THE ELIGIBILITY OF CLAIMANTS TO COMMENCE DERIVATIVE LITIGATION ON BEHALF OF CHINA'S JOINT STOCK LIMITED COMPANIES

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Derivative actions in modern company law play a crucial role in promoting the efficiency of corporate law and the soundness of corporate governance. However, since China's inauguration of derivative action in 2005, now enshrined in s 151 of the Chinese Company Law (CCL) 2013 (revised in 2013 and enforced on 1 March 2014), there have been complications surrounding the eligibility of shareholder claimants in terms of taking derivative action, especially for joint stock limited liability companies (JSLCs). Under art 151 of the CCL 2013, JSLCs are treated differently from limited liability companies (LLCs). Standing requirements are imposed on shareholders in JSLCs, whereas any shareholder has the right to sue in LLCs. Shareholders who intend to bring derivative action are required to

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separately or jointly hold 1 per cent or more of the company's shares for 180 consecutive days. These prescribed thresholds may not only prevent trivial or malicious suits but also hinder the effective enforcement of the mechanism. Through doctrinal, comparative and empirical analyses of the eligibility of claimants to bring derivative action in JSLCs, the article puts forward proposals for how the effectiveness of the regime in China can be improved in hope of increasing the effectiveness of the mechanism and the enforcement of company law, contributing to the fairness and accountability of corporate governance. It is argued that future revision of laws concerning claimants' eligibility should not only make sure that reasonable shareholders are able to use the mechanism but also take into account current commercial practices, stock market structures and government policy.

1. Introduction

Initially derived from English and US laws, derivative action works as an exception to the rule that defines the company itself as the proper person or legal entity to bring action when seeking redress against wrongdoers who are in control of the company.[1] It is a tool to enable

[1] The rule in *Foss v Harbottle* (1843) 2 Hare 461 provides a negative answer to the question of whether an individual shareholder is able to bring a complaint before the court if an irregularity has been committed in the course of a company's affairs, or if some wrong has been done to the company. This is also the case in China. Article 119 of the Civil Procedure Law 2012 in China required the claimant to have direct interest in the litigation. Following this, a corporate victim is supposed to sue a wrongdoing director or senior officers. However, in a number of cases, this civil procedure rule fails to give remedy for the corporate victim, while it is difficult for the legal representatives of the companies or members of the board of directors to bring a lawsuit against directors or senior officers. Therefore, it is crucial to enable qualified shareholders to bring derivative law suits on behalf of a corporate victim. In common law, the decisions on whether legal proceedings are to be instituted or not is the decision of the company's board of directors according to English law, but the board may decide not to commence proceedings on behalf of the company. The legal regime is now codified in the UK Companies Act 2006 and was enforced from October 2007 for the purpose of simplifying and modernising the

individual shareholders to act in support of the rights and interests of the company. The scheme has been seen as a useful tool to both mitigate the dominant power of controlling shareholders and curb opportunistic behaviours by the board of directors.[2] It provides that if a shareholder can establish a case in which the action harming the company constitutes a fraud on the company and where the wrongdoers control the company, he will be permitted to take proceedings which derive from the company's right to institute proceedings. Different from direct minority protection mechanisms such as unfair prejudice remedies[3] or winding ups[4] in common law countries or their equivalents, the process was designed to protect the company, allowing shareholders to bring an action on behalf of the company. Shareholders may benefit from successful recoveries since the value of shares will increase *pro rota* as the assets of the company improve in value.[5] This protection mechanism has since been inserted in legislation in a number of countries with developed markets, such as the United Kingdom, Hong Kong,[6]

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old company law to improve its accessibility, since the common law system lacked clarity and was inaccessible. Law Commission, Shareholder Remedies: Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965 (London: Stationery Office, Law Com No 246, Cm 3769, 1997) p 7 and para 6.4; see also ss 206–264 of the Companies Act 2006.

[2] S Tenev, Chunlin Zhang and Loup Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (Washington, DC: World Bank and the International Finance Corporation, 2002) p 149.

