Shareholder Remedies in China – Developments towards a More Effective, More Accessible and Fairer Derivative Action Mechanism

Jingchen Zhao*

Chuyi Wei†

ABSTRACT

The introduction and enforcement of derivative actions are important aspects of the continuing debate surrounding corporate law and governance in many jurisdictions worldwide, including China. In order to ascertain the trends of law in practice, this article offers a comprehensive case study by looking through all 380 reported cases of derivative action in China from 2006 to 2019, and addresses the question of whether the mechanism has been consistently and authoritatively used by shareholders. The article tries to identify problems in the application of the mechanism in China by focusing on complications surrounding consistency and accuracy in terms of judgements of derivative actions in different courts, litigated by different kinds of shareholders in China.

Key words: Derivative Action, Shareholder Remedies, Chinese Company Law, Accessibility, Fairness, Effectiveness.

* Professor of Law, Director of Centre of Business and Insolvency Law, Nottingham Law School, United Kingdom, Jingchen.Zhao@ntu.ac.uk. This research is kindly supported by the ESRC (ES/P004040/1).
† Corresponding author; Lecturer in Law, Jinan University, China; Research Fellow, School of Law, University of Leeds, United Kingdom; corresponding email: chuyiwei@jnu.edu.cn.

1. Introduction

A derivative action is a lawsuit brought by a shareholder on behalf of a company. Generally speaking, this type of lawsuit can only be brought when the company has a valid cause of action but has refused to use it, or has not used it within the period of time stipulated by law. A statutory derivative action mechanism is now embedded in several common law[1] and civil law countries.[2] In civil law countries the mechanism substantially allows shareholders to file and litigate a lawsuit on behalf of a company against an insider or a third party whose action has allegedly injured the corporation. It is designed to overcome various inadequacies in the area of shareholder remedies in common law jurisdictions, including the prohibitive cost of litigation, the restrictive standing requirement, and uncertainties concerning the rule and its exceptions.[3] It is an important shareholder remedy and private enforcement measure to implement corporate law.

There is no single expression for "derivative action" in Chinese; common terms for the mechanism include *daibiao susong* (代表诉讼), *paisheng susong* (派生诉讼), *yansheng susong* (衍生诉讼) or *daiwei susong* (代位诉讼). Statutory derivative action was introduced with high expectations as part of the Chinese Company Law (hereinafter CCL) reform in 2005, which came into effect on January 1st, 2006. The changes regarding derivative action were part of a series of changes surrounding shareholder protection, especially for minority shareholders.

The introduction and enforcement of derivative actions are important aspects of the continuing debate with respect to corporate law and governance in many jurisdictions worldwide, including China. It is vital to promote the proper use of derivative actions in China because the country has an emerging corporate governance model, a weak legal system, inefficient enforcement measures and a poor investor protection record. Despite the fact that the new statutory derivative action system gives shareholders the right to bring a claim on behalf of a company, in practice the actual impact of derivative actions upon companies, board members and shareholders has been limited due to a series of legislative loopholes such as high standing requirements,[4] an unclear demand requirement rule,[5] a lack of incentives for claimants, the vague

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[1] For example, see Sections 260–264 UK Companies Act 2006 or Part 2F.1A Australian Corporations Act 2001 to rectify the perceived inadequacies of common law derivative action.

[2] For example, see Articles 847–848 Japanese Company Law 2005.

[3] Ian M. Ramsay & Benjamin B. Saunders, 'Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action' (2015) 6 *Journal of Corporate Law Studies* 397, 406–410.

[4] Standing requirements are imposed on shareholders in Joint Stock Limited Companies in China. Shareholders who intend to bring a derivative action are required to separately or jointly hold 1 per cent or more of the company's shares for 180 consecutive days.

[5] The demand requirement is a US concept that requires shareholders to demand that the board of directors initiate a lawsuit to recover harm done to the corporation. The Company Law in China also

identity of the "third person" as defendant, high litigation fees and an immature judicial system, including a lack of knowledge and skill among legal practitioners and Chinese judges. These problems are closely related to China's unique hybrid corporate governance model and the problems associated with it,[6] such as culture, judicial system, shareholding structure and public enforcement measures.

Looking at the existing research concerning derivative action in China, studies conducted thus far can be roughly divided into two groups. Before the 2006 legislative reform, research mainly focused on the importance of transplanting the derivative action mechanism to the Chinese context and the preliminary construction of this regime. After the promulgation of the CCL, based upon discussions of limited reported cases, the literature tended to focus on the interpretation of the legislative wording and the problems of the new regime. There is a gap when it comes to ascertaining trends of law in practice, the government's legislative agenda, and identifying problems in the application of the mechanism. This can be only achieved through a comprehensive study of all reported cases, regardless of location, result, size of the company and shareholding percentage, since it is impossible and unnecessary to identify a valuable, consistent and representative sample against a number of criteria and variations. Focusing on law in practice, this article tries to fill this gap by focusing on complications surrounding consistency and accuracy in terms of case judgements of derivative action in different courts, litigated by different kinds of shareholders in China.

The paper aims to reflect upon all reported cases from 2006 to 2019 and address the question of whether the mechanism has been consistently and confidently used by shareholders. Assessing the period after the enactment of the CCL, we will seek to ascertain whether the new statutory mechanism has achieved its legislative goals such as redressing the wrongs done to companies, improving the position of shareholders, deterring directors from breaching their duties and punishing breaches where they do occur.[7]

Compared with previous work, this paper is the most complete case study to date, covering all available cases from 2006 to 2019. It is challenging to provide a complete picture of all derivative actions in China, as there is no single, comprehensive source of data on the issue. Hence, this paper uses different means to piece together a full picture of China's derivative actions. It looks at cases from two databases, *Beida Fabao* and *China Judgments Online*, and it also uses direct online searches using Chinese search engines and the websites of various courts. Careful consideration of path dependence factors, such as the deeply-embedded non-litigious culture, *guanxi* and *renqing*, the judicial system and government interference, will also add originality to

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adopts this concept and requires qualified shareholders to make a demand in writing to the appropriate body before raising proceedings.

[6] See Andrew Keay & Jingchen Zhao, 'Transforming Corporate Governance in Chinese Corporations: A Journey Not A Destination' (2018) 38 *Northwestern Journal of International Law and Business* 187.

[7] John C. Coffee, Jr. & Donald E. Schwartz, 'The Survival of the Derivative Suit: An Evolution and a Proposal for Legislative Reform' (1981) 81 *Columbia Law Review* 261 at 302–309.

the paper. The uniqueness of the Chinese context makes these arguments multi-faceted and complicated.

This research should provide an essential primer for legal practitioners and in-house counsel who deal with shareholder litigation and corporate governance issues on a regular basis, as well as for legal and business theorists on corporate law and governance. The research outcome will also be helpful for legislators and policy makers to understand potential problems in the application of the law and directions for reform. Finally, it will enable practitioners to comprehend and prepare for the inconsistency and complications that will arise when different courts interpret and apply the law in different ways.

The article proceeds as follows. Section 2 explains our methodology and the selection of the 380 cases for our study, in order to clarify why our cohort of cases is the most complete and comprehensive to date. Section 3 presents eight key findings of our empirical analysis, with follow-up reflections and reform proposals. Section 4 contextualises these findings and reaffirms our proposals in terms of the "triple criteria" of (1) accessibility, (2) effectiveness, and (3) fairness in the unique Chinese context. Finally, there will be some concluding remarks.

2. Case Analysis in China, and Our Sample

In this section we will present a brief introduction to the Chinese case report system, together with a description of the methodology we used to establish a complete sample of derivative action cases for the study.

2.1 The Case Report System in China and its Function

The case report system started at national and local levels in early 2000. The Supreme People's Court (hereinafter the SPC) started a pilot programme for the reporting of court decisions as early as 2000 at national level, and courts at all levels have been required to publish their decisions since 2009. However, a national official database for judicial decisions was not established until recently.[8] From 2014 onwards the SPC has issued regulations that require all judicial decisions to be published online.[9] Subsequently, an electronic database – *China Judgments Online* – was established to publish all judicial decisions in the country. The total number of cases contained in the database had reached over 55 million as of November 2018.[10]

This enhanced reporting system for judicial decisions is part of the SPC's efforts to strengthen the judiciary and improve the quality and accountability of judicial

[8] Björn B. Ahl & Daniel D. Sprick, 'Towards Judicial Transparency in China: The New Public Access Database for Court Decisions' (2017) 32 *China Information* 3.

[9] The SPC's provisions on the publication of the People's Courts' judicial decisions on the internet [最高人民法院关于人民法院在互联网公布裁判文书的规定] (published in 2013, amended in 2016).

[10] See J. Xu, The Total Number of Visits to the China Judging Online exceeded 20 Billion (中国裁判文书网总访问量突破两百亿) 14th Nov 2018, http://ip.people.com.cn/n1/2018/1114/c179663-30400147.html

decisions.[11] An open database also facilitates consistency and predictability in judgements. Judges will be able to refer to previous decisions both horizontally, based on the level of the courts, and vertically based on the timing of the judgements. In addition, access to judgements online may stimulate legal research and scholarly discussions. With more transparency and consistency in judicial decisions, it is practicable and meaningful to conduct empirical research to evaluate judicial decisions and examine the government's legislative agenda.

2.2.Selection of 380 Cases

We identified 380 cases of derivative action to constitute our full sample. Effort has been made to ensure the best possible completeness of the sample through two streams: searching for the key phrase 'representative action *daibiao susong* (代表诉讼)' in the category of corporate-related disputes, as well as the relevant provisions. It is the common practice of Chinese courts to use the term 'representative action'.

After we had collected all relevant cases, we carefully analysed each one and confirmed that the litigations in the cases were derivative actions. We eliminated cases that only dealt with jurisdiction, as well as cases that were easily confused with derivative actions, including cases that were classified as shareholders' direct actions and companies' actions.

