

The Statutory Derivative Actions in China and the UK: Ten Years On

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Abstract

The statutory derivative actions were introduced over ten years ago into China under the *Chinese Company Law 2005* and into the United Kingdom under the *Companies Act 2006*. This paper conducts a comparative and empirical analysis of the development and effectiveness of statutory derivative actions in China and the UK. It also evaluates the rules on derivative actions in the *Provisions of the Supreme People's Court on Several Issues concerning the Application of the Company Law of the People's Republic of China IV*, which became effective on 1st September 2017.

Introduction

Derivative actions allow shareholders to bring an action against wrongdoing directors on behalf of the company. They play an important role in building a better regime for corporate governance, in particular in deterring directors from breaching their duties, holding directors accountable to their companies and in protecting the interests of companies and shareholders. Derivative actions were introduced into China for the first time in the *Chinese Company Law 2005* (the 'CCL 2005')¹. In total 103 derivative action cases were filed over the eight-year period from 1st January 2006 to 30th August 2013². By contrast, almost at the same time the derivative claims were codified in the United Kingdom in the *Companies Act 2006* (the 'CA 2006')³. They replaced the complex and highly unsatisfactory procedures at common law. Despite the codification, the statutory derivative claims have not been frequently used since they came into force. A total of 22 derivative claims were instituted in the UK between October 2007 and September 2015⁴.

¹ The *Chinese Company Law 2005* came into force on 1st January 2006 and the derivative actions were stated in Art 152 of the CCL 2005. The current rules are stated in Art 151 in the *Chinese Company Law* (revised in 2013).

² Shaowei Lin, *Derivative Actions in Chinese Company Law* (Kluwer Law International, 2015), p 123.

³ Sections 260-263, CA 2006.

⁴ Keay, "Assessing and Rethinking the Statutory Scheme for Derivative Actions under the *Companies Act 2006*" (2016) 16 *Journal of Corporate Law Studies* 39, 41.

At first glance, it appears from the number of cases that the derivative actions in China are more successful and more popular than those in the UK; however, on a closer look, the rules in China are far from perfect. This paper analyses the effectiveness of derivative actions in China by comparing with their counterparts in the UK; in particular, it explores the reasons why they are widely used in China and rarely permitted in the UK. The judicial attitudes will be assessed by reference to recent empirical studies of derivative action cases⁵. This paper will, by way of comparison, identify any lessons that China and the UK can learn from each other or any pitfalls to be avoided whilst taking into account the different socio-economic and legal backgrounds.

The Chinese Supreme People's Court, after over one year's Consultation⁶, recently published the *Provisions of the Supreme People's Court on Several Issues concerning the Application of the Company Law of the People's Republic of China* (the 'SPC Provisions 2017')⁷. They became effective on 1st September 2017 and introduced detailed rules on the validity of board decisions and shareholder resolutions as well as shareholders' rights and remedies. In particular, the SPC Provisions 2017 contain specific rules on shareholders' right to information, shareholders' right to dividends, pre-emption rights and derivative actions⁸. This paper will evaluate whether they have clarified the uncertainties of derivative actions in China.

1. Derivative Actions prior to the *Chinese Company Law 2005*

Derivative actions were not established under the previous *Chinese Company Law 1993* (the 'CCL 1993') and only a few cases were accepted in local courts. When shareholders intended to initiate derivative actions, the lack of statutory rules led to the courts' restrictive attitudes⁹

⁵ Huang, "Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis" (2012) 27 *Banking and Finance Law Review* 619. Shaowei Lin, "A New Perspective on China's Derivative Actions: Who is Best Suited to Assessing Derivative Actions?" (2016) ICCLR 1. Shaowei Lin, *Derivative Actions in Chinese Company Law* (Kluwer Law International, 2015)

⁶ The SPC published the *Consultation Paper on the SPC Provisions on the Application of Chinese Company Law* on 12th April 2016. <http://www.chinacourt.org/article/detail/2016/04/id/1837721.shtml>

⁷ *Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gongheguo Gongsi Fa Ruogan Wenti de Guiding* (4). Interpretation No. 16 [2017] of the Supreme People's Court.

⁸ Rules 23-26, *SPC Provisions 2017*.

⁹ In many cases, the courts were reluctant to hear derivative actions because of a lack of substantive and procedural rules in the CCL 1993. Such lawsuits would in all likelihood be unsuccessful; for example, in *Chengdu Hongguang Industrial Corporation Case*, the claim was rejected by the court on the basis that the minority shareholders were not qualified as claimants. Yang, "Comparative Corporate Governance: Reforming

and inconsistent judgments which in turn left the interests of companies and shareholders insufficiently protected¹⁰. Despite these obstacles, a few derivative actions cases were accepted by the courts and successfully litigated¹¹; for example, the judgment in *Xinlida*¹² was based on the general principle contained in Art 1 of the CCL 1993 that “the legitimate rights and interests of companies and shareholders should be protected”¹³. In *Hengtong*¹⁴, it was held that, in accordance with the general principle of “fairness, honesty and credibility” in Art 4 of the *General Principles of Civil Law 1986*, the controlling shareholder should compensate the company’s losses. These innovative judgments were applauded as they allowed derivative actions despite the lack of legal basis.¹⁵ They have been followed by more derivative actions such as *Wu Fang Zhai*¹⁶ and *Zhongqi Qihuo*¹⁷. The judgments, however, were inconsistent and it was difficult for shareholders to predict the result of the litigation in advance because of the lack of rules on derivative actions under the CCL 1993¹⁸. The

Chinese Corporate Governance” (2005) 16 *ICCLR* 8, 17. Deng, “Building an Investor-friendly Shareholder Derivative Lawsuit System in China” (2005) 46 *Harvard International Law Journal* 347, at 365. Art & Gu, “China Incorporated: The First Corporation Law of the People’s Republic of China” (1995) 20 *Yale J. Int’l L* 273, 299. “CSEC’s Report on Serious Violation of Law by Chengdu Hongduang Corporation” [Zhongguo Zhengquanhui Guanyu Chengdu Hongguang Shiye Gufen Youxian Gongsi Yanzhong Weifa Weigu Anjian de Tongbao], Issue No 11, 1998, available at <http://www.csrc.gov.cn>.

