongly encouraged to bring litigation. However, there is a concern that the traditional culture of unwillingness to raise proceedings and the lack of competent judiciary may hinder the improvement of derivative actions. Indeed, the Confucianism encouraging people to resolve disputes without going to the courts and the old policy permitting retired military officers to work as judicial authorities seem to provide obstacles for establishing effective derivative action system. Nevertheless, this part demonstrates that this worry is groundless owing to the co-existent culture of Legalist school and the enactment of the Judges Law.

§4.02 IMPROVING CHINA'S DERIVATIVE ACTIONS

The previous chapter identified some loopholes in and problems with derivative actions in China. Although some possible solutions were provided in the process of analysis, some issues are not resolved. As such, this part will focus on tackling these unsolved loopholes and thus improve the system by looking to UK and US jurisdictions. In light of the importance of funding rules in providing incentives for shareholders to initiate derivative litigation, the funding issue will be examined separately in the next chapter.

[A] Who Can Sue?

The standing requirement for individual shareholders to bring derivative actions in China is criticized for having too high a standard. This is because as an eligible plaintiff shareholder in JSC is required to hold 1% or more of the total shares separately or aggregately for at least 180 consecutive days. It is argued that this standing requirement should be relaxed in order to provide stronger protection for minority shareholders. Moreover, there may be some other factors that could be borrowed from standing requirements in the UK and the US.

[1] The Standing Requirement in the UK

The scope of *locus standi* for shareholders in the UK to bring derivative actions has been widened. According to section 260(5)(C), a derivative action can now be initiated either by a shareholder or by a person who is not a member of the company but to whom shares in the company have been transferred or transmitted by operation of

law.[18] In addition, a shareholder ownership threshold does not need to be met, which means that it is theoretically possible for a claimant to purchase one share with the view to commencing derivative litigation. The new statutory rule also retains the common law position that a shareholder is entitled to initiate litigation even where the cause of litigation arose before he or she became a member of the company. This is different from the standing requirements in the US.

[2] The Standing Requirement in the US

Individual shareholders must meet certain requirements in order to initiate derivative actions in the US. There are currently four general standing requirements. First, the plaintiff must be a member of the company when the action is initiated regardless of a record owner of shares or have some beneficial interest in an equity security. Second, so-called contemporaneous ownership is required. This means that the plaintiff has to have been a shareholder when the alleged conduct took place. They may also meet this requirement if they acquired their shares by operation of law from a former holder who owned the shares at the time that the conduct complained of occurred. Third, 'continuing ownership' is also required. This means that the plaintiff must continuously be the member of the company during the period of the action. Lastly, the plaintiff must be able to represent the interests of the shareholders fairly and adequately.

[3] Suggestions for China

Clearly, standing requirements in the UK and the US are quite different from one another. It seems that the scope of plaintiff shareholders in the UK is much wider than in the US, which may create the perception that derivative actions are stronger and more frequently utilized and favoured in the UK as compared to the US. However, this is not the case as there are a number of other factors that affect the function of derivative actions in these two countries. Standing in these two countries is analysed further below.

[a] Is the Principle of Contemporaneous Ownership Needed?

In the UK, contemporaneous ownership is not necessary to bring a derivative action as such actions are intended to benefit the corporate entity as opposed to any individual shareholder. It has therefore been found that 'it never can be held that the acquiescence of the original holder of stock in illegal acts of the directors of a company will bind a subsequent holder of that stock to submission to all future acts of the same character'.[19] However, this lack of restriction on the standing of plaintiffs may provide opportunities for malicious shareholders to bring frivolous litigation.

18. Section 260(5)(c) of the Companies Act 2006.
19. *Bloxam v. Metropolitan Rly Co* (1868) 3 Ch. App 337 at 354 *per* Lord Chelmsford LC.