[3] Section 994 of the Companies Act 2006; *O'Neill v Phillips* [1999] 1 WLR 1092.

[4] Sections 122(1)(g) and 124(1) of the Insolvency Act 1986; *Re J E Cade & Son Ltd* [1991] BCC 360; *Re Thomas Brinsmead & Sons Ltd* [1897] 1 Ch 406; *Re Yenidje Tobacco Co* [1916] 2 Ch 426.

[5] Z Zhang, "Making the Shareholder Derivative Actions Happen in China: How Should Lawsuits Be Funded?" (2008) 38 *HKLJ* 523, 526.

[6] Sections 731–738 of the New Companies Ordinance 2012 (Cap 622) (the section commenced operation on 3 March 2014).

Australia,[7] Canada,[8] Japan,[9] New Zealand[10] and Singapore,[11] as well as in countries with emerging markets including India,[12] Brazil[13] and Russia.[14]

Following this trend, derivative action was introduced to China, with high expectations in art 152 of the Chinese Company Law (CCL) 2005,[15] in the form of a short provision:

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[7] Part 2F.1A of the Corporations Act 2001; see L Thai, "Australian Statutory Derivative Action — Defects, Alternative Approaches and Potential for Law Reform" in CB Picker and G Seidman (eds), *The Dynamism of Civil Procedure — Global Trends and Developments* (Heidelberg: Springer, 2016) p 237.

[8] Sections 232 and 242 of the Canadian Business Corporations Act 1985; see also B Cheffins, "Reforming the Derivative Action: The Canadian Experience and British Prospects" (1997) 2 *Company Financial and Insolvency Law Review* 227, 234; DH Peterson and MJ Cumming, *Shareholder Remedies in Canada* (Ontario: LexisNexis, 2nd ed., 2009).

[9] Articles 847–848 of the Japanese Company Law 2005; see also H Oda, "Shareholder's Derivative Action in Japan" (2011) 8(3) *European Company and Financial Law Review* 334.

[10] Sections 165 and 166 of the Companies Act 1993 (New Zealand); see also P Prince, "Australia's Derivative Action: Using the New Zealand Experience" (2000) 18 *Company and Securities Law Journal* 493; S Watson, "A Matter of Balance: The Statutory Derivative Action in New Zealand" (1998) 19 *Company Lawyer* 236.

[11] Section 216 of the Companies Act 1994 (Singapore) (Cap 50); see P Koh, "The Statutory Derivative Action in Singapore: A Critical and Comparative Examination" (2001) 13 *Bond Law Review* 64; AK Koh, "Excusing Notice under Singapore's Statutory Derivative Action" (2013) 14 *Australian Journal of Asian Law* 1.

[12] Section 245 of the Companies Act 2013 (India); see also V Khanna and U Varottil, "The Rarity of Derivative Action in India: Reasons and Consequences" in DW Puchniak, H Baum and M Ewing-Chow (eds), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge: Cambridge University Press, 2012) p 369.

[13] Articles 155 and 157 of the Brazilian Civil Code 2002.

[14] Item 2 of art 71 for Russian Joint Stock Companies 2007.

[15] This legislative amendment came into effect on 1 January 2006. It was originally enshrined into the CCL 2005 as art 152, and subsequently renumbered as art 151 of the CCL 2013. X Huang, "Shareholders Revolt?

> "the shareholders in the case of a LLC, or a shareholder that has independently held, or the shareholders that have held in aggregate, 1% or more of the shares of the company for more than 180 consecutive days in the case of a JSLC, may request in writing the board of supervisors, or the supervisors, in the case of a LLC without a board of supervisors, to institute proceedings with the people's court; where the supervisors fall under the circumstance set forth in Article 149 hereof, the foregoing shareholders may request in writing the board of directors, or the executive directors in the case of a LLC without a board of directors, to institute proceedings with the people's court".

The provision was renumbered as art 151 but the content was wholly preserved in the Company Law 2013 reform, remaining in full force today.