¹⁰ Lu Wang, “The First Case in the Stock Market – Shareholder Sues Chairman on Behalf of the Corporations” [Zhengquan Shichang Youchu Diyi An – Gudong Daibiao Gongsi Zhuanggao Dongshizhang], *Shanghai Securities Daily* [Shanghai Zhengquan Bao], 9 April 2003.

¹¹ Junhai Liu, *Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies* [Xin Gongsifa de Zhidu Chuangxin: Lifa Zhengdian yu Jieshi Nandian] (Law Press, China, 2006), p.248.

¹² [Xiamen Yuanyiyuan Fangchan Kaifa Youxian Gongsi yu Xiamen Xinlida Youxian Gongsi, Xiamen Xinlida Fangchan Kaifa Youxian Gongsi, Fujian Sheng Xiamen Shi Siming Qu Renmin Fayuan] available at case database www.lawyee.net (in Chinese).

¹³ MinAn Zhang, “Legal Protection for Minority Shareholders’ Rights” [Xiaogudong Quanli de Falu Baohu], in Huixing Liang (ed.), *Civil and Commercial Law Review* [Minshang Fa Lucong], vol.9, Law Press [Falu Chubanshe], 1998, at p.160, in which he argued that minority shareholders were excluded from this protected group in practice.

¹⁴ *Nanchang Real Estate Ltd and Pudong Investment Management Ltd v. Xinjiangnan Industries Co. Ltd* (2000) Jiangsu Higher Court No 206, (2000) WuXi Court No 140. See also *Gazette of the Supreme People’s Court of the People’s Republic of China*, 2001, No 6.

¹⁵ Peizhong Gan, “The Protection of Minority Shareholders in Limited Liability Companies - From the Perspective of Litigation” [Youxian Gongsi Xiaogudong Liyi Baohu de Faxue Sikao-Cong Susong Shijiao Kaocha], *Studies in Law and Business* (Fashang Yanjiu), No 6, 2002.

¹⁶ It was decided by the Intermediate People’s Court of Jiaying City, Zhejiang Province in 2001. Xiaoping Lu, “The Wufangzhai Case Led to Many Legal Issues” [Wufangzhai Shijian Yinfa Zhuduo Falu Wenti], *Shenzhen Legal Daily* [Shenzhen Fazhi Bao], 30 July 2001, p.14. Yang Yang, “The Loss of RMB 2.58 million Paid by the Chairman Personally” [RMB 2,580,000 Sunshi You Dongshizhang Geren Pei] *Shanghai Legal Daily* [Shanghai Fazhi Bao] 22 August 2001, p.5.

¹⁷ It was decided by the High People’s Court of Beijing in December 2005. See the comments by Wang Na, “The Significance of Zhongqi Qihuo Case” [Zhongqi Qihuo An de Biaogan Yiyi], available at http://news.xinhuanet.com/newmedia/2006-01/09/content_4027001.htm 9 January 2006.

¹⁸ Ma, “The Deficiencies of Derivative Actions in China” (2010) 5 *Company Lawyer* 149, pp 150-152.

introduction of specific rules on derivative actions was highly desirable for the protection of shareholders' interests¹⁹.

Prior to the CCL 2005, a total of 23 derivative action cases were decided in China²⁰, out of which 4 cases were refused on the ground that the claimant shareholders were not eligible to bring an action against the wrongdoers on behalf of the company; 16 cases were accepted and 2 cases were settled²¹. Almost all of the cases concerned limited liability companies (the 'LLC')²² and only one case was related to listed company²³. It appears that the courts took a more conservative attitude towards derivative actions involving listed companies due to the complexity of the cases and their impact on the public.²⁴ As will be discussed below, this trend has continued after the introduction of derivative actions in the CCL 2005.

2. Derivative Actions under the *Chinese Company Law 2005*

The derivative actions are contained in Art 151 of the CCL 2005 (revised in 2013). The *locus standi* requirements of the claimant and the scope of defendants are discussed as well as the role of the company in a derivative claim.

a. The *Locus standi* requirements

The *locus standi* requirements concern the essential scope of derivative actions and play an important part in preventing unmeritorious suits. Different requirements apply to joint stock companies (the 'JSCs') and LLCs. JSC shareholders must hold separately or aggregately no less than 1% of the company's shares for at least 180 days.²⁵ These requirements are not imposed on LLC shareholders; thus, any shareholder is qualified as a claimant in a derivative action. The less restrictive approach reflects the sympathies for LLC shareholders due to their

¹⁹ Guanhua Yu, "Towards an Institutional Competition Model of Comparative Corporate Governance Studies" (2003) 6 J.Chinese & Comp.L (H.K).31, 56.

²⁰ Shaowei Lin, *Derivative Actions in Chinese Company Law* (Kluwer Law International, 2015), p 101.

²¹ The remaining one case was not published at the time of the research. The publication of court judgments is not compulsory in China and therefore not all judgments were available on the database.

²² Shaowei Lin, *Derivative Actions in Chinese Company Law* (Kluwer Law International, 2015), p 101.