In the US, the answer to this question differs as contemporaneous ownership is required. It was originally established to prevent collusion in manipulating cases to create federal jurisdiction.[20] The requirement has now been developed to prevent unjust enrichment on the part of those who acquired their shares with knowledge of an alleged wrong to discourage the litigation of purchased grievances. However, the justification for this rule has been strongly contested by scholars as the requirement goes well beyond these legitimate policy objectives. Two problems have been identified with the rule: first, it is argued that preventing the purchase of suits is not the true concern of this rule. Thus, the rule may be relaxed to allow a shareholder who bought shares before discovering an alleged wrongdoing to initiate a derivative action despite not being a member of the company when the wrongdoing occurred. Second, the prevention of unjust enrichment cannot act as a true justification as any recovery will go to the company and thus all current shareholders would benefit no matter when he or she became the member of the company. A windfall for some shareholders is therefore inevitable. In fact, some shareholders who purchased shares after the alleged wrong may sustain injury under the rule as they are highly unlikely to have paid a discounted price for the shares if the wrongdoing was not publicly disclosed.

The above concerns have been recognized resulting in the adoption of a corrective doctrine of 'continuing wrong exception' in some jurisdictions. Under this doctrine, a shareholder is entitled to initiate a derivative action if the alleged wrong was still 'continuing' at the time when they bought the company's shares. However, it is argued that this exception makes the contemporaneous ownership requirement more complicated, as the standards to define 'continuing wrong' have been applied differently.[21] For example, one court stated that a wrong is a continuing one when 'it spans the plaintiff's ownership, or if new elements in a pattern of wrongful conduct occur after acquisition'.[22] By contrast, another court has framed this continuing wrong exception as occurring when the conduct forming the basis for the cause of action was legally complete.[23] Furthermore, some courts have been very conservative towards this doctrine as it might swallow the contemporaneous ownership rule.

The above discussion suggests that the contemporaneous ownership rule may be appropriate for adoption in China. In addition to the general aforementioned rationales behind this principle, there are some other circumstances that justify the adoption of this rule. First, the absence of contemporaneous ownership may create a market for claims. If an investor knows of wrongful behaviours taking place in a company in which he does not hold any shares, he may seek to purchase a shareholding of that company to bring an action. It may at first sight seem to be good for the company's

20. The original purpose behind the contemporaneous ownership rule was that the US courts feared that shareholders who resided in the same state as the corporate defendants would transfer their shareholdings to individuals who resides in other states in an effort to confer diversity jurisdiction upon the federal courts. See R. C. Ferrara, K. T. Abikoff and L. L. Gansler, *Shareholder Derivative Litigation: Besieging the Board* (L. J. Press 2005) s. 4.02 [2].
21. See R. C. Ferrara, K. T. Abikoff and L. L. Gansler, *Shareholder Derivative Litigation: Besieging the Board* (Law Journal Press 2005) s. 4.02 [3] [b].
22. *Bateson v. Magna Oil Corp.*, 14 F,2d 128, 130 (5th Cir. 1969), cert, denied 397 US911 (1970).
23. *Brambles USA, Inc. v. Blocker*, 731 F. Supp. 643, 650 (D. Del.), rehearing denied 735 F.Supp.1239 (D.Del.1990).

shareholders as the initiation of such proceedings could protect their interests from being exploited. However, it fails to be advantageous for the capital market in the long run as buying claims is not only morally wrong but also against the capital market's aims. Generally, buying a company's shares implies that you value that company or at least believe that its shares price will increase sooner or later. However, if the purpose of buying those shares is to bring an action rather than make a profit, the objective of the capital market is affected or hampered. Second, a market for claims is not only conducive to investors and harmful to the entire market, but also hurts a company's development. A company can easily be rendered vulnerable to unmeritorious litigation as a result of such a market and its daily management would be inevitably affected. This is particularly serious in China in light of the short time that its capital market has been established and the imperfections of the country's legal system. Therefore, the contemporaneous ownership rule should be transplanted into China.