In order to differentiate derivative actions, direct actions and company actions systematically, we reference Articles 23–26 of the Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (IV) 最高人民法院关于适用＜中华人民共和国公司法＞若干问题的规定（四） (Provision IV). Provision IV clarified that Article 151 provides for two different types of litigation – the "company's direct action" (*gongsi zhijie susong* 公司直接诉讼) and the derivative action. To be specific, Provision IV states that at the request of shareholders, the board of directors/executive director or the board of supervisors/supervisors can bring actions against wrongdoers. Such actions are viewed as company actions brought directly by the company itself, and the company will be treated as the claimant in such actions.[12]

In practice, a strict approach has been adopted in Chinese courts to segregate the direct/derivative dichotomy. Cases that are brought as direct actions but contain a legal basis for derivative action are usually rejected by the courts on the basis of making the wrong claim. We have eliminated such cases from our sample, as their merits were not considered by the courts. Under Chinese law, shareholders' direct actions can be brought under Articles 20, 22 and 152. In our opinion, this strict approach is not necessarily the most efficient. We identified a number of cases where direct actions were brought but the claims were rejected because the courts thought that claimants should have initiated the cases as derivative actions, although the courts could have heard the cases as derivative actions so that these cases could be

[11] Björn B. Ahl & Daniel D. Sprick, 'Towards Judicial Transparency in China: The New Public Access Database for Court Decisions' (2017) 32 *China Information* 3.

[12] Provision IV, Article 23.

settled more efficiently. These cases always involved scenarios where wrongs were found to cause loss to the company, including signing or terminating a contract to the detriment of the company,[13] siphoning corporate assets,[14] undervaluing transfers[15] and unauthorised disposal of the company's property.[16]

The courts have strictly distinguished between losses to the company and personal losses to shareholders, and found that shareholders may not make a personal claim where their loss is only incurred indirectly as a result of the loss to the company. We have not included these cases in our sample because the courts rejected the cases without considering their merits. To our knowledge, no claimants have initiated follow-up derivative actions.

3. Key Findings and Reflections

This section presents seven key research findings of our empirical analysis, and some reflections.

3.1 Number of Cases by Year and Pattern of Cases in Joint Stock Limited Companies (JSLCs) and Limited Liability Companies (LLCs)

The number of cases is a straightforward statistic with meaningful implications. The following figures indicate the flow of cases every year since the enactment of CCL 2005 on January 1st, 2006. The data indicate that the mechanism has been reasonably used by shareholders for the deterrence of mismanagement, and for compensating companies and their shareholders for harm caused. We found 380 derivative actions during the period from 2006 to 2019 – an average of 27 cases per year. The overall trend is rising, with increasing popularity of derivative actions since 2014. This may be explained by improved understanding of derivative actions, including among lawyers, judges and shareholders, particularly after the issuing of Provision IV in 2014, which offered guidance before it was formally enacted in September 2017.

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[13] *Chen Zhixiong v Chen Zhiwen* (2014 GanMinErZhong No. 13)[陈志雄与陈志文损害股东利益责任纠纷案(2014)赣民二终字第 13 号]; *Mo Haijun v Hu Haibo et al.* (2013 GuishiMinerZhongZi No. 183) [莫海军与胡海波等损害股东利益责任纠纷上诉案(2013) 桂市民二终字第 183 号].

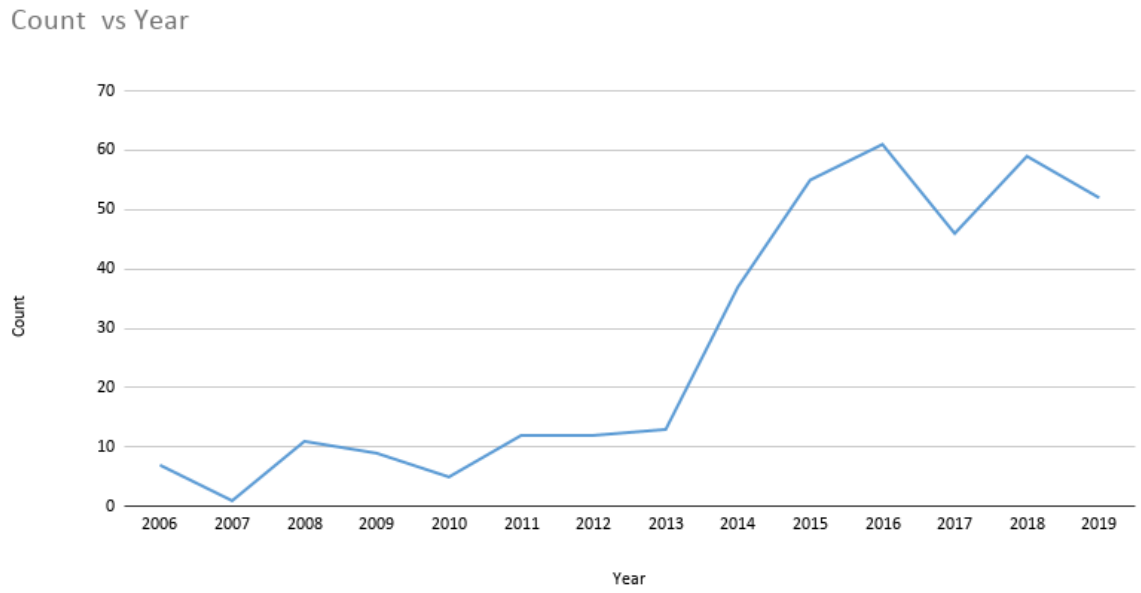
Mo Haijun v. Hu Haibo et al. (2013 GuishiMinerZhongZi No. 183) [莫海军与胡海波等损害股东利益责任纠纷上诉案(2013)桂市民二终字第 183 号].

[14] *Chen Guorong v Huang Qing Shao* (2014 ZhuZhongfaliMinzhonZi No. 234) [陈国荣等诉黄庆韶等损害股东利益责任纠纷案 (2014)珠中法立民终字第 234 号].

[15] *Zhang Ding v Zhang Yong* (2016 Lu 01 Minzhong No. 5133) [张丁诉张勇等损害股东利益责任纠纷案(2016)鲁 01 民终 5133 号]; *Li Jian v Hao Gui Dong* (2016 Supreme People's Court Minshen No. 84) [李健诉郝贵东等损害股东利益责任纠纷案(2016)最高法民申 84 号]; *Tan Lixing v Li Jingwei* (2014 Supreme People's Court MinshenZi No. 693) [谭利兴等诉黎经炜等董事、高级管理人员损害股东利益赔偿纠纷案(2014)民申字第 693 号].

[16] *Luo Xiaofeng v. Wenzhou is Xu Film and Television Production Co., Ltd.* (2014 WenluShangchuZi No. 5108)[罗晓凤诉温州正栩影视制作有限公司等公司债权人利益责任纠纷案(2014)温鹿商初字第 5108 号].

Figure 1: Number of Derivative Action Cases (2006–2019)



"The biggest problem of derivative actions in China is not too many lawsuits, but too few of them."[17] The lack of such cases in China has been seen as a result of the non-litigious culture and the civil law legal system.[18] We believe it is meaningful to investigate the number of cases in other jurisdictions, in order to give a comparative view of the practical application of the mechanism purely based on the criterion of case numbers.

A detailed analysis will be offered of the cases brought in JSLCs in our sample. One case brought by a single shareholder was rejected by the court on the grounds that the shareholder did not meet the shareholding percentage requirement of 1%; also the shareholder had not satisfied the procedural requirement of demanding that the company should take action first.[19] However, the court supported the other two cases brought collectively by shareholders in JSLCs. In one of these two cases,[20] institutional shareholders were joined by individual shareholders (four plaintiffs in total), and they sued the controlling shareholder for failing to repay a loan borrowed from the company. In the second case[21] four individual shareholders collectively brought an

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[17] Junhai Liu, *Modern Corporation Law 现代公司法* (3rd ed. Beijing: Law Press 2015) 408.

[18] Lilian Miles, "The Application of Anglo-American Corporate Practices in Societies Influenced by Confucian Values" (2006) 111 *Business and Society Review* 305.

[19] *Gu Shanhua v Hong Kong Shengxun Enterprise Co., Ltd. et al.* (SuMinZhong No. 217) [顾善华因诉香港盛迅企业有限公司、镇江八佰伴商贸 有限公司及第三人镇江百货股份有限公司损害公司利益案（2016）苏民终 217 号].

[20] *Kaiming Construction et al. v Huang Dayin et al.* (2017 Yu 0110 MinChu No. 9690) [原告凯明建筑等与被告黄达银等损害公司利益案 (2017) 渝 0110 民初 9690 号].

[21] *Huang Congfu et al. v Huang Runguo et al.* (2016, Xiang 1022 MinChu No. 711) [原告黄丛付等与被告黄润国等损害公司利益责任纠纷一 案 (2016) 湘 1022 民初 711 号].

action against third persons who defaulted on a contract with the company.[22] Interestingly, the individual plaintiffs were residents of the same village with the same family name, and the company involved was a "village enterprise".

3.2 Case Location

We have found that most cases, including derivative actions, are generally concentrated in economically developed areas such as Beijing, Shanghai, Zhejiang, Guangdong and Jiangsu. As the most developed regions in China with the highest GDPs (see Table 1), these cities and provinces play an essential role in the economic growth of the country. Beijing is the capital city and political centre of China. Shanghai is the biggest city in China and lies at the centre of the Yangtze River Delta, the most economically developed region in China with economic growth largely driven by Jiangsu and Zhejiang provinces. Zhejiang is home to 92 of the top 500 privately-owned companies, and has been ranked highest in terms of economic performance among all provinces in China for 21 consecutive years.[23] The economic performance of Guangdong is not as strong as that of Zhejiang, but it was the original site of reform and opening up, and incorporates the Pearl River Delta. This is an area closely linked with Hong Kong and includes metropolises such as Shenzhen and Guangzhou. The two main stock exchanges in China are located in Shanghai and Shenzhen, and they have grown to become the 2nd and 4th largest in Asia and the 4th and 8th largest globally, with 2,208 and 1,575 listed companies respectively and total free-floating market capitalisations of 8,515 trillion as of December 2019.[24] Due to the number of commercial transactions, these areas with high GDPs are, unsurprisingly, the areas where most cases are heard. Tianjin City seems to be an exception, although this major northern port municipality has admitted to falsifying GDP data.