²³ Lu Wang, "The First Derivative Action Was Not Accepted" [Shouli Gudong Daibiao Susong Wei Shouli], *Shanghai Securities Daily* [Shanghai Zhengquan Bao], 22 April 2003. In the case of *Sanjiu Medical and Pharmaceutical Co. Ltd* (2003), Shenzhen Intermediate People's Court rejected the case and ruled that the claimant shareholder must obtain authorization from all the shareholders of Sanjiu before bringing the lawsuit to the court because a derivative action should be brought in the interests of all shareholders.

²⁴ Xiaoning Li, *A Comparative Study of Shareholders' Derivative Actions: England, the United States, Germany and China* (Kluwer: Deventer, 2007), p. 271.

²⁵ Art 151(1), CCL 2005.

difficulties in transferring their shares and leaving the companies;²⁶ however, an easy access to judicial remedies is often accompanied by the risk of increased litigation and potentially a rise in the number of malicious suits.

The requirements imposed on JSC shareholders are criticised as being too restrictive. In listed companies with a highly concentrated shareholding ownership, hardly any individual shareholder, apart from the top three shareholders, can meet the 1% requirement.²⁷ Even in listed companies where the shares are widely dispersed, it is unrealistic to bring minority shareholders together because of the expense and time involved as well as their varied and often conflicting views. It is argued that the percentage requirement should be lowered or preferably totally abolished so that any current shareholder would be entitled to initiate a derivative action which is the case in UK.

In addition to the shareholding percentage requirement, the claimant shareholders of JSCs must hold the shares for at least 180 days *until the day when the litigation is initiated*²⁸. As many individual shareholders, in particular those of listed companies, purchase shares for short-term investment, the average shareholding period is relatively shorter compared to 180 days. According to Jin Xin's study, the average shareholding period on the securities market in China was less than four months (about 120 days);²⁹ thus, the 180 days requirement may be a real obstacle for individual minority shareholders in listed companies. This hurdle may be one of the main reasons that very few cases were brought by shareholders in listed companies in China. It is therefore argued that the shareholding period be shortened or abolished in order to protect the interests of shareholders in JSCs.

²⁶ Zhiyong Zhang, "The Rules on Derivative Actions in the Company Law Reform Proposal Draft 2005" [Dui Woguo Gongsifa Xiuding Caoan Paisheng Susong Tiaojian de Sikao] (2005) 5 *Chinese Lawyer* [Zhongguo Lushi] 52, 52.

²⁷ Jinzhu Yang, "The role of shareholders in enforcing director's duties: A comparative study of the United Kingdom and China (Part 2)" (2006) 17 *I.C.C.L.R.* 381, 390. According to the survey of the ownership structure of listed companies in China conducted by Yang, on average, the proportion of shares held by the largest shareholder is in excess of 45%, the second largest is about 5%, the third is about 3%, and afterwards, no individual shareholder held more than 1% of company's issued shares.

²⁸ In 2006, the Supreme People's Court promulgated the judicial interpretation entitled "Regulations on the Application of Company Law of the People's Republic of China" [Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gongheguo Gongsifa Ruogan Guiding Yijian 2006].

²⁹ Jin Xin, *Shareholding Structure and Corporate Governance in Listed Companies* [Shangshi Gongsifa Guqian Jiegou yu Gongsifa Zhili], *China Finance Press* [Zhongguo Jinrong Chubanshe], 2005, pp 143-144.

Recent research has shown that derivative actions in China have been used more widely in LLCs than JSCs. Huang conducted an empirical study³⁰ on the derivative actions from 1st January 2006 to 30th December 2010. The research located 50 reported cases during the five-year period³¹ since the introduction of the derivative action in China. The study shows that all reported derivative action cases involved LLCs³² whilst no action was brought in relation to JSCs³³. This finding is echoed by Lin's study of derivative action cases from 1st January 2006 to 30th August 2013, which concludes that there are "almost no cases" involving derivative actions in JSCs, listed or unlisted³⁴.

This trend could be explained by taking into account the strict *locus standi* requirements for JSC shareholders, who must hold separately or aggregately no less than 1% of the company's share capital for at least 180 days. By contrast, these requirements do not apply to LLC shareholders and as such there are fewer barriers for LLC shareholders in pursuing derivative actions compared to JSC shareholders. Moreover, it may be difficult for LLCs shareholders to sell their shares and exit the companies because there are usually restrictions on the transfer of shares and they cannot be traded on the stock markets. By contrast, shareholders in JSCs particularly listed companies may find it relatively easy to exit the companies. LLCs shareholders therefore have more incentives to redress corporate wrongs and recover their losses. The courts may also take a more restrictive approach towards JSCs and in particular state-owned enterprises because of concerns that the management of companies may suffer undue interference from shareholders' malicious lawsuits.

The requirements on *locus standi* in China are stricter than those in the UK where any current shareholder of a company can bring a derivative claim. Neither the shareholding percentage

³⁰ Huang, "Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis" (2012) 27 *Banking and Finance Law Review* 619, 627.

³¹ The number of cases per year is listed below: 12 cases in 2006, 11 in 2007, 16 in 2008 and 11 in 2009. Huang argued that the number of cases has stayed relatively constant over the 5 years. No case was recorded in 2010 when the study was carried out mainly because the cases filed in 2010 were still open or just decided and not collected yet in the database.

³² Huang, "Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis" (2012) 27 *Banking and Finance Law Review* 619, 635. In almost half of all cases (24 out of 50 cases), derivative suits were brought as a means to resolve dispute between two shareholders. In particular, the claimant has a large shareholding in the company; in 66 percent of all cases (33 out of 50), the claimant held 10 percent or more of shares in the company; in 46 per cent of all cases (23 out of 50), the claimant had more than one third shareholding. The claimant had less than 10% shareholding in just two cases.

³³ Huang, "Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis" (2012) 27 *Banking and Finance Law Review* 619, 631.