However, this rule must be relaxed to cater for the problems which have been identified above. The strict implementation of this principle may bring unfairness to shareholders, particularly when they buy shares without the knowledge of wrongdoing. As such, it is suggested that an individual shareholder should have standing to commence and maintain a derivative action even if he or she acquired the shares after the occurrence of alleged wrong provided that the alleged wrongdoing was not disclosed or specifically communicated to that shareholder. This approach emphasizes the importance of the public disclosure of alleged wrongs and it is believed that it can overcome the negative aspects of contemporaneous ownership rule.

[b] *Is the Continuing Ownership Rule Needed?*

It is unclear in China whether a derivative action should be terminated if a plaintiff shareholder losses his or her qualification as a member of the company. It is also not clear in the UK whether a former shareholder is permitted to continue a claim as a derivative claim. In the US, plaintiff shareholders are required to continue to hold the relevant shares until the time of judgment. The rationale for this requirement is the prevention of the abuse of derivative actions, as a former shareholder, who would not benefit from the recovery, may be willing to accept an improper or inadequate settlement.[24] However, whilst understandable, this rule should not be overextended as it might cause problems in certain special situations, like during mergers. Indeed, the State of Delaware has established two exceptions to the application of this rule: (1) a former shareholder might be entitled to initiate a derivative action when the merger itself is for the purpose of depriving shareholders' standing to sue or is the subject of a claim of fraud; (2) a shareholder is also allowed to sue when shareholders receive different securities due to a merger but effectively remain the owners of the same business.[25]

24. ALI Principles, s. 7.02(a)(2), Comments D.
25. X. Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer Law International 2007) 159.

It is submitted that the Delaware's approach could be adopted in China. Although the continuing ownership rule is not favourable for plaintiff shareholders as litigation would be terminated if they are no longer a member of the company, there are two reasons for adopting the US approach. First, former shareholders are unlikely to act in a company's interests; rather, they would probably act in their own interests as they have no direct relationship with the company. Second, even where a former shareholder is allowed to continue litigation, his or her claim would be rejected by the court because of their lack of direct interest in the outcome of the action.[26] Although it is argued that a failure to be a qualified shareholder may result from the manipulation of controlling shareholders or directors, this argument is addressed by Delaware's introduction of two exceptions aimed at protecting the interests of plaintiff shareholders under these circumstances.[27] These two exceptions should also be borrowed by China as a plaintiff shareholder could lose their qualification as a company member as a result of a manipulated merger. In view of the severe agency costs in China,[28] it is highly possible for controlling shareholders to disqualify plaintiff shareholders using mergers.

[c] *Is Fair and Adequate Representation Needed?*

In the US, fair and adequate representation is needed to qualify shareholders to initiate derivative actions. This requirement, which derives from Rule 23.1 of the Federal Rules of Civil Procedure, reflects the recognition that a derivative action is above all a representative action and is thus subject to many of the same abuses and problems as are class actions. Traditionally, the law of fiduciary duties provides broad standing for shareholders to contest corporate practice. As a consequence, individual shareholders may take advantage of this and gain leverage to advance those of their interests that are not shared by such holders as a class. Where such conflicts have been identified by the courts, shareholder standing to initiate derivative actions is denied. In deciding whether plaintiff shareholders are fair and adequate representatives for the interests of the company's shareholders, the primary concern is how to define 'adequacy'. Three aspects have been identified in this regard: (1) the existence of any conflict of interest that would compromise the plaintiff's ability to serve as a representative of other shareholders; (2) the competence of the lawyer representing the plaintiff; and (3) any other evidence suggesting that the action will not be prosecuted vigorously.[29]

26. Article 119 of Civil Procedural Law requires a plaintiff should have a direct interest with the case.
27. The ALI Principles also recognize these two exceptions and thus provides that a former shareholders is allowed to commence and maintain derivative actions if his failure to own the shares until the time of judgment is 'the result of corporate action in which the holder did not acquiesce, and either: (A) the derivative action was commenced prior to the corporate action terminating the holder's status, or (B) the court finds that the holder is more able to represent the interests of the shareholders than any other holder who has brought suit. See ALI Principles, s. 7.02(a)(2).
28. For more details about the agency costs in China, please refer to Ch. 2.
29. See ALI Principles, s. 7.02(a)(4), comments E.