The mechanism was adopted to address one of six major defects in the Company Law of 1993,[16] functioning as part of a series of changes surrounding shareholder protection and

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The Statutory Derivative Action in China" (Comparative Research in Law and Political Economy Research Paper 49/2009, 2009) pp 4–6; H Huang, "The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform" (2007) 4(2) *Berkeley Business Law Journal* 227.

[16] Fourteenth Session of the Tenth National People's Congress Standing Meeting from 25 to 28 of February 2005 Beijing, for conference discussions on company law see http://www.people.com.cn/GB/14576/28320/44506/44789/index.html; the six defects were summed up by Fan and Wang. See J Fan and J Wang, *Corporate Law* (Beijing: Law Press, 4th ed., 2015) p 59; they were proposed to the Standing Committee of the National People's Congress in February 2005 including the registration of companies; corporate governance-related issues including the rights and liability of shareholding meetings, boards of directors and supervisory boards; the protection of minority shareholders and creditors including a more effective derivative action system; issuing, transferring and listing of shares; the supervision of listed companies; and fiduciary duties and related liability of board directors and supervisors.

shareholders' rights.[17] Notwithstanding the significance of derivative action in modern China, the ability and/or eligibility of shareholders to bring derivative action have been largely overlooked by scholarly works in this fast-growing nation. Indeed, analyses in the following sections reveal that despite the fact that art 151 is a relatively brief and seemingly straightforward provision, a detailed examination of its nature, designated scope and relevant data from securities markets concerning its practical effects exposes various problems hindering its application in joint stock limited liability companies (JSLCs). The article focuses on the eligibility issue, by addressing two of these problems, namely the shareholding percentage requirement and the shareholding time period requirement. Research on the eligibility of claimants in derivative action is significant in terms of maintaining a proper balance between affording disgruntled shareholders an effective remedy to seek relief and restraining excessive number of shareholders from launching derivative suits against companies, which may lead to boards and management being overloaded with unnecessary lawsuits and becoming distracted/discouraged from managing the company's affairs, as well as extra workload for the Chinese judicial system. Almost 11 years after the enforcement of art 151, the virtually complete lack of reported cases in the field[18] suggests that it is time to conduct systematic research to revisit the eligibility of claimants in derivative actions in Chinese JSLCs, with particular regard to the fast growth of China's financial markets, the increasing diversification of its investors and the now massive group of minority shareholders.

[17] In detail, two distinct litigation techniques have been introduced for shareholders to vindicate their interests in the company on occasions where the directors' fiduciary duties are breached by key members of the company, such as directors, supervisors, senior management executives and sometimes the controlling shareholders. The mechanisms include direct suits and derivative suits as shareholder remedies, enabling them to bring legal action against the controllers of the company in accordance with ss 151 and 152 of CCL 2013.

[18] Considering the current situation, which is that only one case has been brought against JSLCs, including listed companies.

The article aims to explore whether the eligibility requirements in art 151 hinder minority shareholders in JSLCs, especially listed companies, from initiating a derivative suit. The eligibility of shareholder claimants according to art 151 of the CCL 2013 will be critically analysed in order to deliver a comprehensive picture of the rationale for different treatments of limited liability companies (LLCs) and JSLCs and to determine whether shareholders in JSLCs are truly eligible to bring derivative actions in China. After exposing the defects in current laws, the article makes suggestions for reforms to the current regime. As well as doctrinally clarifying the eligibility of shareholders in terms of raising derivative suits and filling the existing legal loopholes, the research is also important from an international business perspective, given the increasing number of foreign investors in China.[19] A legal mechanism providing more effective remedial means for investors will make China a more attractive place for investment, in the sense that foreign investors will be reassured that their rights will be more substantially protected.