³⁴ *Sanlian Shangshe* case is the only one case involving a JSC (and a listed company) after the implementation of the CCL 2005.

nor the time period is required.³⁵ Although the strict requirements in China aim to prevent frivolous suits, it may prevent JSC shareholders from bringing derivative actions and redressing corporate wrongs. The less restrictive approach in the UK does not necessarily encourage unmeritorious suits because of the strict procedures whereby the claimants have to seek permission from the courts to continue the claims. As a corollary, the courts in China should be given greater discretion in such cases in order to prevent malicious suits; however, this requires a competent and experienced judiciary to adopt a well-designed procedure to filter out the malicious suits.

b. The role of the company

The SPC Provisions 2017 have clarified the role of the company in a derivative action, which was not specified under the CCL 2005. According to Rule 24 (1), the company should be treated as a third person in a derivative action. Rule 24 (2) states that if other shareholders of the company, who meet the requirements in Art 151(1) of CCL 2005, wish to bring the same claim and join the litigation before the close of court debate in the first instance, they should be listed as co-claimants. These rules have filled a gap in the CCL 2005 by providing clearer guidance for the courts in the trial of such cases.

C. The scope of defendants

The scope of defendants directly affects the functions of derivative actions as a deterrent against corporate wrongs. Under the CCL 2005, a shareholder can bring a derivative action against any *director, supervisor or senior manager*³⁶ who has violated laws, administrative regulations or the company's articles of association in the course of performing their duties for the company and thereby caused damage to the company.³⁷ A derivative action can also be brought against *any other person* who has infringed the company's interests and caused damage to the company.³⁸

³⁵ S 261, CA 2006.

³⁶ The senior manager is defined as "a manager, deputy manager, any person in charge of a company's finance, the secretary of the board of directors of a listed company as well as any other person as stated in the articles of association". Art 217, CCL 2005.

³⁷ Art 150, CCL 2005.

³⁸ Art 151(3), CCL 2005 states that "Where another person infringes upon the lawful rights and interests of a company and thus causes losses to the company, the shareholders specified in the first paragraph of this Article may bring a lawsuit to a people's court in accordance with the provisions of the preceding two paragraphs."

In the light of the misconduct of the majority shareholders which took place on a wide scale in China, majority shareholders are subject to derivative actions in the CCL 2005³⁹; however, the definition or scope of “any other person” is unclear. Gan proposed that “any other person” should include outsiders such as the company’s creditors or administrative bodies who have infringed the company’s interests.⁴⁰ Cai, however, argued for a more restrictive view fearing an increase in the number of lawsuits. He suggested that “any other person” should be limited to insiders of the company such as the majority shareholders, liquidators and auditors.⁴¹ Recent studies show that a broad interpretation of “any other person” has been adopted by the courts.

According to Huang’s study⁴², directors (including senior managers) are the most common defendants (almost half of all defendants), followed by “other people” and supervisors. “Other people” mainly include controlling shareholders or actual controllers who do not hold any office in the company, contractual counterparties of the company, and competing companies which were set up by directors of the company⁴³. In terms of the cause of action, the most common type of complaints is the breach of duty of loyalty, in particular, self-dealing or related transactions, setting up a new competing company and misappropriating corporate assets. A small number of cases are related to the breach of duty of care⁴⁴.

Similar findings were made in Lin’s research of 103 cases from January 2006 to August 2013⁴⁵. The defendants are directors or senior managers in 72 cases, which is nearly 70 per cent of all the cases. The defendants are “other people” in 51 cases. In 26 cases the defendants are shareholders only (which means that they are neither directors nor senior managers). In only 4 cases the defendants are supervisors. This study shows that many defendants fall into the category of “other persons” and Art 151 has extended the scope of

³⁹ CCL 2005, Art 21 states that controlling shareholders will be responsible for the company’s losses if they take advantage of their affiliated relationships and cause damages to the company.

⁴⁰ Peizhong Gan, “Lessons for Derivative Actions in Chinese Company Law” [Jianping Zhongguo Gongsifa dui Gudong Paisheng Susong Zhidu de Jiejian], in Xudong Zhao(ed.), *Company Law Review* [Gongsifa Pinglun] (People’s Court Press, 2005, No 1), p.27.

⁴¹ Lidong Cai, “The Scope of Respondents in the Shareholder Derivative Actions” [Lun Gudong Paisheng Susong zhong Beigao de Fanwei] (2007) 21 *Contemporary Law Review* (Dangdai Faxue) 153, 158.

⁴² Huang, “Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis” (2012) 27 *Banking and Finance Law Review* 619, 635.

⁴³ *ibid*, 636.

⁴⁴ *ibid*, 637.

⁴⁵ Shaowei Lin, *Derivative Actions in Chinese Company Law* (Kluwer Law International, 2015), pp 126-127.

defendants to third parties. This is a very welcome step forward because such a broad interpretation will ultimately help to protect the interests of companies.

The SPC Consultation Paper 2016 suggests that “other people” refer to people who are not directors, supervisors or senior managers in the company or its wholly-owned subsidiary⁴⁶. It also states that the directors, senior managers, board of supervisors, or supervisors in Art 151(1) and Art 151(2) include those in the company’s wholly-owned subsidiary. Unfortunately, these definitions were not adopted in the SPC Provisions 2017 and as such the scope of “other people” remains unclear.

3. The demand rule in China

In China, it is recognized that derivative actions are unusual forms of litigation which bypass the majority rule and the separate corporate personality principle.⁴⁷ If used improperly, the interests of the company and other shareholders will be at risk. It is essential therefore to strike a proper balance between a company’s autonomy and judicial interference, and between the protection of minority shareholders and the prevention of malicious lawsuits. It is crucial to place some procedural hurdles in the path of derivative actions.