There is no such requirement in China or the UK. This standing requirement is good for the company as a whole, because the interests of the company could be harmed if a plaintiff shareholder cannot fairly and adequately represent the other shareholders. However, this requirement is not suitable for wholesale transplantation into the Chinese system as the interpretation and application of the principle are too vague and difficult for China's courts in practice. In order to ensure that litigation interests are adequately represented and the application is clear, two matters can be considered by the courts in determining that litigation is not adequately represented. These pertain to the following situation: (1) where the purpose of the plaintiff shareholder to bring a derivative action is to gain personal benefit. For example, the shareholder may use the action as a tool to threaten a company's managers in order to obtain compensation privately. In such a situation, a plaintiff shareholder loses their standing to bring a derivative action; and (2) where the plaintiff shareholder has authorized or acquiesced to the claimed wrongdoings. As a shareholder cannot come to court with clean hands and is actually a co-defendant in such a situation, they are surely disqualified from raising proceedings.

In light of the above, it can be concluded that the fair and adequate representation rule is not suitable for adoption in China. Instead, the court should assume that the claimant shareholder adequately and fairly represents the body of shareholders unless the two circumstances outlined in the preceding paragraph apply.

[B] Who Can Be Sued?

The scope of the defendants in derivative actions in China has been extended from directors or managers to include 'other persons'. That means that a third person who is neither a company member nor a director could also be sued where they infringe the legitimate rights and interests of a company, and cause a loss. This approach is the same as that of the US where any person who damages the interests of a company may be subject to a derivative action.

In the UK, a new statutory rule has provided that a cause of action may be brought against a third party other than a director.[30] Unlike in China or the US, this provision does not mean that any third party who is not relevant to the directors could be a defendant. It only applies to those persons who have assisted directors in the breach of their duties.[31] Although the scope of defendants in the UK has been broadened, there are still some restrictions on a third party being sued, when compared to China and the US.

The current scope of potential defendants in China, particularly the scope of third parties, should be maintained for two reasons: first, 'other persons' should be interpreted liberally to include shareholders or controlling shareholders under the Chinese Company Law. Restrictions on this would inevitably create a risk that some shareholders be excluded from being sued in derivative actions. Second, an empirical

30. Section 260(3) of the Companies Act 2006.
31. D. Kershaw, *Company Law in Context: Text & Materials* (Oxford University Press 2009) 556.

study has shown that about 45% of all defendants in China fall into the category of 'other persons'.[32] If the scope of third persons were confined to those who have assisted directors in the breach of their duties, some wrongdoers could not be disciplined.

There may be a counter-argument asserting that this broad scope of defendants could put a third person at risk, especially when they are doing the business with managers or directors in good faith. Furthermore, this wide scope could be harmful to commercial certainty, which is significantly important to economic development. Indeed, it would be unfair to third persons if they were to become a potential defendant because of a good faith transaction in which they had not colluded with directors or acts. However, the law does recognize this situation and thus provides a mechanism to protect such third parties. This is stipulated in China's Property Law[33] rather than its Company Law. Article 106 of the Property Law stipulates that an assignee should be entitled to obtain the ownership of real property or movable property even if the assignor has no right to dispose of such property, as long as the following circumstances are met: (1) the assignee has accepted the real or movable property in good faith; (2) the property is transferred at a reasonable price; and (3) the property has been delivered to the assignee or registered, if that is required.[34] As such, concerns about the validity of transactions and commercial certainty are unnecessary if a third person acts in good faith.