In total, cases in these five developed regions out of 23 provinces and 4 municipalities, apart from Tianjin, account for 59.21% (216) of all derivative actions.[25] The result is not surprising as more conflicts will be generated between shareholders and controllers of companies in large economies. The result may also reflect better awareness and understanding of derivative actions from shareholders, and more claims and better professional knowledge among lawyers with more experience in corporate law cases. In China, where most company laws are enacted as an example of a legal transplant,[26]

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[22] The four defendants in this case had contracted with the company but failed to pay contracting fees to the company in accordance with the contract. The shareholders' claim was for the defendant to pay the contracting fees in arrears as well as a penalty.

[23] See Xi Nan, China's top 500 private enterprises announced, Zhejiang ranked first in 21 consecutive years 中国民营企业 500 强公布, 浙江上榜数量连续 21 年第一, Zhejiang Online, Aug. 22nd 2019, http://js.zjol.com.cn/ycxw_zxtf/201908/t20190822_10859820.shtml

[24] The WFE Statistics Team, *Market Statistics - January 2020* https://focus.world-exchanges.org/issue/january-2020/market-statistics

[25] These cities and provinces have the highest GDP per capita in China. See http://www.xuetz.com/xuetz-info/64552.html

[26] The concept of legal transplant is defined as a transfer of laws and institutional structures across geopolitical or cultural borders which may be imposed or voluntary, and may encompass entire legal

economic development in a region is usually the foundation for effective enforcement of law, and provides stimulation for more comprehensive legal practice.

Table 1: Court location

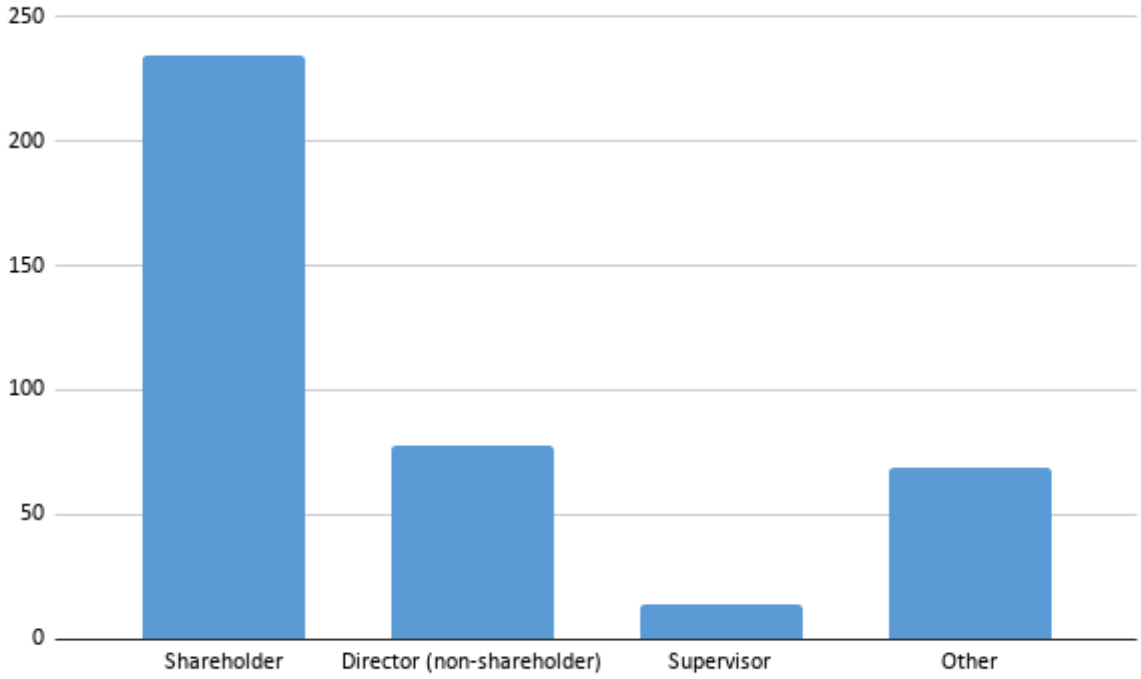
Area	Number of Cases	Percentage	GDP per capita 2019 (thousand USD)
Guangdong	57	15%	1.38
Jiangsu	46	12%	1.79
Shanghai	43	11%	2.28
Zhejiang	43	11%	1.58
Beijing	39	10%	2.38
Developed Regions Total	**225**	**59.21%**	
Others	155	40.79%	
Total	380	100%	

3.3 Defendant

As illustrated in Figure 2, we found that the largest group of defendants was shareholders (234), and the second largest was non-shareholder directors (78). Supervisors were the smallest group (14), and the number the defendants falling in the category of 'other people' was only slightly smaller than the number of directors (69). It should be noted that there are cases in which more than one defendant is sued, so the total number of defendants (395) is larger than the number of cases.

systems or a single legal principle; see John Stanley Gillespie, *Transplanting Commercial Law Reform: Developing a 'Rule of Law' in Vietnam* (1st edn, London: Routledge, 28 November 2006) 17–38.

Figure 2: Defendant Identity



The fact that 59% (234/395) of the defendants are shareholders sheds light on two significant aspects of corporate governance problems in China. First, we have found that most of these cases were in relation to LLCs with no clear separation between ownership and control, where the main agency problem arises between the controlling shareholder and the minority shareholders. It is always the case that the defendants have the dual identity of shareholders and directors, but, strangely, the case files record the defendants as shareholders, rather than directors. This also reveals a problem whereby the claimants may have a stronger recognition of the defendants' identity as controlling shareholders rather than as directors, and a direct litigation might have been a more appropriate channel. Second, it may indicate that the claimants' knowledge and understanding of the nature of derivative actions (as a litigation brought on behalf of the company) are immature.

In terms of "other people" defendants besides shareholders, directors and supervisors, Article 151(3) explicitly permits shareholders to bring a derivative action against "other people" who infringe on the interests of the company and cause loss to the company. This is a catch-all phrase for both insiders and outsiders of the company. The number of outsider defendants is larger than the number of supervisor defendants, who might lack real power and have limited opportunity to abuse it. According to Section 151(1), defendants in derivative actions include directors, supervisors and senior officers. The category of "any other person" as a defendant embedded in Section 151(3) makes the law uncertain. The result of our sample places "other people" in the following five categories: (1) companies connected with the

controlling shareholder/director; [27] (2) family and relatives of the controlling shareholder, director or those with dual identity;[28] (3) accessories to fraud against the company;[29] (4) third parties who have contractual or tortious relationships with the company;[30] and (5) governmental agencies that have infringed the interests of the company.[31] However, the judicial practice is inconsistent. It may be concluded that derivative actions may not be brought against "outsiders" of the company in some courts.[32]

Looking at the equivalent provisions in UK company law, "the cause of action may be against the director or another person (or both)",[33] and it is claimed that "another person" only applies to those persons who have assisted directors in the breach of their duties.[34] Chinese scholars have also made some attempts to interpret the term. Liu argues that defendants in derivative actions may include directors, supervisors, senior managers, majority shareholders and third persons (监事、高管、大股东、第三人等人员对公司的侵害行为).[35] Rather than explicitly listing constituencies, we think it may be more reasonable to describe the scope of "other people" as Cai interpreted the term, namely that defendants should include parties against whom companies are not capable or not willing to institute a litigation (公司无意或无力起诉的人).[36] Together with the interpretation of the UK law, "other people" can include those persons who have assisted directors and supervisors in the breach of their duties but against whom companies do not intend to bring or are not capable of bringing a litigation. This interpretation delimits the scope of eligible defendants in such cases, and may enhance the accessibility and effectiveness of the law. Shareholders may gain access to the mechanism where companies are incapable of initiating litigation. The

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[27] *Gao Bingrui v Shunming Fujian Construction Engineering Co. Ltd.* (2012 SanminChuZi No. 118) [高炳瑞与顺明福建建设工程有限公司等损害公司利益责任纠纷 一案 (2012) 三民初字第 118 号].

[28] *Zhang Baode v Li Heping, Cheng Qinghui* (2017 Shan 0303 Minchu No. 2421) [张宝德与李和平、成清慧损害公司利益案 (2017) 陕 0303 民初 2421 号].

[29] *Sichuan Huqiang Equity Investment Fund Management Co. Ltd. et al. v Sichuan Shengyu New Rural Construction Co. Ltd.* (2015 ChenghuaMinChuZi No. 6212) [四川省互强股权投资基金管理有限公司等与四川圣禹新农村建设有限公司损害公司利益案 (2015) 成华民初字第 6212 号]; *Deng Xiyan et al. v Guangzhou Jicaoyuan Cosmetics Co. Ltd.* (2014 HuiYunFaMinerChuZi No. 767) [邓喜艳等诉广州集草缘化妆品有限公司加工合同纠纷案 (2014) 穗云法民二初字第 767 号].

[30] *Zhang Lijuan v Dong Yongkang et al.* (SuZhongShangChuZi No. 00289) [原告张丽娟诉被告董永康损害公司利益案 (2014) 宿中商初字第 00289 号].

[31] *Guo Mouhai et al. v Danzhou City Government* (2012 HainanErZhonghangZhongZi No. 13) [郭某海等诉儋州市人民政 府土地行政登记案（2012）海南二中行终字第 13 号].

[32] *Liang Chengjia v Bao Aiguo et al.* (2014, JinMiner(Shang)ChuZi No. 168)[梁成佳与包爱国、赵炜、陈芝荣 损害公司利益案 (2014) 金民二(商) 初字第 168 号]; *Yang Guiping v Kaiyuan Zhongxin Toys Co. Ltd.* (2013 JuhouShangChuZi No. 0142) [杨桂平诉江苏开元众鑫玩具有限公司利益案 (2013)句后商初字第 0142 号].

[33] Section 260 (3), UK CA 2006.

[34] David Kershaw, *Company Law in Context: Text & Materials* (Oxford: Oxford University Press 2009) 556.

[35] Kaixiang Liu, 'The Judicial Application and Legislative Perfection of Shareholder Representative Action 股东代表诉讼的司法适用与立法完善' [2008] *China Legal Science 中国法学* 157.

[36] Lidong Cai, 'The Scope of Defendant in Derivative Suit 论股东派生诉讼中被告的范围' (2007) 21 *Contemporary Law Review* 当代法学 153 at 158.

flexibility of this definition will also enhance the effectiveness of the mechanism to give courts guidance to evaluate the eligibility of defendants.