Before derivative claims are filed, shareholders must make a written demand to either the board of directors or the board of supervisors⁴⁸. If directors or senior managers breach their duties, a demand should be made to the board of supervisors. If supervisors breach their duties, a demand should be made to the board of directors or to an executive director of a LLC which does not have a board of directors. This cross-demand aims to avoid a conflict of interests when the board makes the decision regarding litigation. If the board of directors or supervisors refuses to initiate the litigation, or fails to bring a lawsuit within 30 days of receipt of the request, a shareholder is entitled to bring a derivative action.⁴⁹ This demand rule aims to make full use of all the internal remedies of a company and to save time and expense of litigation if the board decides to ratify the misconduct or to sue the wrongdoer.

⁴⁶ SPC Consultation Paper 2016, Art 31(2).

⁴⁷ Baoshu Wang, “The Concept of Commercial Law and the Conceptual Commercial Law” [Shangshifa de Linian yu Linian shang de Shangshi Fa], in Baoshu Wang (ed.) *Commercial Law [Shangshi Fa Lunji]* (Law Press, 1997), p.7.

⁴⁸ Art 151, CCL 2005.

⁴⁹ *ibid.*

The question is whether this rule has achieved its aims without making the procedure unduly complex for shareholders.

Although the legislators intended to avoid conflict of interests by imposing the cross-demand rule, the lack of independence on the part of a board of supervisors may cast doubt on whether it can make an impartial decision with regard to taking litigation against directors. The demand rule is unclear on which corporate body minority shareholders should make the demand if both directors and supervisors have breached their duties to the company and/or if majority shareholders are involved in the misconduct. It is also unclear whether a demand could be made on a shareholder meeting.

Furthermore, the content of the demand is not specified under Art 152. In the United States, the demand must be adequate for its purpose and it should at least include “the identity of the alleged wrongdoers, the factual basis for the allegation, the harm caused to the corporation, and the remedial relief requested”.⁵⁰ It must also contain information reasonably specific for the board of directors to make an informed business judgement as to “whether to invest the resources of the corporation in pursuit of the shareholders’ claim”⁵¹ or to try and resolve the matter internally. It is recommended that detailed requirements of the content of the demand should be specified in China. The feasibility of this approach depends to a great extent on the shareholders’ ability to access all relevant information.

Finally, although the 30-day limit aims to prevent the board from postponing or ignoring shareholders’ demand, it is considered unreasonable in some situations; for example, when the board needs more time in some complicated cases to investigate the case and make the final decision to go to litigation. As shareholders can bring a derivative action providing the board fails to do so within 30 days, the tight timetable may rush directors into making irrational decisions which may not be in the best interests of the company. Although it is difficult to fix a time limit to suit all situations, it is recommended that a court, upon request from the board of a company, should extend the time limit when necessary.

The demand rule can therefore be criticised for the lack of requirements on the content of the demand. There are also concerns about whether a board can make independent and impartial

⁵⁰ Rule.23.1, *Federal Rules of Civil Procedure*.

⁵¹ *Spiegel v Buntrock* 571 A 2d 767 at 773 (Del 1990).

decisions regarding the shareholders' demand because it is not required to investigate the veracity of the content of the demand nor justify their decisions. In addition, shareholders' lack of access to relevant information and the inflexibility of the time limit are further concerns. If the demand rule is expected to play an effective role in deterring malicious suits, the above problems need to be addressed adequately in any future company law reform⁵².

In order to provide a timely remedy for shareholders when demand is futile, this demand requirement can be exempted in "emergency situations" or "when the damage to the company will be irrecoverable if shareholders do not bring proceedings immediately".⁵³ The meaning of the emergency situations, however, is unclear. Meng has suggested that it should include the following: there is a danger that the limitation of actions will shortly expire, or there is a high risk that some properties will be transferred, or other situations which the judges consider as urgent.⁵⁴ The broader this scope is, the more derivative claims can evade the demand requirement. The Supreme People's Court judge Xiaoming Song has rightly propounded that the demand rule should be used as guidance for judges and not as a compulsory procedure.⁵⁵ This would appear to be a most sensible way forward which would allow the emergency situations to be interpreted on a much broader basis for the protection of shareholders' interests.

Huang's study shows that the demand was actually made in 17 cases out of the total number of 50 cases reported from January 2006 to December 2010. Of the 17 cases, shareholder's demand was rejected in 5 cases and the company did not act within 30 days in the remaining 12 cases⁵⁶. It appears that as long as a demand is made the claimant shareholder can proceed with the derivative claim, regardless of the reasons why the demand was rejected. By contrast, a demand was not made in 26 cases over this period, out of which the court dismissed the case on the basis of the failure to make a written demand in 6 cases and the court excused the demand requirement in 20 cases⁵⁷.

⁵² Ma, 'The Deficiencies of Derivative Actions in China' (2010) *Company Lawyer* 150, 154.

⁵³ Art 151 (2), CCL 2005.

⁵⁴ Xianggang Meng, "Shareholders' derivative actions" [Gongsi Gudong Daibiao Susong de Shenli] (2007) 4 *Law Application* (Falu Shiyong) 19, p 21.

⁵⁵ Guohui Li, "The Corporate Practice and Trial Experience – An Interview with the Chairman of the Civil Tribunal of the SPC regarding the Difficulties in the Application of the New Company Law" [Yanjiu Gongsi Fawu, Zhidao Shenpan Shijian] 4 (2007) *Law Application* (Falu Shiyong), p. 3.

⁵⁶ Huang, "Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis" (2012) 27 *Banking and Finance Law Review* 619, 638.

⁵⁷ *Ibid*, 639.

Furthermore, Lin's study demonstrates that the demand was not made in 22 cases out of 103 cases reported from January 2006 to August 2013⁵⁸. This could be attributed to the fact that those shareholders may not be familiar with the demand requirement or they may think that it was pointless to make a demand on the company which was controlled by the wrongdoers⁵⁹. In some cases, however, the court adopted strict approach towards the demand requirement and the cases were rejected by the courts on the basis of the failure to comply with the demand requirement⁶⁰.