The study begins with an examination of the company law framework and legislative processes in China. Also, it plans to examine what other jurisdictions have sought to do in relation to shareholder eligibility to bring derivative actions, in order to find solutions to the problems that are encountered by JSLCs in China. This involves comparative analyses of the legislations in jurisdictions such as Japan, Korea, the United States, the United Kingdom, Germany and Taiwan, as well as empirical analyses of listed companies in China and their top 10 shareholders. The empirical analysis of the publicly available data assists the

[19] It was reported that China became the largest foreign direct investment (FDI) recipient in the world in 2014; see United Nations Conference on Trade and Development (UNCTAD), World Investment Report 2015: Reforming International Investment Governance (United Nations, 2015) pp 4–5. It was reported that foreign firms invested $128bn in China and $86bn in the United States.

researchers to work out a more sensible and internationally compatible threshold for derivative mechanism which fits Chinese shareholders.

The article is structured as follows. After the introduction, the rationale for different treatments of LLC and JSLCs in current CCL and the importance of enhancing minority shareholder protection in JSLCs are examined in Section 2, based upon which their eligibility issues are discussed in detail. Two interrelated issues are addressed to explore why JSLCs are treated differently in derivative action — on one hand, the mechanism threshold which avoids malicious litigation considering the number of shareholders in JSLCs in China, and on the other hand, the significance of Chinese reform for more user-friendly shareholder remedy mechanisms in JSLCs. Section 3 moves on to assess whether the shareholding percentage threshold requirement for JSLCs embedded in art 151 of CCL 2013 is appropriate, enforceable and effective. In Section 4, the validity and effectiveness of the shareholding period threshold requirement for JSLCs, also embedded in art 151 of the CCL 2013, is considered. Section 5 goes on to present legislative experience from other jurisdictions, in hope of clarifying and promoting the necessity of reconsidering the issue in JSLCs in China. Finally, there are some concluding remarks.

2. Rationale for Enquiries about the Quantity of Derivative Suits and Justification of Different Treatments for LLCs and JSLCs

Article 151 of the CCL 2013 provides a threshold requirement concerning the size of the shareholding and the period for which it must be held, but it only operates in relation to

shareholders in JSLCs who wish to bring derivative actions, not to their counterparts in LLCs. Before discussing the threshold requirement in detail, it is important to analyse the rationale for offering different treatments to minority shareholders in JSLCs and LLCs in terms of bringing a derivative action. In addition, the reasons why the protection of shareholders in JSLCs is becoming increasingly significant will be investigated in the context of the transformation of Chinese corporate governance and the Chinese economy.

(a) Enquiries about the Status Quo

Research concerning derivative action in China thus far can be roughly divided into two groups; before the 2006 legislative reform, research mainly focused on the rationality of transplanting a derivative action mechanism to the Chinese context and the preliminary construction of this regime. After the promulgation of the CCL 2005, the literature, based upon discussions of reported cases, tended to focus on the interpretation of the legislative wording and the functions of the regime.[20] One presumption behind most research was that shareholders, including minority shareholders, Chinese shareholders, would not hesitate in opting to use derivative action if they feel mistreated. However, even a cursory look at relevant legal practices would cast doubt on this presumption. As reported by the China Securities Regulatory Commission's (CSRC) 2014 annual report, only 163 cases were closed, and 158 decisions were made to impose sanctions involving fines and disgorgement orders due to the misconduct of directors in listed companies in 2014. These included 36 disclosure violation cases, 69 insider trading cases and 15 market manipulation cases. A total of 86 and

[20] For example, "shareholders that have held in aggregate" has been interpreted by M Hu and P Zhang, "Research on Legal Application of Derivative Action in China (股东代表诉讼的法律适用研究)" (2007) *People's Judicature* 人民司法 79; on the function of the mechanism see X Mi, "Analysis of Some Important Measures to Protect Minority Shareholders" Rights & Benefits In The New 'Corporation Law' 评新《公司法》对小股东权益保护的几项重要举措" (2006) *Law Science Magazine* 法学杂志 72.