3.4 Claimants

3.4.1 Nature of Claimants – Individual vs Institutional Shareholders

As illustrated in Table 2, it is uncommon for institutional shareholders to bring derivative actions, accounting for only 30% (111/380) of all claimants. This may come as a surprise, since institutional shareholders are regarded as important parties in monitoring companies' performance with a strong motivation to engage in corporate governance.[37] Furthermore, they also have access to information and resources that should make it easier for them to institute an action on behalf of companies.

Table 2: Plaintiff identity: Natural Persons vs Institutions

Number of plaintiffs	Number of cases	Percentage
Individual	269	70%
Institutional	111	30%
Total	380	100%

Compared with countries with mature financial markets and a high level of shareholder activism such as the US, Japan, the UK or Australia,[38] it may seem worrying that institutional shareholders in China have a less active involvement in corporate governance.[39] There are obviously means other than derivative actions by which institutional shareholders can monitor and evaluate directors' performance, ranging from the threat of diverting their shares to the active use of voting powers in board elections and proxy contests.[40] The existing literature seems to suggest that in general, these shareholders prefer behind-the-scenes private tactics.[41] Proposals at shareholders' meetings, dialogues in public, activist engagement and courtroom confrontations are regarded as the last resort.[42] The lack of cases and incentives for institutional shareholders to initiate derivative proceedings may be the result of

[37] See Bo Gong, *Understanding Institutional Shareholder Activism: A Comparative Study of the UK and China* (London: Routledge 2014).

[38] Lazard's Shareholder Advisory Group, *2019 Review of Shareholder Activism* (January 2020).

[39] Bo Gong, 'The Limits of Institutional Shareholder Activism in China and the United Kingdom: Some Comparisons' in R. Tomasic (Ed.) *Routledge Handbook of Corporate Law* (London: Routledge 2017).

[40] Wenfeng Wu, Sofia A. Johan & Oliver M. Rui, 'Institutional Investors, Political Connections, and the Incidence of Regulatory Enforcement Against Corporate Fraud' (2016) 134 *Journal of Business Ethics* 709 at 712.

[41] Yamin Zeng, Qingbo Yuan & Junsheng Zhang, 'Dark Side of Institutional Shareholder Activism in Emerging Markets: Evidence from China's Split Share Structure Reform' (2011) 40 *Asia-Pacific Journal of Financial Studies* 240 at 259.

[42] Chao Xi, 'Institutional Shareholder Activism in China: Law and Practice (Part 1)' (2006) 17 *International Company and Commercial Law Review* 251 at 253.

reputational costs. These are in addition to the regulatory thresholds, with minimum required shareholding percentages and periods, as discussed earlier in this paper. Another reason why institutional shareholders are not actively involved might be that most derivative actions are litigated in LLCs with a limited number of institutional shareholders.

3.4.2 Nature of Claimants – Collective vs Individual Actions

As illustrated in Table 3, 80% (304/380) of cases involve single claimants, while only 20% (76/380) of cases involve shareholders that have filed derivative actions collectively.

Table 3: Nature of Claimants – Single vs Collective

Number of plaintiffs	Number of cases	Percentage
Collective	76	20%
Single	304	80%
Total	380	100%

Collective litigation is not a common practice in China. This echoes our previous finding related to the lack of claims in JSLCs, and the difficulties for shareholders who wish to bring a collective action in satisfying 'the aggregate 1% or more' threshold.[43] It is difficult to initiate collective action among shareholders in JSLCs, especially in listed companies, at least in China where most minority shareholders are individuals.[44] Organising a number of individual shareholders who are willing to bring a collective derivative action can be a very difficult and problematic process. These shareholders almost invariably rely on the 'last resort' of soliciting other shareholders publicly, which will damage the confidence of public investors and could affect the reputation of the company.[45] Information asymmetry has also proved to be a major practical obstacle for joint derivative action claimants, who struggle to acquire sufficient information about their fellow shareholders.

3.5 Court Fees

As illustrated in Figure 3, litigation fees for derivative actions in China are charged based on a sliding scale system, where the litigation fee is in proportion to the amount

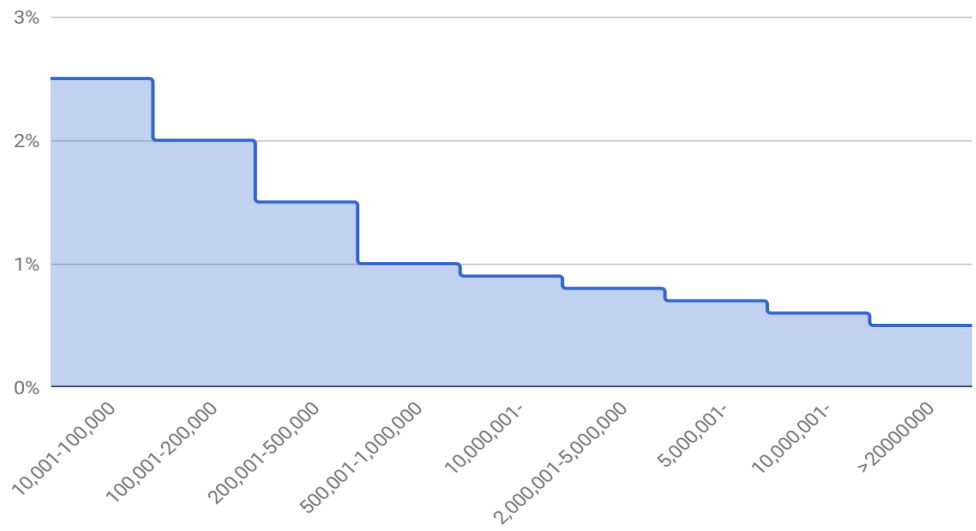
[43] Article 151 CCL 2013.

[44] Fidy Xiangxing Hong & Say H. Goo, 'Derivative Action in China: Problems and Prospectus' [2009] *Journal of Business Law* 376 at 388.

[45] Junhai Liu, 'Experience of Internationalization of Chinese Corporate Law and Corporate Governance: How to Make the Hybrid of Civil Law and Common Law Work?' (2015) *European Business Law Review* 107 at 119.

of damages the defendants seek to claim. This is calculated according to Article 13 (1) of the Measure on Payment of Litigation,[46] which is shown in the following figure.

Figure 3: Court fees



Positively, following the UK rule of the 'indemnity order' which was first made legitimate in *Wallersteiner v Moir (No 2)*,[47] successful shareholders may be indemnified for investigation fees, assessment fees, notary fees and other reasonable costs incurred during the litigation.[48] Therefore, if the court supports the claim, either fully or partially, in the first instance and no appeal is raised by the defendant, the shareholder may recover fees from the defendant. However, the claimant shareholder may need to pay an additional sum of money for the enforcement of the judgement.

In derivative actions, claimants may have to pay huge amounts in litigation fees if the claimed damages are high. This is particularly likely to be the case for listed companies due to their size, capitalisation, and the seriousness of the potential damage. In China, from historical evidence related to case numbers it was concluded that the current sliding system serves as "a robust disincentive to prospective shareholders suing derivatively on behalf of the company".[49]

It is worth looking at the Japanese experience as a reference for reform, where the sliding scale system was historically adopted but was proven to be a barrier to shareholder derivative claims.[50] The *Nikko Securities* case created an impetus for a

[46] Section 6, Measure on Payment of Litigation(诉讼费用交纳办法) 2007.
[47] *Wallersteiner v Moir (No 2)* [1975] QB 373; see also *Masri v Consolidated Contractors International Co SAL* [2011] EWHC 1024; *Air Canada v Secretly of State for Trade (No. 2)* [1983] W.L.R. 494.
[48] Article 35, Provision IV.
[49] Fengpeng Meng, 'Funding Derivative Action in China: Lessons from Wallersteiner v Moir (No.2) for the Court' (2010) 31 *Company Lawyer* 29 at 29.
[50] Magnus Blomstrom & Summer La Croix, *Institutional Change in Japan* (London: Routledge 2006) 241.

significant increase in derivative suits.[51] The court supported the shareholders' argument that the stamp fee for bringing a derivative action should be tailored to a normal fixed rate, because the economic benefit to shareholders from derivative actions is in practice incalculable.[52] As a result, filing a derivative action was given a flat fixed fee of 8,200 Yen, subsequently revised to 13,000 Yen, for litigations where the damages sought do not exceed 1.6 million Yen.[53] This amendment is regarded as one of the most influential events in Japanese corporate governance history.[54] This welcome change in Japan confirms the possibilities of partly transplanting such a rule in China, to promote accessibility and effectiveness of the derivative action mechanism there.

However, based on our observations as shown in Figure 4, compared with Japan, the filing fees for derivative cases in China are highly variable with a high standard deviation. Therefore, it might be unreasonable to adopt a one-size-fits-all approach. Also, a fixed fee could lead to an increased litigation fee for smaller claims and discourage litigate shareholders in small cases.

We use a box plot in Figure 4 to describe the distribution of filing fees for derivative actions in our cohort. As shown by the box plot, the mean (average) of the data (represented by the dotted line) is 53,274 RMB and the median (represented by the line within the box) is 12,221 RMB. The upper fence of the data is 101,084 RMB, which indicates that in 90% of the cases filing fees are lower than this amount, with a minimum amount of 40 RMB. The data above the upper fence are outliers, indicating extremely high costs in these cases. The highest filing fee in our sample was 1,802,760 RMB.[55]

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[51] Shiro Kawashima & Susumu Sakurai, 'Shareholder Derivative Litigation in Japan: Law, Practice, And Suggested Reforms' (1997) 33 *Stanford Journal of International Law* 9.