[C] The Status of the Company

One of the features of derivative actions is that they are initiated by individual shareholders on behalf of the company owing to the fact that the company itself has failed to raise civil proceedings against the wrongdoers. It therefore seems that the company does not need to participate in this litigation as it has a plaintiff shareholder, and a director or third person as a defendant. However, as the results of the litigation will have a direct impact on the company, it should surely be involved in the derivative action in some capacity. Unfortunately, the Company Law does not stipulate what the legal status of the company is in China.

In the US, a company has a dual status in derivative actions. On the one hand, it can only serve as a nominal party defendant, as the company refuses to bring an action against wrongdoers on its behalf. On the other hand, it is the real party plaintiff as any compensation from the litigation will be ascribed to the company instead of the plaintiff shareholder.[35] In the UK, a company is also the nominal party defendant as the organ

32. See H. Huang, 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis' (2012) 27 *Banking and Finance Law Review* 619-654.
33. The Property Law of the People's Republic of China (hereinafter Property Law) was adopted at the 5th session of the Tenth National People's Congress on 16 Mar. 2007 and entered into force on 1 Oct. 2007.
34. Article 106 of the Property Law.
35. See H. G. Henn, *Handbook of the Law of Corporations and Other Business Enterprises* (2nd edition, West Publishing 1970) s. 358 at 750.

(general meeting or board of directors) of the company does not permit the initiation of an action and is thus disqualified from being a party plaintiff.

So what should the legal status of the company in China's derivative suit be? Obviously, it cannot be positioned as a party plaintiff for the following reasons: first, the Company Law specifically stipulates that the plaintiff must be a shareholder, which would be violated if the company is regarded as a party plaintiff. Second, a shareholder as the plaintiff in derivative litigation is widely accepted in various jurisdictions. Third, since the company refuses to bring a suit, it is inappropriate to treat it as a party plaintiff. Fourth, there are no cases indicating that the company should be positioned as a party plaintiff (see Table 4.1). In light of this, can the company be treated as a nominal party defendant, like in the UK and US? The answer is negative for two reasons: first, there is no such concept of nominal party defendant in the Chinese legal system. Therefore, the civil procedural law would have to be revised in order to accommodate this concept if it were adopted. Second, since there is a fundamental conflict of interests between wrongdoers and the company, a nominal defendant position would confuse or ignore this difference.

As a company is neither suitable to be regarded as a party plaintiff nor a nominal party defendant, naturally it falls within the scope of a third party without an independent claim in the litigation. According to Article 56 of the Civil Procedural Law, a third party without an independent claim refers to a party who has no independent claim to the object of the litigation, but who has a legal interest in the outcome of the case.[36] Some commentators argue that a company is not qualified to be a third party without an independent claim as in actuality it actually does have such an independent claim.[37] Indeed, a company whose interests have been damaged by a wrongdoer is supposed to have an independent claim. However, that claim is transferred to the plaintiff shareholders after the company refuses to bring an action. Therefore, a company does not have an independent claim at least in the process of a derivative action.

Moreover, the position of a third party is recognized both in regulation and practice. In 2007, the Shanghai High People's Court issued the Several Opinions on the Cases of Shareholder Derivative Actions, in which Article 2 stipulates that a company should be positioned as a third party when the People's Court is hearing shareholder derivative action case. Although these Opinions do not have any binding effect throughout the country as a whole, they do impact courts in other provinces. This has been proved by an empirical study conducted by Huang, in which the companies were treated as third parties in an overwhelming majority of cases between 2006 and 2010.[38]

36. Article 56 of Civil Procedural Law.
37. See J. Liu, *Xingongsifa de Zhidu Chuangxin: Lifazhengdian yu Jieshinandian* [Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies] (Law Press China 2006) 263.
38. H. Huang, 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis' (2012) 27 *Banking and Finance Law Review* 619.