77 cases were concluded in 2013 and 2012, respectively.[21] In detail, these cases were due to various reasons including a breach of duties owed by the directors, supervisors and senior managers because of the violation of laws, administrative regulations or the articles of association, losses caused to the company and the controlling shareholder or actual controlling parties using their dominant position to control the company's assets and harm the interests of the company. Most of these cases could have easily become reasons for minority shareholders to bring lawsuits on behalf of the company. However, shareholders in JSLCs in China are not currently using derivative action as a mechanism, even though it is a system used in public companies in many other jurisdictions.[22] In other words, there is a great untapped potential for derivative action to be used by shareholders in JSLCs.

The limited use of derivative action seems to be particularly acute in JSLCs.[23] Cases in which shareholder(s) have brought derivative actions on behalf of companies have been reported in the Chinalawinfo (*Bei Da Fa Bao*) search engine since the enforcement of the Company Law 2005.[24] Purely judging from the number of cases identified by Huang, we

[21] CSRC, 2014 Annual Report, p 31.

[22] See Section 5 of this article.

[23] In CCL, the LLC and the JSLC are the functional equivalents of a private company and a public company under English law; see J Wang, *Company Law in China: Regulation of Business Organizations in a Socialist Market Economy* (Cheltenham: Edward Elgar, 2014) pp 50–51; see also M Gu, *Understanding Chinese Company Law* (Hong Kong: Hong Kong University Press, 2006) pp 22–23.

[24] "Chinalawinfo" was launched by the Legal Information Centre of Peking University and Peking University IAC Technology Co, Ltd jointly as a one-stop intelligent legal information retrieval platform: see http://www.pkulaw.cn/ (Chinese version of the website) and http://www.lawinfochina.com/ (English version of the website).

agree that the derivative action mechanism has had a noticeable impact in China.[25] However, an in-depth investigation of the corporate contexts in which the actions occurred suggests otherwise. The claimants in these reported cases are shareholders in LLCs only. Since the implementation of art 151, there has only been one lawsuit brought by shareholders of JSLCs (unreported in *Bei Da Fa Bao*), which was subsequently accepted by the Shandong Higher People's Court on 11 December 2009,[26] implying that shareholders in JSLCs were either extremely reluctant or encountered significant difficulties in bringing cases of litigation on behalf of their companies. As will be discussed, the latter seems to be the major reason: at the current time the derivative action legal mechanism functions as no more than window dressing or "a big disappointment"[27] for shareholders in JSLCs in China.

(b) Treating LLCs and JSLCs Differently

Article 2 of the CCL 2013 provides that "the term 'companies' refers to LLCs and companies limited by shares established within the territory of China pursuant to the Law (namely JSLCs)".[28] Regarding the investment of shareholders in China, a shareholder in an LLC can limit his liability to the equitable capital contribution, whereas the liability of the shareholder in a JSLC is limited to the full payment of shares for which he subscribed.[29] Despite the fact that LLCs are not exclusively small and medium-sized enterprises (SMEs), the LLC form is

[25] H Huang, "Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis" (2012) 27 *Banking and Finance Law Review* 619, 644.

[26] The case involves an attempt by the plaintiffs, 78 shareholders of *Sanlian Shangshe*（三联商社）, to bring a derivative claim against the former controlling shareholder.

[27] Huang (n 25 above) p 644.

[28] Equivalent of private and public companies.

[29] Article 3 of the CCL 2013.

most attractive for SMEs in China.[30] Compared to LLCs, JSLCs are characterised by more dispersed ownership and larger sizes. There are four main differences between JSLCs and LLCs in China.

First, traditionally speaking, many listed companies within the scope of JSLCs in China still constitute "listed state-involved enterprises (SIEs)", and the largest shareholder normally is the state, which dominates the shareholding in listed companies. It is reported that an average of 31.27 per cent of the shares in these companies are held by the government.[31] This ownership by the state may suggest concentrated shareholding as a characteristic of Chinese corporate governance in terms of shareholding structure, due to the dominance of state shares in China. However, a detailed investigation into the share ownership composition of listed companies would suggest diversity rather than concentration: individual and non-state institutional shareholders have increased dramatically in the last 10 years with 91 million *gu min* (the shareholder population) in July 2015, and an incredible 80 per cent of urban Chinese households which are or were formerly investors in the equity market.[32] The