It is argued that the demand rule is a simple procedure which does not set up the necessary hurdles to filter malicious suits. It is unclear which criteria the courts will use to accept or reject claims because of the lack of guidance in the CCL 2005. It seems that shareholders can bring a derivative action when the board refuses to sue or simply wait for 30 days after the demand; thus, even if the board decides that litigation is not in the best interests of the company, such as when the costs of litigation far exceed the benefits, shareholders can still proceed with a derivative action. It is therefore argued that the procedures under the CCL 2005 are insufficient to function as a deterrent against unmeritorious lawsuits and the courts should play a more active role and have more control over derivative actions in China.

4. The litigation costs in China

The costs of litigation in China may deter weak and frivolous claims but at the same time they are main obstacles for shareholders considering derivative actions. When deciding whether to pursue litigation or not, shareholders inevitably evaluate the costs of litigation and any chances of recovery. In particular, shareholders face three main disincentives: firstly, any recovery goes directly to the company and the claimants may only benefit indirectly from the outcome; secondly, other shareholders who do not join the litigation still benefit as much as the claimants, which more often than not leads to the free-riding problems; finally, it is unclear whether and in what circumstances the courts will order the company to indemnify the claimants' costs.

⁵⁸ Shaowei Lin, *Derivative Actions in Chinese Company Law* (Kluwer Law International, 2015), p 125.

⁵⁹ In *Shao Feiyue v Ningbo Zhenhai Litian Investment Consultant Co* (2008) the claimant argued that the defendant controlled the company and as such any request on the company to bring litigation against the defendant was ineffective.

⁶⁰ For example in *Zhang Ke v Actual Controller and senior managers of Zhangchen Co* (2008), *Shunde Zhaoyu Electronic Hardware* (2006) and *Beijing Dingyu Special Type Electric Cable Co Ltd* (2008).

The litigation costs in China mainly consist of the court's fees and the lawyers' fees. The courts' fees include the filing fees and other expenses.⁶¹ The former is paid to the courts before litigation proceeds whilst the latter, such as the fees for investigation and preservation of assets, are incurred during the hearing. The general rules on the allocation of costs in China are similar to those in the UK:⁶² the losing party pays the filing and other statutory fees, but not the lawyers' fees of the prevailing party.⁶³ If the litigation is unsuccessful, the claimant shareholders have to pay their own costs of litigation as well as those of the defendant. Even if successful, the claimants still have to pay their own lawyer's fees. By contrast, the claimants in the UK are in a better position because their lawyer's fees are paid by the respondents.

Moreover, the problems associated with high costs in the UK have been alleviated to a certain extent by the costs indemnity order under the *Civil Procedure Rules* 19.9E. A high standard of test of "genuine need"⁶⁴, however, has been established in case law so that a costs indemnity order cannot be granted too easily. There is still no clear guidance on the circumstances where such an indemnity order should be granted. Keay has convincingly argued that the courts tend to be cautious when awarding a costs indemnity order to shareholders who successfully obtain permission to continue a derivative action. Over the eight-year period since the codification of derivative claims in the UK, the courts only granted such orders in 2 out of 8 cases where the shareholder has been successful under the statutory regime⁶⁵.

Without any financial compensation as incentive, fewer individual shareholders in China are willing to take the risk of initiating such uncertain lawsuits, taking into account of the high costs of litigation and the free-riding problems. The rules on costs indemnity cannot be found in the *Civil Procedure Law 1991*. Without such an indemnity order, even if the derivative

⁶¹ Art 107(1), CPL 1991. Litigation costs include filing fee, application fee for enforcement of courts' judgements and other statutory fees (such as the inspection fee, translation fee, travelling expense for witness).

⁶² Wenhai Cai, "Private Securities Litigation in China: Of Prominence and Problems" (1999) 13 *Colum.J.Asian L.*135, 149. Jiang Wei, *Civil Procedural Law* [Minshi Susong Fa] (2nd ed., BeiJing University Press, 2004), p.249.

⁶³ Art 29, *Measures on Payment of Litigation Fees 2006* [Susong Fei Jiaona Banfa 2006], passed by the State Council in December 2006, effective on 1 April 2007.

⁶⁴ *Smith v Croft* [1986] 1 W.L.R. 580, per Walton J.

⁶⁵ Keay, "Assessing and Rethinking the Statutory Scheme for Derivative Actions under the *Companies Act 2006*" (2016) 16 *Journal of Corporate Law Studies* 39, 53.

action is successful, the claimant still has to pay for other reasonable costs such as lawyers' fees. In order to relieve the claimants of some of the financial burdens and uphold shareholders' rights, it was recommended by many academics that a costs indemnity order should be introduced into China whereby companies should be responsible for all the claimant's costs if the litigation is initiated in good faith.

The financial hurdles for shareholders have been, to some extent, lowered by the SPC Provisions 2017. According to Rule 26, if part or all of the derivative claim has been supported by the Court, the company should pay reasonable costs and expenses which incurred by the shareholders in bringing such action. Moreover, the SPC Provisions 2017 introduce specific rules on the outcome of the litigation: any benefit recovered in a derivative action should belong to the company if the litigation is successful⁶⁶. The claim would not be accepted if shareholders try to hold defendants directly liable for themselves⁶⁷. It aims to avoid double recovery from the defendants and draw a clear line between shareholders' personal actions and derivative actions.