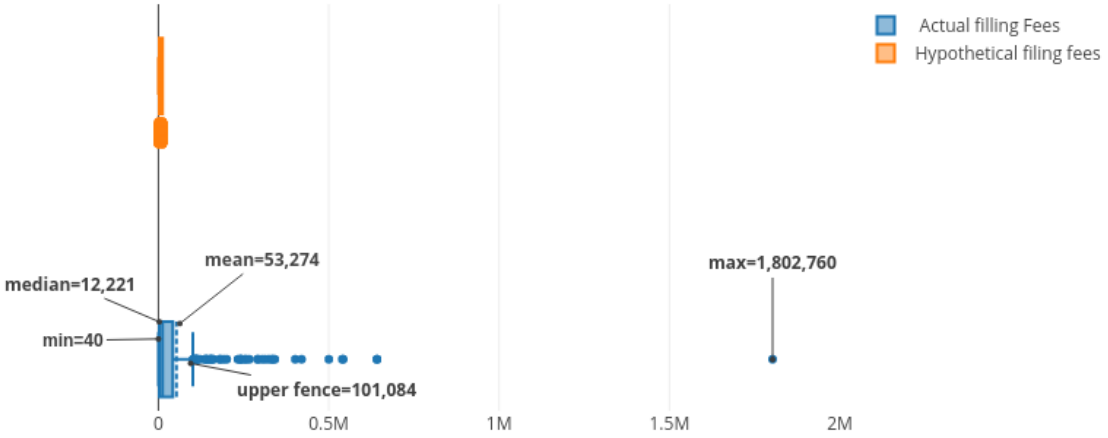
[52] *Shiryou-ban Shouji-Houmu* 70 (Tokyo High Court, 30 March 1993); see also Article 267 (4) Japanese Commercial Code.

[53] Article 4(2) Law on the Fee of Civil Lawsuits of Japan.

[54] Tomotaka Fujita, 'Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision' in H. Kanda (eds) *Transforming Corporate Governances in East Asia* (Abington: Routledge 2008) 13 at 15–16.

[55] *Zhejiang Dianxin Electronic Development Ltd Co et al. v Tonghe Investment Property Ltd Co et al.* (2008 MinerZhongZi No. 123) [浙江和信电力开发有限公司、金华市大兴物资有限公司与通和置业投资有限公司、广厦控股创业投资有限公司、上海富沃企业发展有限公司损害公司权益纠纷上诉案 (民二终字第123号)].

Figure 4 Litigation fees



In order to encourage all qualified shareholders to bring legitimate derivative actions, we propose a fixed ceiling on filing fees. Hypothetically, if the maximum amount is fixed at 12,221 RMB (the median of the actual filing fees), extremely high values could be eliminated and the total amount of the filing fees could be reduced to 15% of the actual amount (see the plot for hypothetical filing fees). This means that in total, the claimants in our sample would save 85% in filing fees if the filing fees were capped at 12,221 RMB. The ceiling for filing fees could even be set lower than this amount, considering that the filing fee for derivative actions in Japan is as low as 13,000 Yen (825 RMB). However, additional empirical research is needed to ascertain the most suitable amount.

3.6 Demand Requirement

With reference to the procedural rules for bringing a derivative action in China, the mechanism of the demand requirement may be adopted to strike a balance between improving shareholder remedies and preventing vexatious suits.[56] This is a screening process for the supervisor, the supervisory board, the board of directors or the executive directors, who have access to more resources in the company as well as information about the behaviours and decisions of directors. This current law and our findings on the application of the rule will be discussed below, followed by some reform proposals.

3.6.1 The Current Law

Shareholders may request, in writing, the board of supervisors or the board of directors (or the supervisors or the executive director of an LLC without such a board)

[56] Hui Huang, 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis' (2012) 27 *Banking and Finance Law Review* 619 at 652.

to bring a derivative action. If these requests are refused, or shareholders receive no response within 30 days, or the situation is too urgent, the shareholders are allowed to lodge an action themselves.[57] This requirement is "a nod to the principle of exhaustion of intra-corporate remedies".[58] The opportunity to correct the misconducts of corporate controllers should be given to the company before legal intervention, because the company is the party that has suffered directly. When assessing the importance and possibilities of continuing a claim the supervisor, the supervisory board, the board of directors or the executive director should consider a number of issues, such as the cost of the proceedings and damage to the company's reputation, before making their decision. If a company successfully employs other approaches to solve the problem, there will be no need to resort to a judicial recourse. The wrong can be corrected by and within the company itself, which may benefit the company.[59]

3.6.2 Our Findings and Three Observations

As illustrated in Table 4, we found that 42% (146/380) of the cases in our cohort satisfied the demand requirement, whereas 39% (138/380) failed to meet the requirement; the situation was unknown for the rest of the cases. Notable circumstances where shareholders failed the demand requirement included making a demand of a single supervisor when there were two supervisors,[60] the supervisory board not receiving the demand letter,[61] and the reflection of the supervisory board after demands were made on the previous board.[62] The rest of the case reports did not clarify whether the plaintiffs had made a demand or not.

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[57] Article 151 CCL 2013.

[58] Shaowei Lin, *Derivative Actions in Chinese Company Law* (Kluwer Law International 2015) p.114.

[59] Deborah A. Demott, 'Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions' (1986-1988) 11 *Sydney Law Review* 259 at 262.

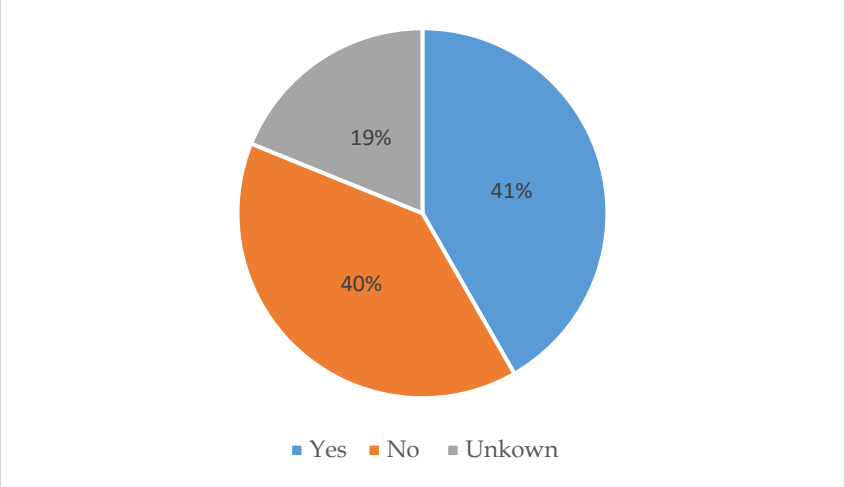
[60] *Yang Guiping v Jiangsu Kaiyuan Zhongxin Toys Co. Ltd.* (2013 JuhouShangchuZi No. 0142 [杨桂平诉江苏开元众鑫玩具有限公司利益责任纠纷案 (2013)句后商初字第 0142 号].

[61] *Shandong Hengkang Real Estate Co. Ltd. v Jiangsu Chunhui Ecological Agriculture & Forestry Co. Ltd.* (2015 GaoShangchuZi No. 762) [山东恒康置业有限公司等诉江苏春辉生态农林股份有限公司公司利益责任纠纷案 (2015)高商初字第 762 号].

[62] *Zheng Hua et al. v Cui Jinping* (2014 ChaoMinchuZi No. 9320) [郑华等诉崔金萍公司利益责任纠纷案 (2014)朝民初字第 9320 号].

Table 4: Demand Requirement

Satisfied demand?	Number of cases	Percentage
Yes	156	41%
No	153	40%
Unknown	71	19%
Total	380	100%



In addition to the percentage satisfying the demand requirement, we can offer a few interesting observations. First, failure to meet the demand requirement is the main grounds for refusing to accept derivative cases. Second, we identified 20 cases where claimants had dual identities, namely shareholders who are also supervisors. Only 7 of these 20 cases were accepted by the courts. In some of the cases that were accepted by the courts, judicial reasoning relied on the rationale that a supervisor could file an action on behalf of the company, and such an action would be the company's action, which does not trigger a demand requirement.[63] In other cases the courts allowed the actions to proceed as derivative actions and exempted the shareholder/supervisor from the demand requirement.[64] Therefore, the courts have been inconsistent in determining whether the demand requirement has been fulfilled, especially when the plaintiff has the dual identify of shareholder and supervisor. When a shareholder is the only supervisor in the company, there is controversy as to whether a

[63] *Zhuhai Pu Enrui Electric Power Technology Co., Ltd. vs Wang Lei et al.* (2017 Yue 04 Minzhong No. 2588) [珠海普恩瑞电力科技有限公司诉王磊、珠海普恩瑞信息技术有限公司损害公司利益案（2017）粤 04 民终 2588 号]; *Fu Weiyong v Hu Xiaojian* (2015 YuMinErZhongZi No. 126) [符伟勇与胡小剑损害公司利益案（2015）余民二终字第 126 号].

[64] *Qu Quyin v Qu Zhenming* (2017 Yue 06 Minzhong No. 3876) [区焜栩因与区振明、区浩源损害公司利益案（2017）粤 06 民终 3876 号]; *Huang Wei Yin v Pan Zhonghe* (2017 Yue 03 Minzhong No. 874) [黄伟因与潘中和损害公司利益案（2017）粤 03 民终 874 号]; *Liao Xianghua v Liao Xianggu* (2016 Yue 16 Minzhong No. 6970)[廖香花与廖香姑损害公司利益案 （2016）粤 19 民终 6970 号].

shareholder/supervisor should make a demand of her-/himself first. Third, follow-up investigations of the cases rejected by the courts revealed an inconsistent application of the law. Some courts adhered to the strict application of the law by insisting that the shareholder(s)/supervisor(s) must make a demand in writing to themselves,[65] and others took a more functional and efficient approach by stating that the plaintiff should have brought the action in their capacity as a supervisor instead of as a shareholder.[66]

3.7 Court Decisions

As illustrated in Table 5, we have categorised court decisions into the headings of Refuse (*caiding bohui qisu* 裁定驳回起诉), Reject and Accept. A refusal refers to a ruling that dismisses a case for noncompliance with procedural requirements.[67] A rejection is a decision to dismiss the merits of the claimant's claim. Acceptance refers to cases accepted by the courts, including cases where the merits of the claim are considered and those without a substantive ruling by application of the law.