[30] RC Art and M Gu, "China Incorporated: The First Corporation Law of the People's Republic of China" (1995) 20 *Yale Journal of International Law* 273, 292. It is claimed that China only had 10,000 joint-stock companies and 2,800 listed companies among 77,469,000 registered companies up to January 2016; see China Industry and Commerce News, "Access Environment Continues to Improve with Stable Competitive Environment and Well-Maintained Consumer Environment" *China Industry and Commerce News* (14 January 2015), available at http://www.cicn.com.cn/zggsb/2016-01/14/cms81467article.shtml (last visited on 6th June 2018)

[31] Y Thanatawee, "Ownership Structure and Dividend Policy: Evidence from China" (2014) 6 *International Journal of Economics and Finance* 197, 199, quoted by OECD, OECD Survey of Corporate Governance Frameworks in Asia (2017).

[32] See the report of CSDC, available at http://www.chinaclear.cn/english/en_index.shtml (last visited on 6th June 2018).

dispersed share ownership makes it sensible to introduce eligibility provisions for JSLCs with the purpose of preventing boards of directors or the courts from being overloaded with lawsuits. Comparatively, LLCs must be invested in and established by no more than 50 shareholders.[33] Shareholders in LLCs are thus more likely to have a substantial share ownership percentage. Indeed, an investigation reveals that fellow shareholders in Chinese LLCs are usually family members, relatives, colleagues or close friends.[34] Shareholders in LLCs need compelling reasons to break these close ties and enforce their rights to bring a derivative action, considering the close *guanxi*[35] (either family *guanxi* or friend *guanxi*) between shareholders and directors in LLCs.

Second, despite the fact that shareholders in JSLCs do enjoy freedom in terms of buying and selling shares, it is still important and necessary for them to have comprehensive and accessible remedies. It is clear that dissatisfied shareholders in JSLCs could very easily leave the company by selling their shares on the stock markets, whereas there is no liquid market for potential share transactions in LLCs. The disadvantaged position of shareholders

[33] Article 25 of the CCL 2013.

[34] J 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, 118–119; see also SS Tang, "Corporate Avengers Need Not Be Angels: Rethinking Good Faith in the Derivative Action" (2016) 16 *Journal of Corporate Law Studies* 471.

[35] *Guanxi* means close relationship in Chinese. It is, in essence, a coalition-based network of stakeholders sharing resources for survival, and it plays an important role in achieving business success in China. See JH Pac and YH Wong, "A Model of Close Business Relationship in China (Guanxi)" (2001) 35 *European Journal of Marketing* 51; S Ruehle, "Guanxi as Competitive Advantages during Economic Crises: Evidence from China during the Recent Global Financial Crisis" in X Fu (ed), *China's Role in Global Economic Recovery* (Abingdon: Routledge, 2012) p 64; J Dunning and C Kim, "The Cultural Roots of Guanxi: An Exploratory

in LLCs is exacerbated by the legal requirement imposing a legal restriction on equity transfers in LLCs. A member must obtain the consent of at least half the other shareholders prior to the member selling their shares.[36] Therefore, the tie between the shareholders and company in LLCs seems to be stronger, and it is less likely that shareholders will abuse the system and want to buy shares for the purpose of bringing a derivative action or using them to put pressure on board members in the interests of shareholders.

Third, although JSLCs are subject to more demanding reporting requirements, including promoter's agreements, minutes of general meetings, minutes of the meetings of the board of directors, minutes of the meetings of the board of supervisors, financial and accounting reports[37] and the information disclosure requirements embedded within the corporate governance code for listed companies, information asymmetry problems between minority shareholders and corporate controllers, either as the result of shareholders' limited access to information or their ignorance and/or lack of understanding of the available information, are still a significant issue in JSLCs. This places minority shareholders in a disadvantaged position in terms of triggering derivative action.[38] In terms of derivative action, shareholders are required to gather facts in order to evaluate whether an action should be commenced or to assess the strength of any potential action.[39] Therefore, information is an important precondition and incentive for successful litigation. Minority shareholders may not

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Study" (2007) *The World Economy* 329, 333; K Xin and J Pearce, "Guanxi: Connections as Substitutes for Formal Institutional Support" (1996) 39 *Academy of Management Journal* 1641.