Huang has argued that the current rules on derivative actions in China have made a "noticeable impact" in terms of the number of cases brought before the court and the benefits realized from them⁶⁸. The sheer number of cases (a total of 50 cases from January 2006 to December 2010) makes a "stark contrast" with the limited number of derivative suits before 2006 (a total of 23 cases). The substantial increase in the number of cases indicates that the current regime has at least "facilitated" the derivative suits in China⁶⁹. More recently, Lin's study shows that a total number of 103 derivative actions cases were decided between January 2006 and August 2013. Of the 103 cases, the claim was accepted by the court in 47 cases (less than half of cases), rejected in 55 cases and settled between parties in only one case. This demonstrates that the judges are "increasingly willing to accept" derivative actions⁷⁰.

⁶⁶ Rule 25, SPC Provisions 2017.

⁶⁷ Ibid.

⁶⁸ Huang, "Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis" (2012) 27 *Banking and Finance Law Review* 619, 627.

⁶⁹ Ibid.

⁷⁰ Shaowei Lin, *Derivative Actions in Chinese Company Law* (Kluwer Law International, 2015), p 123.

The introduction of derivative actions in the CCL 2005 represents a significant milestone in the protection of shareholders' interests⁷¹. The provisions have been further enhanced and clarified by the SPC Provisions 2017. The broad scope and relaxed procedure make derivative actions subject to abuse from malicious suits and therefore more judicial control should be in place in order to protect the company. It is therefore necessary to examine the possibility of borrowing the ideas from the UK because of its relative sophisticated rules on derivative actions and the influence of English law globally⁷².

5. The Statutory Derivative Claims in the United Kingdom

Shareholders must follow a two-stage procedure in section 261 of the *Companies Act 2006* to apply for permission to continue derivative claims⁷³. It reflects the Law Commission's proposal that it should be for the *courts* to determine whether a derivative action should proceed.⁷⁴ At the first stage, the claimant is required to establish a *prima facie* case and the court considers only the application and the evidence filed by the claimant. If it does not show there is a *prima facie* case, the court must dismiss the application at this stage and make any consequential orders it considers appropriate.⁷⁵ If the court is satisfied at this stage, it may give directions for evidence to be filed by the company and may adjourn the proceedings to enable that evidence to be obtained.⁷⁶ In this way, the court can dismiss unmeritorious cases at an early stage without involving the defendant directors or the company.

At the second stage but before the substantive action begins, the court may "give permission to continue the claim on such terms as it thinks fit or refuse permission and dismiss the claim".⁷⁷ It also has the jurisdiction to adjourn the proceedings and give directions, for example, to order a general meeting to take place. This is designed to meet the situation where the course that should be taken by the court is not yet clear.⁷⁸ The permission will be refused if the court is satisfied with one of the following circumstances: firstly, the claimant in accordance with the duty under s.172 of the CA 2006, which is to promote the success of the company, would not seek to pursue the claim; secondly, if the breach of duty has not

⁷¹ Krause & Qin, "An Overview of China's New Company Law" (2007) *Company Lawyer* 316, 316.

⁷² Ma, "Chinese Take-aways: What Can China Learn from the English Experience of Derivative Actions?" (2013) *International Journal of Private Law* 6(3), pp 273-275.

⁷³ *Practice Direction* 19C.

⁷⁴ Law Commission, *Shareholder Remedies* (Law Commission Report No. 246, Cm 3769, Stationery Office, 1997), para 6.68.

⁷⁵ S 261(2), CA 2006.

⁷⁶ S.261(3), CA 2006.

⁷⁷ S 261(4), CA 2006.

⁷⁸ *Blackstone's Guide to The Companies Act 2006* (Oxford University Press, 2007), 14.24.

occurred, it has been authorised by the company; thirdly, if the misconduct has already occurred, it was authorized by the company before it occurred or ratified by the company since it occurred.⁷⁹

In other situations, the court can exercise its discretion to take into account all the relevant circumstances in s 263(3), in particular, the claimant's good faith, the success of the company, the possibility of being authorised or ratified, the decision not to sue, alternative personal action and the views of members who have no personal interests.⁸⁰ There are some concerns over the list of criteria which appears to be a set of hurdles which claimants have to overcome. The list was considered "as a signal to adopt an over-restrictive approach and maintain a policy of not favouring a derivative action".⁸¹ As Lowry argued, the new procedure involves the exercise of judicial discretion and it is unlikely to be more efficient or more cost-effective.⁸² It is questionable whether the judges' old restrictive attitudes towards shareholders' derivative actions remains.⁸³ Recent study has shown that restrictive judicial approach has been adopted. According to Keay, the permission was only granted in 8 cases out of the 22 cases over the eight year period since the derivative claims were codified⁸⁴.

The success of statutory derivative claims in the UK also depends on whether they are more popular than the unfair prejudice remedy. Some academics are sceptical of the success of the statutory derivative claims. As Payne has argued, although the new procedure has removed the problems associated with the "fraud" and "wrongdoer control", it seems unlikely to increase the use of the derivative actions in the face of the unfair prejudice remedy.⁸⁵ Sugarman shared similar views by arguing that the unfair prejudice remedy is likely to remain the remedy of first choice because of its advantages over derivative claims in terms of broad scope of application, simpler procedure and flexible remedies.⁸⁶ The concerns about the restrictive judicial attitudes towards such claims are, to some extent, reflected in *Mission*

⁷⁹ S 263(2), CA 2006.

⁸⁰ S 263(3) and s 263 (4), CA 2006.

⁸¹ Law Commission, *Shareholder Remedies: A Consultation Paper* (No.142, Stationery Office, 1996), para 16.43.

⁸² Lowry, "Reconstructing Shareholder Actions: A Response to the Law Commission's Consultation Paper" (1997) 18 Co. Law 247, at 249.

⁸³ Sealy, "Shareholders' Remedies in the Common Law World" [1997] CFILR172, at 180.

⁸⁴ Keay, "Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006" (2016) 16 *Journal of Corporate Law Studies* 39, 57.