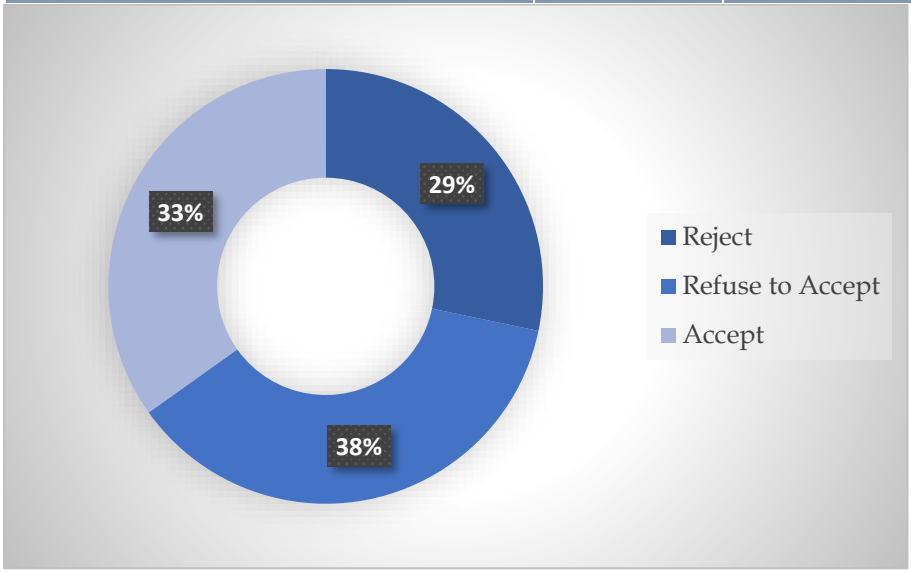
[65] *Liu Wei et al. v Zhang Shenghua et al.* (2016 Yu 0811 Minchu No. 968) [刘巍、范卫国与张胜华、焦作瑞彤科技有限 公司损害公司利益责任纠纷案 (2016)豫 0811 民初 968 号].

[66] *Zhang Yueliang v Wang Weiguo et al.* (2016 Yue 0306 Minchu 24966) [张岳良与王维国、冯军华、深圳新思维电工器材有限公司损害公司利益案 (2016) 粤 0306 民初 24966 号].

[67] Ping'an Tian, *Civil Procedural Law [民事诉讼法]* (Beijing: Law Press: 2005) 186.

Table 5 Decisions in All Cases

Decision	Count	Percentage
Reject (substantial)	111	29%
Refuse to accept (procedural)	144	38%
Accept	125	33%
Total	380	100%



Comparing the support/acceptance rates of the cases collected by Lin before 2006 (70% support/acceptance) and our cases from 2006 to 2013 (46%), the support/acceptance rate has dropped. We think there may be multiple reasons for this, which may not necessarily indicate a conservative judicial attitude in Chinese courts. First, the number of cases has increased, and the decline of the acceptance rate may actually demonstrate that the courts are becoming more relaxed in accepting cases. A relaxed attitude within the capability of the court workload would be helpful to promote the accessibility of the mechanism and would promote a more balanced judicial attitude. However, shareholders also need to be prepared to invest time and money, which they may claim in reimbursement from the company, into the litigation to challenge the potential misconduct of the controller.

Second, more support should be offered to eligible shareholders to enable them to bring derivative actions with confidence. We propose a unique enforcement format to regard derivative action as a private enforcement mechanism supported by the public enforcer. In addition to promoting the accessibility and effectiveness of the derivative action mechanism, support from the public enforcer will help vulnerable shareholders who lack knowledge, resources and information, and facilitate the formation of groups of willing shareholders to initiate collective actions. For example, with the

assistance of the China Securities Investor Services Centre (ISC, 中证中小投资者服务中心),[68] a not-for-profit organization established in 2014 under the supervision of the CSRC, the accessibility of the derivative action mechanism could be promoted through the services provided by the ISC, including delivering education, legal, information, technology and other services for small and medium investors to safeguard their rights. This is promising and in line with the nature of administrative corporate governance in China, which is instituted by the government and is characterised by governmental control and intervention. [69] Government policy in China has placed increasing importance on establishing a market economy with the shift towards a rule-based framework. We believe that government policy and administrative power may have an impact on the effective use of derivative actions by promoting the educational and communication role played by the ISC and the CSRC.

To date, the ISC has supported three false representation actions brought by investors in listed companies. The ISC played an essential role in these actions by organising investors, collecting evidence and providing legal services.[70] In the future, the ISC could also contribute to the development of derivative actions in listed companies by monitoring listed companies and facilitating collective action among shareholders. In order to exercise shareholders' rights on behalf of small investors, the ISC has purchased a small package of 100 shares from each of the listed companies on both the Shenzhen and Shanghai Exchanges. As a shareholder, the ISC can monitor listed companies and demand that their boards of directors/supervisors take action against wrongdoers. If such a demand is unanswered, the ISC is in a position to organise minority shareholders to fulfil the 1% shareholding requirement and initiate a derivative action.[71] It is also possible for the ISC to bring a derivative action on its own, as it is not subject to the 1% shareholding requirement.[72] The role of the ISC in derivative actions and the private enforcement of company law and securities law in China will be further discussed in Section 4.

3.8 Cause of Action

Theoretically, in a derivative action Article 151 should be cited together with other provisions in relation to any breach of duty or duties by directors or shareholders.

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[68] See the official website of the ISC: http://www.isc.com.cn/.

[69] Andrew Keay & Jingchen Zhao, 'Transforming Corporate Governance in Chinese Corporations: A Journey Not A Destination' (2018) 38 *Northwestern Journal of International Law and Business* 187 at 195.

[70] Robin Hui Huang, 'Rethinking the Relationship between Public Regulation and Private Litigation: Evidence from Securities Class Action in China' (2018) 19 *Theoretical Inquiries in Law* 333.

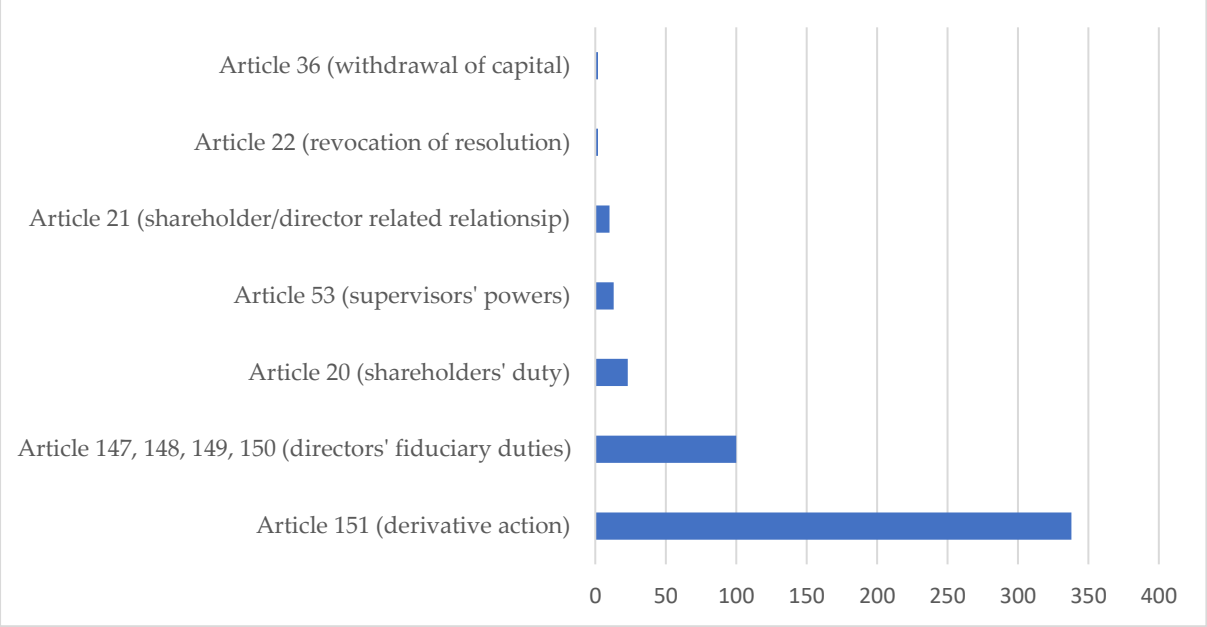
[71] *Framework of the Shareholder Rights of the ISC* [投服中心公益股东权的配置及制度建构], IOLAW, http://www.iolaw.org.cn/showArticle.aspx?id=5439 (Jan. 1, 2018); *People's Republic of China : Financial Sector Assessment Program – Detailed Assessment of Observance of the Iosco Objectives and Principles of Securities Regulation*, IMF, https://www.imf.org/en/Publications/CR/Issues/2017/12/26/Peoples-Republic-of-China-Financial-Sector-Assessment-Program-Detailed-Assessment-of-45517 (Dec. 26, 2017).

[72] Article 94(3), Chinese Securities Law (2019 revision).

This is because Article 151 only states that shareholders are allowed to bring a derivative action against directors on behalf of the company, but the cause of action needs to be found in other provisions of the CCL.

We found that Article 151 (152 previously)[73] was cited in 368 out of 380 cases in our sample (see Figure 5). This means that judicial practice in China is generally consistent but sometimes inaccurate; sometimes Article 151 was not cited in judgements even where cases were characterised as derivative actions.[74] Further, the main cause of action seems to be breach of duty by directors, since provisions regarding directors' duties (Articles 147–150) were cited most frequently (110 times out of 380 cases). Breach of duty by shareholders was also a major cause of action, as shown by the fact that the articles on shareholders' duty (Article 20) and shareholder/director relationships (Article 21) were cited 30 and 10 times respectively. Articles on the power of the supervisor (Articles 53) featured 13 times, and Articles regarding the revocation of resolutions (Article 22) and the withdrawal of capital (Article 36) were also mentioned (2 times each).

Figure 5 Cause of Action and Law Provision



These findings have further shed light on the classic scenario of derivative action in China. Although shareholders are not explicitly mentioned as potential defendants by

[73] The CCL was amended in 2013 and the numbering of the article has been changed.
[74] *Shanghai Hengsheng EE Co Ltd. v Ye Mou* (2011 HongMinerShangchuZi No. 182) [上海恒生电讯工程有限公司诉叶某纠纷案 (2011 虹民二商初字第 182 号)]; *Yu Ru v Wang Dong* (2016 Hu 0112 Minchu No.8831) [于茹诉王东损害股东利益责任纠 (2016) 沪 0112 民初 8831 号].

Article 151, it is clear from our findings that controlling shareholders are commonly sued for causing losses to the company, and in fact they are the main defendants in derivative actions (Figure 2). Combined the findings demonstrated in Figures 2 and 5, we can conclude that in a typical scenario for a derivative action in China, a single individual shareholder will claim against a defendant who is a director-shareholder in an LLC for breaching his/her duties. This is consistent with the finding in our sample that more than half of the shareholder defendants held the position of directors. Therefore, it seems that to a large extent, derivative action has addressed the oppression problem in LLCs in China.[75] We agree that the mechanism has been used as an effective way to enforce directors' duties, at least in LLCs, and we feel that it also has great potential for resolving agency problems in JSLCs.