[36] CCL 2013 art 72.

[37] *Ibid.*, arts 90, 96 and 97.

[38] J Oliver, W Qu and V Wise, "Corporate Governance: A Discussion on Minority Shareholder Protection in China" (2014) 6 *International Journal of Economics and Finance* 11.

[39] L Field, M Lowry and S Shu, "Does Disclosure Deter or Trigger Litigation?" (2005) 39 *Journal of Accounting & Economics* 487.

have effective access to the information; they are likely to be limited to the information already available to the public. This may be another reason why a more functional and effective shareholder remedy system should be promoted in China for JSLCs including listed ones. More effective and user-friendly mechanisms for derivative action will facilitate information exchanges between shareholders who are willing to bring litigation together and will encourage those shareholders who "lose hope" in derivative actions in terms of acquiring knowledge about the companies and becoming more concerned about the performance of the companies in a positive manner.

Finally, different requirements for derivative actions in LLCs and JSLCs mitigate different problems stemming from various modes of ownership and control. In non-state-controlled enterprises, ownership and control are becoming separated with the purpose of transformation from an administrative and planned economy to a more market-oriented economy — professional directors are appointed for corporations just as they are in countries with industrialised and developed markets, such as the United States or the United Kingdom,[40] where there has been encouragement of a more scattered and diversified shareholding structure and hence the legal systems have fostered better protection of minority shareholders.[41] In order to promote the corporate governance of JSLCs that are non-state-controlled, effective shareholders' remedies in these companies, as one of the critical fairness goals for corporate governance, are key for the transformation of the economic model in China from a planned to a market economy, including the transformation of corporate

[40] AA Berle and GC Means, *The Modern Corporation and Private Property* (New York: The Macmillan Corporation, 1932).

[41] R La Porta, F Lopez-de-Silanes, A Sheifer and R Vishny, "Law and Finance" (1998) 106 *The Journal of Political Economy* 1113.

governance from an administratively oriented model to a more economic-oriented one as desired by the Chinese government.

In state-controlled enterprises, the boards of directors, many of whom are Bureau of State Asset Management officers, are trying to maximise the interests of the state, who is the biggest shareholder. They are civil servants employed by the government, whose remunerations are decided by the government and their administrative ranking, rather than relating to the performance of the corporations they manage. These directors will "align their interests with the local government, whose political interests may be to preserve employment rather than increase the efficiency of the listed (companies)".[42] These non-economic concerns could lead to the trend of diverting the company's profits or assets which may harm the economic interests of the company, and for that matter, the interests of the minority shareholders. Many listed companies, especially state-controlled ones, do accommodate objectives other than profit maximisation, most commonly, public welfare goals. Apart from making profits, such corporations have other more immediate administrative missions such as the maintenance of urban employment, other social and environmental purposes or various administrative tasks required by the CSRC in order to regulate China's stock market. Administrative interference aims to serve the state's interests and strategic plans by controlling or influencing multifarious issues of business operation.[43] The administrative approach stems from the government policy in maintaining a full or controlling ownership in

[42] LH Tan and JY Wang, "Modelling an Efficient Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy" (2007) 7 *Journal of Corporate Law Studies* 143, 149.

[43] HX Wu, "Accounting for the Sources of Growth in Chinese Industry 1980-2010" in L Song, R Garnaut and C Fang (eds), *Depending Reform for China's Long-Term Growth and Development* (Canberra: The Australia National University Press, 2014) pp 431, 432–433.

corporations so as to achieve direct control of key industries such as energy, banking and telecommunications.[44] Furthermore, it may entail direct involvement in upstream industries due to their strategic importance in sustaining the growth of downstream industries.