⁸⁵ Payne, "Bigger and Better Guns for Minority Shareholders" [1998] C.L.J. 36 at 37.

⁸⁶ Sugarman, "Reconceptualising company law: Reflections on the Law Commission's Consultation Paper on Shareholder Remedies: Part 1" (1997) 18 Co Law 226, 243.

*Capital Plc v Sinclair*⁸⁷ and *Franbar Holding Ltd v Patel*⁸⁸. The application for permission was rejected for similar reasons in both cases; in particular, it was held that the claimant could achieve all that it properly wanted through the unfair prejudice petition or through shareholders' personal actions rather than derivative actions.⁸⁹ In some cases, however, the existence of unfair prejudice remedy is not considered a complete barrier to bringing a derivative action. In *Kiani v Cooper*⁹⁰, it was held that the availability of an alternative remedy under the unfair prejudice grounds did not prevent permission being granted. Similarly in *Ritchie v Union of Construction, Allied Traders and Technicians*⁹¹, it was held that the alternative remedy was merely an important factor to be taken into account in the exercise of a court's discretion.

The statutory derivative actions have replaced the complex and obscure rules at common law and they have provided some clarity and certainty; however, they have not been frequently used in the United Kingdom since they came into force in October 2007. Only 22 derivative actions were instituted in the UK between October 2007 and September 2015⁹². The main reasons for the few number of cases are well explained by Keay as follows: the judges appear to have adopted a "fairly strict approach" to permission application, the unfair prejudice remedy is considered substantially more desirable than derivative actions mainly because its wide scope of application and personal reliefs. Moreover, the high costs of litigation and the uncertainties of the costs indemnity order may deter shareholders from bringing such action; shareholders may also lack financial incentive to pursue an action which they can only indirectly benefit; and finally, shareholders may be dissuaded from taking action because of the free-riding problems⁹³.

Conclusion

The success of derivative actions in China and the UK not only depends on the effectiveness of their own substantive and procedural rules, but also on many other factors such as judicial attitudes, the costs of litigation and the availability of alternative remedies. In China, the CCL

⁸⁷ [2008]EWHC 1339 (Ch).

⁸⁸ [2008]EWHC 1534 (Ch).

⁸⁹ [2008]EWHC 1534 (Ch). Para 54.

⁹⁰ [2010] EWHC 577 (Ch).

⁹¹ [2011]EWHC 3631 (Ch).

⁹² Keay, "Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006" (2016) 16 *Journal of Corporate Law Studies* 39, 41.

⁹³ *Ibid*, pp 43-44.

2005 and the SPC Provisions 2017 have provided consistent legal basis for judges to try these cases and derivative actions have been widely used in LLCs since their introduction because of their broad scope of application, relaxed procedure and the absence of alternative remedies in China. The substantial number of cases indicates that the courts are more willingness to allow derivative claims, to redress corporate wrongs and protect the interests of both the company and shareholders, at least in LLCs. The scarcity of cases in JSCs; however, raises serious concerns about the role of derivative actions in such companies. It is therefore recommended that the current shareholding percentage and shareholding period for JSC shareholders should be lowered or preferably abolished.

Derivative actions, if used in an inappropriate manner, have the potential to disrupt the management of a company. It is essential to strike the *proper balance* between the protection of shareholders' rights and the protection of a company's day-to-day management. In light of the simple demand rule in China, it is desirable to adopt the English approach whereby the courts consider a number of factors such as whether the claimant acts in good faith, whether the misconduct has been authorised or ratified; and whether the company has decided not to sue. The effectiveness of derivative actions may also depend on whether there is an alternative and more popular remedy. If alternative remedies are more effective and easier than derivative actions, there may be less demand for the latter; for example, the success of statutory derivative actions in the UK is compromised by the popular unfair prejudice remedies⁹⁴. In China, shareholders' personal remedies are limited; for example, appraisal remedies do not apply when the majority shareholders have infringed minority's interests⁹⁵. Moreover, as the unfair prejudice remedies do not exist in China, shareholders have no alternative remedies other than derivative actions to redress unfairly prejudicial misconduct by majority shareholders or directors. As a consequence, shareholders rely heavily on derivative actions to redress corporate wrongs. It is recommended that the unfair prejudice remedy should be considered for adoption in China in order to provide a more efficient personal remedy for shareholders⁹⁶.

⁹⁴ S 994, CA 2006.

⁹⁵ Art 75 and Art 143, CCL 2005.

⁹⁶ Ma, "A Challenge for China: Is It Possible to Introduce Unfair Prejudice Remedies? (Part 1)" [2009] 12 *International Commercial and Company Law Review* 417, 417-426. Ma, "A Challenge for China: Is It Possible to Introduce Unfair Prejudice Remedies? (Part II)" [2010] 13 *International Commercial and Company Law Review* 1, 1-11.

Shareholders in both China and the UK may be discouraged from bringing derivative actions by the high costs of litigation and the free-riding problems. In particular, shareholders in China may be discouraged because of the traditional Chinese culture of avoiding litigation and the difficulties of getting access to information⁹⁷. The SPC Provisions 2017 have clarified the procedural rules on derivative actions, reduced the costs for bringing such actions and clarified the outcomes of a successful claim⁹⁸. These rules will help to establish a more comprehensive and practicable system of derivative actions in China and achieve the ultimate aim of protecting the interests of companies and their shareholders.

⁹⁷ Ma, 'The Deficiencies of Derivative Actions in China' (2010) *Company Lawyer* 150, 157.

⁹⁸ Lin Ye, 'The Logic and Essence of the SPC Provisions on Shareholders' Derivative Actions', published on 5th September 2017 at <http://www.chinacourt.org/article/detail/2017/09/id/2989337.shtml>, accessed on 21st September.