This classic scenario demonstrates the double agency problem in China, including the vertical problem between shareholders and directors and the horizontal problem between majority and minority shareholders.[76] In LLCs, ownership is only marginally separated from control. A dialogue channel is normally established between the board of directors and the shareholders, owing to their close ties. A problem from these ties is confusion about claims against shareholders in derivative actions. Bringing a derivative claim action against a shareholder who is not a director seems to require the claimant to rely on provisions for shareholders' duties (e.g. Articles 20 or 21) in addition to Article 151.[77] If the plaintiff only cites Article 151 in making a claim against the shareholder, the court may reject the claim on the grounds that an action under Article 151 is mainly intended to address wrongs done by directors, supervisors or senior managers, and such an action cannot be initiated against shareholders.[78] Therefore, the reasons underlying such claims are perplexing: did the controllers breach their duties as shareholders or as directors? These actors owe very different duties towards the company under company law. For example, shareholders do not owe fiduciary duties towards the company. The controlling shareholder may owe duties towards minority shareholders, either directly or indirectly, but that duty should be used as the standing for bringing derivative action.

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[75] Nicholas C. Howson, 'Twenty-Five Years On – The Establishment and Application of Corporate Fiduciary Duties in PRC Law' (University of Michigan Law & Econ Research Paper No. 17-024) (2017) SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3102551 .

[76] Shaowei Lin, 'Double Agency Costs in China: A Legal Perspective' (2012) 9 *The Asian Business Lawyer* 116 at 119.

[77] *HNA Hotel Holdings Group Co., Ltd. v Zhao Xiaohai* (2016 ShanMinzhong No. 228) [海航酒店控股集团有限公司与被人赵小海损害公司利益责任 纠纷一案（2016）陕民终 228 号].

[78] *Yan Lixin & Feng Ruquan v Shandong Tianan Chemical Co. Ltd.* (2015 LinShangchuZi No. 1332) [隋立新与冯如泉、山东天安化工 股份有限公司股权转让纠纷案 (2015)临商初字第 1332 号]; *Hangzhou Ruili Real Estate Group Co. Ltd. v Hangzhou Xinsheng Real Estate Development Co. Ltd.* (2014 HangBinShangchuZi No. 640) [杭州瑞立房地产集团有限公司诉杭州欣盛房地产开发有限公司等 利益责任纠纷案 (2014)杭滨商初字第 640 号].

4. Codification and Integration

In this section, the reform proposals offered in Section 3 will be codified according to three important criteria: accessibility, fairness, and effectiveness. We will also consider how private enforcement backed by a public regulator could improve derivative actions along each of the three criteria.

4.1 Ascertaining the Themes

This paper chooses to assess the derivative action law in China according to three criteria: accessibility, fairness, and effectiveness.

4.1.1 Accessibility

Accessibility to shareholders is essential for improving the effectiveness of derivative actions. This requires a basic awareness of available remedies and access to courts without excessive litigation fees or unreasonable procedural barriers. Measured against this criterion, the derivative action mechanism in China still has many deficiencies as revealed by our study, such as high litigation fees, standing requirements, and barriers brought by difficulties in initiating collective action in JSLCs. As a result, most of the existing derivative action cases have single, natural person claimants, and cases in JSLCs with dispersed ownership are extremely rare.

The accessibility of the derivative action mechanism could be further undermined by legal transplant effects in China and other developing countries. As an imported law, it might be less effective than an internally developed law[79] as people might be unaware of their legal rights or less willing to make such a non-traditional claim.[80] We have found that these are all unbalancing phenomena that hinder the accessibility of the mechanism.

In order to address these obstacles to accessibility, we make a number of reform proposals, including a maximum cap for filing fees, a more enabling litigating environment to facilitate a more active role for institutional investors, and a supporting role for a public enforcer. Compared with individuals who are usually "one shot litigants", institutional investors are usually "repeat players" and thus have the legal experience and bargaining power to challenge the board and majority shareholders.[81] The role of institutional investors is particularly important in JSLCs as they are more likely to overcome the collective action problem and meet the 1% shareholding threshold. In China, a public enforcer such as the CSRC could assist shareholders by providing education, legal representation, and other resources. The establishment of the ISC under the auspices of the CSRC might be the start of a

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[79] Torpman Jan & Fredrik Jörgensen, 'Legal Effectiveness: Theoretical Developments Concerning Legal Transplants' (2005) 91 *Archives for Philosophy of Law and Social Philosophy* 515.

[80] Bryant G. Garth & Mauro Cappelletti, 'Access to Justice: The Newest Wave in the Worldwide Movement to Make Rights Effective' (1978) 27 *Buffalo Law Review* 181.

[81] *Ibid.*

promising new model of derivative action, with private enforcement supported by a public enforcer.

4.1.2 Fairness

The effectiveness of derivative actions should also be assessed against a fair mechanism in order to strike a balance between strengthening shareholder protection and respecting corporate internal governance. Derivative actions should give shareholder remedies against abuse by company controllers, but if courts are overly liberal in accepting these actions, companies might lose the opportunity to resolve conflicts through internal procedures, and the decision-making power of the board will be compromised. Compared to internal remedies, derivative actions can be lengthy and costly and damage a company's reputation. An abundance of lawsuits might also become a drain on judicial resources.[82]

The unique corporate governance model and mix of shareholders in China also necessitates a flexible and fair approach for derivative actions. In contrast to the UK and the US, corporate governance problems in China are fundamentally different in that the main agency problem is caused by abuse by controlling shareholders, rather than conflicts between board and shareholders. Nevertheless, experience from the UK and the US highlights the importance of respecting the internal governance of companies or board decisions when considering whether it will be effective to make a demand of the board, particularly through the business judgement rule.[83]

In the case of LLCs, a fair mechanism requires the system to be slightly tilted towards the accessibility of derivative actions. Due to the lack of an open market, regulatory oversight, and a fully-fledged oppression remedy, derivative actions in LLCs in China should offer more protection to less sophisticated shareholders. For example, the demand requirement should be excused in a case brought by a lone supervisor who is also a shareholder in a small company. On the other end of the spectrum, in listed JSLCs derivative actions should tilt towards protecting board discretion and the companies' collective interests. Even taking this into account, however, we have observed that the eligibility requirements could be loosened to create a fairer derivative action mechanism.

Another necessary aspect of fairness in derivative actions is a balance between litigation and alternative dispute resolution mechanisms. It is important to preserve

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[82] James Kirkbride, Steve Letza & Clive Smallman, 'Minority Shareholders and Corporate Governance: Reflections on the Derivative Action in the UK, the USA and in China' (2009) 51 *Intentional Journal of Law & Management* 206.

[83] For example, see Auerbach v Bennett, 393 N.E.2d 994 (NY 1979); Sinclair Oil Corp. v Levien, 280 A.2d 717 (Del. 1971); Shlensky v Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 19). Australia has a statutory business judgement rule; see Corporations Act 2001 (Australia), Section 180; see also Carole F. F. Wilder, 'The Demand Requirement and the Business Judgment Rule: Synergistic Procedural Obstacles to Shareholder Derivative Suits' (1984) 5 *Pace Law Review* 633.

established, long-term relationships within companies, especially given the central role of *guanxi* and *mianzi* in Chinese society. We observe that the prevalence of derivative action cases in JSLCs and LLCs is rather unbalanced; in LLCs the personal and business relationships of the shareholders are usually intertwined, with the consequence that a formal action in court might lead to a breakdown of relationships. In this situation, a derivative action might not be the best method for resolving conflicts. To complement derivative actions, alternative dispute resolution mechanisms such as arbitration and out-of-court settlements could be encouraged. These methods may be more cost-effective and may preserve long-term relationships among shareholders.[84]

4.1.3 Effectiveness

If law is viewed as a tool for social engineering, i.e. regulating or shaping the behaviours of members of society, the effectiveness of law must be measured by the extent to which it fulfils its objectives. The aims of law can be divided into preventive or curative objectives. A preventive law is effective if it can deter undesirable behaviours and prevent wrongdoing. A curative law is effective if it can remedy wrongs *ex post facto* and compensate the wronged parties.[85]

The effectiveness of the derivative action law should be measured according to both preventive and curative objectives, since it has a dual nature. First, the law seeks to deter directors and controlling shareholders from causing damage to the company and shareholders. Second, the law also seeks to compensate shareholders who have suffered losses. By both deterring and compensating, the law is able to ameliorate agency problems in companies and strengthen corporate governance.[86]

4.2 Integrating Problems, Proposals and Themes

We believe that the criteria stated above are key for addressing problems and promoting sound corporate governance and operative corporate law. These criteria may be addressed through the reform proposals in this article. For example, accessibility may be improved through the reform of substantive and procedural rules, including more relaxed claimant eligibility for JSLCs and capped litigation fees, in order to improve the predictability and consistency of the legislation while reducing cultural and reputational hindrances. We have studied various aspects of derivative actions and proposed a number of reforms, all of which bear on one or more of the stated criteria. These correspondences are detailed in Figure 6 and Figure 7, and each aspect is described in more detail in Appendix 1.

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[84] Ida Kwan Lun Mak, *Alternative Dispute Resolution of Shareholder Disputes in Hong Kong: Institutionalizing Its Effective Use* (Cambridge: Cambridge University Press 2017) 130.

[85] Antony Allott, 'The Effectiveness of Law' (1980) 15 *Vanderbilt University Law Review* 229.

[86] Stephen P. Ferris, Tomas Jandik, Robert M. Lawless & Anil Makhija, 'Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings' (2007) 42 *Journal of Financial and Quantitative Analysis* 143.

Figure 6: Aspects of Derivative Actions and their Influence on Accessibility, Fairness and Effectiveness

Aspect	**Accessibility**	**Fairness**	**Effectiveness**
Number of Cases	x		x
Regional Distribution	x		x
Type of Company (mostly LLCs)	x	x	x
Type of Company (few JSLCs)	x	x	x
Claimant	x		x
Defendant	x		x
Cause of Action	x	x	x
Court Fees	x		x
Demand Requirement	x	x	
Court Decision	x		x

Figure 7: Reform Proposals and their Influence on Accessibility, Fairness and Effectiveness

Reform	**Accessibility**	**Fairness**	**Effectiveness**
Consistent Judicial Approach	x	x	x
Increasing Use of Derivative Action for JSLCs	x		x
Maximum Cap for Filing Fees	x		x
Balanced Approach to Demand Requirement	x	x	x
Statutory Business Judgement Rule		x	x
Private Enforcement Supported by Public Enforcer	x		x

4.3 Private Enforcement Backed by Public Regulator in China: The Case of the Investor Services Centre in Supporting Derivative Actions

In the context of a unique hybrid corporate governance model with inevitable and necessary government interference, we think it is important to include a section containing a more detailed analysis of private enforcement supported by a public enforcer.

Private and public enforcement can be viewed as two basic forms of social control. Social controls imposed on businesses can be classified into four categories: market discipline, private litigation, public enforcement, and state ownership. We have found that derivative actions are rarely used by listed companies, and it is difficult for shareholders to surmount the shareholding/procedural/financial obstacles in order to bring derivative actions. Therefore, private enforcement supported by a public regulator is the most suitable model for policing derivative actions in China, and this is compatible with the institutional and political environment of the country.

The ISC is an example of movement in the right direction. Although the mission and functions of the ISC, a newly established organisation, are still unclear, it has the potential to become a quasi-public regulator that constitutes an extension of the CSRC and enforces its orders. As such, however, the ISC may become too politicised to escape "regulatory capture", like the CSRC itself. We think it would be better if the ISC became a public institutional investor that is actively involved in corporate governance, in order to achieve the following missions.

First, as a public institutional investor the ISC can improve the accessibility of derivative actions for listed companies. It provides education and information to shareholders so as to increase awareness of the derivative action mechanism as part of the shareholders' rights. The ISC could also assist shareholders in bringing derivative actions by coordinating collective actions, providing information and legal representation, and preserving a fund that could provide financial assistance to claimants. In addition, by becoming a shareholder in listed companies the ISC would be a legitimate party to monitor corporate governance and initiate derivative actions as a claimant against misbehaviours. The Securities Law, revised in 2019, provides that the ISC is not subject to the 1% shareholding requirement,[87] which means that the ISC, as a small shareholder, can bring a derivative action against the directors or controlling shareholders of any listed company if they have acted improperly.

It has been found that public institutional investors such as public pension funds have been instrumental in improving the effectiveness of class actions, and they are more active than private institutional investors in the corporate governance process.[88] The

[87] Article 94(3), Chinese Securities Law (2019 revision).

[88] James D. Cox & Randall S. Thomas, 'Does the Plaintiff Matter – An Empirical Analysis of Lead Plaintiffs in Securities Class Actions' (2006) 106 *Columbia Law Review* 1587.

public nature of these funds seems to make them different from private institutional investors, who may be discouraged by free-rider problems and the prospect of bearing hefty litigation costs. The managers of public pension funds are "political entrepreneurs" who are motivated by political gains in addition to economic gains. In pursuing actions for the benefit of all shareholders, public institutional investors actually provide a public good that private investors are unwilling to fund.[89]

Second, the ISC may be instrumental in achieving fairness between accessibility and other considerations such as respecting internal governance, maintaining long-term relationships and saving judicial resources. As a public institutional shareholder, the ISC has an informational advantage and is more likely to exhaust internal remedies before instigating lawsuits. Consequently, derivative actions initiated by the ISC are more likely to be meaningful and achieve corrective justice, which is the goal and value of private law.[90] Additionally, the ISC could even facilitate other dispute settlement measures.

Third, the ISC can initiate more cases, which will facilitate the development of more consistent legal rules. For example, our empirical findings demonstrate that the demand requirement has been applied rigidly and inconsistently by Chinese courts. This reflects overly formalised judicial procedure and constrained judicial discretion in comparison with civil law countries.[91] It is impracticable to expand the discretion of Chinese courts so that they could develop legal rules for excusing the demand requirement based on the business judgment rule, as courts in the US can do. If this constraint is not corrected, it could lead to more uncertainty, inconsistency, delay, corruption, or miscarriages of justice.[92] Corrective guidance from the SPC will only be possible with an accumulation of judicial practice.

Fourth, the ISC could act as a bridge between the CSRC and courts, facilitating communication between the government agency and judges. This would help to coordinate administrative sanctions and civil litigations against wrongdoers. In particular, the ISC could channel experience from the CSRC to the courts regarding fiduciary duties in listed companies, since the CSRC has been the main enforcer of these duties in China.[93] However, public enforcement will be insufficient for deterring or compensating and bringing reputational damage to the company. Therefore, in order to provide a better remedy for shareholders, the ISC should actively enforce fiduciary duties through derivative actions, with support from the CSRC.

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[89] Roberta Romano, 'Public Pension Fund Activism in Corporate Governance Reconsidered' (1993) 93 *Columbia Law Review* 795.

[90] Ernest J Weinrib, The Idea of Private Law (Oxford: Oxford University Press 1995) 56-58.

[91] Andrei Shleifer, 'Understanding Regulation' (2005) 11 European Financial Management 439.

[92] *Ibid.*

[93] Guangdong Xu, Tianshu Zhou, Bin Zeng & Jin Shi, 'Directors' Duties in China' (2013) 14 *European Business Organization Law Review* 57.

Moreover, although the ISC only represents shareholders in listed companies, its enforcement of fiduciary duties will also be beneficial for shareholders in LLCs. Derivative action is the main method for challenging controlling shareholders in LLCs in China. In general, derivative actions brought by the ISC will help courts to develop more specific rules for fiduciary duties, and to clarify the procedural rules for derivative actions.

Fifth, the ISC could promote shareholder activism by monitoring the disclosures of listed companies and preventing abuse *ex ante*. As a shareholder, the ISC can exercise its shareholder rights by participating in shareholders' meetings and inspecting financial documents. In China it is common for listed companies to require shareholders to provide documents in addition to those provided by law and regulations, thereby imposing illegal obstacles in the way of minority shareholders attending and voting in shareholder meetings. The involvement of the ISC could reduce such practices and safeguard the rights of minority shareholders.

5. Concluding Remarks

Throughout our studies of the legal cases and our follow-up investigation of the institutional environment for reform, we have considered many path dependencies that are deeply embedded in China, such as judicial resources, juridical attitudes, Chinese cultural attributes such as *guanxi*, the shareholding structure, shareholder activism or passivity, and the availability of alternative remedies. Our findings have led us to believe that the context and form of derivative action in China are unique. Our goal is to promote derivative action as a widely recognised and appropriately used mechanism, which should help it to achieve a reputation for being user-friendly, with legal practitioners willing to suggest it and shareholders willing to seek remedies relying on it.

From our empirical research on derivative actions based on 380 cases in China, we have found that: (1) there have been increasing numbers of derivative action cases in China from 2006 to 2019, but the mechanism may still be underused; (2) there is a disparity in the regional distribution of derivative action cases, most of which are concentrated in economically developed areas; (3) disparity also exists in the type of companies involved, with the overwhelming majority of cases brought for LLCs; (4) the most typical scenario for a derivative action in China involves a shareholder in an LLC suing the controlling shareholder who also acts as the director; (5) the demand requirement and court fees are the major obstacles in bringing derivative actions, since less than half of all cases satisfied the demand requirement and court fees can be extremely high; (6) the success rate for raising a derivative action is relatively low, at 35%; (7) court fees are highly variable with a high standard deviation; and (8) derivative actions are difficult in China because of collective action problems, but these problems can be overcome by shareholders with established *guanxi*.

In response to these findings, and with the purpose of building a more effective framework by maintaining a balance between upholding minority shareholder rights and avoiding frivolous suits, we put forward a few proposals for a more accessible derivative action mechanism. First, the judiciary should develop a more consistent approach towards derivative actions, particularly in terms of interpreting the demand requirement, directors' duties, and shareholders' duties. The legitimacy of the judiciary, and ultimately the rule of law, depends a consistent and predictable application of law. Second, derivative actions should be made more accessible to shareholders in JSLCs by lowering the shareholding requirement, reducing litigation fees, giving a more active role to institutional shareholders, and better coordinating collective actions, which may be supported by quasi-public organisations such as the ISC.

Third, a maximum cap for filing fees should be implemented, and fourth, when considering whether to accept a derivative action case, instead of using a rigid application of the demand requirement courts should make a comprehensive consideration regarding the costs of proceedings, the company's reputation, judicial resources, and alternative remedies (e.g. internal remedies and settlements). Guidance from the SPC is desirable here. Fifth, a statutory business judgment rule should be introduced as a complementary system, and finally, the derivative action system in China should be consolidated as a private enforcement measure supported by a public enforcer. The investor protection institution should play an educational and supporting role for shareholders, especially minority shareholders, to facilitate derivative action in JSLCs, particularly listed ones.

As one of the legal regimes with high expectations, working side by side with statutory oppression remedies,[94] we believe that the derivative action mechanism has the potential to become an effective and ingenious accountability mechanism for both LLCs and JSLCs. As a milestone in CCL and corporate governance reform,[95] the derivative action system in China must be established with specific local variations to fit with the many unique characteristics of China's history, economy, and society.

Under the three criteria of accessibility, fairness, and effectiveness, derivative actions in China should be developed to serve these competing goals. On one hand, the mechanism should encourage a variety of shareholders, individually as well as collectively, to participate in litigation to deter misconduct among management personnel. On the other hand, it should also constrain shareholders from abusing derivative actions that may easily encroach upon the powers of corporate management and impose unnecessary burdens on them.

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[94] Article 20, CCL 2013.

[95] Nils Krause & Chuan Qin, 'An Overview of China's New Company Law' (2007) 28 *Company Lawyer* 316 at 316, 319.

Finally, we believe that case law in China offers a precious opportunity to fill in the gap between "law in books" and "law in action". Judicial precedent is becoming increasingly important in China as the traditional view of the role of the courts is changing.[96] However, it is dangerous to exaggerate the function of case law in China, considering the inconsistent and inaccurate application of the law in different courts at various levels.

[96] Shaowei Lin, 'Private Enforcement of Chinese Company Law: Shareholder Litigation and Judicial Discretion' (2016) 4 *China Legal Science* 73.