Different corporate forms understandably entail different agency costs. As argued by Lin, two kinds of agency costs are particularly acute in China, namely vertical agency costs between shareholders and managers, and horizontal agency costs between majority shareholders and minority shareholders due to the vulnerability of minority shareholders and the exploration of blockers; the latter is common in jurisdictions with concentrated ownership jurisdictions, particularly those with widespread SIEs.[45] Generally speaking, the incentive for SIEs to maximise the interests of other non-state shareholders could be less distinct and relies more on managers taking autonomous executive actions. Inversely, effective protection means offered to minority shareholders in state-controlled JSLCs would serve the dual purpose of mitigating the conflicts of interest between shareholders and boards of directors and between majority shareholders (ie, the state) and minority shareholders.[46] They might be particularly helpful to those who invest in state-controlled JSLCs but have been mistreated in the process of corporations pursuing administrative goals set by the government.

In stark contrast, in LLCs, ownership is only marginally separated from control. These kinds of companies typically have an ownership structure comprising several

[44] Q Liu and Z Lu, "Corporate Governance and Earnings Management in the Chinese Listed Companies: A Tunnelling Perspective" (2007) 13 *Journal of Corporate Finance* 881, 884; see also LSO Wanderley, R Lucian, F Farache and JM de Sousa Filho, "CSR Information Disclosure on the Web: A Context-Based Approach Analysing the Influence of Country of Origin and Industry Sector" (2008) 82 *Journal of Business Ethics* 369.

[45] S Lin, "Double Agency Costs in China: A Legal Perspective" (2012) 9 *The Asian Business Lawyer* 116, 129.

[46] A Shleifer and RW Vishny, "A Survey of Corporate Governance" (1997) 52 *Journal of Finance* 737.

significant shareholders.[47] Instead of various information disclosure requirements, a dialogue mechanism is normally established between the board of directors and the shareholders owing to their close ties.[48] This dialogue will be comparatively easier with limited shareholder requirements and the overlap between shareholders and board members. In most circumstances, the board seats in an LLC are directly occupied by shareholders themselves.

Therefore, it can be shown that LLCs and JSLCs are treated differently in China due to their different shareholding structures, different levels of separation of ownership and control, different levels of information disclosure requirements, their shareholder volume and their different practices for issuing shares. The variations in the treatment of LLCs and JSLCs are necessary to avoid both malicious litigation and increasing the workloads of boards of directors, supervisor and the courts. Furthermore, a balance should be maintained between giving boards discretion to manage companies in the way that they consider will promote the success of the company and monitoring mechanisms and intervention in any proceedings from shareholders to which the company is a party at an appropriate level.

(c) Importance of Effective Derivative Action as a Tool to Protect Companies' Interests for Shareholders in JSLCs

[47] A Gomes and W Novaes, "Multiple Large Shareholders in Corporate Governance" (Unpublished working paper, Philadelphia, PA: The Wharton School, 1999); see also N Attig, SE Ghoul and O Guedhami, "Do Multiple Large Shareholders Play a Corporate Governance Role? Evidence from East Asia" (2009) 32 *The Journal of Financial Research* 395.

[48] It is also suggested by the European Confederation of Directors' Association Corporate Governance guidance and Principles for Unlisted Companies in European 2015 Principle 7 that:

> "There should be a dialogue between the board and the shareholders based on the mutual understanding of objectives. The board should as a whole have responsibility for ensuring that a satisfactory dialogue with shareholders take place."

Derivative action is a critical mechanism, operating in the interests of companies and their shareholders to promote corporate governance goals such as fairness, accountability and effectiveness. After all, one issue that all corporate governance mechanisms attempt to address is opportunistic and abusive corporate behaviours by controllers of a company.[49] It is expected that improved shareholder remedy schemes will also promote the sustainable development of the capital market. It is positive to see that a number of mechanisms have been introduced in China for shareholder protection purposes, such as cumulative voting systems,[50] guidelines[51] and notifications.[52] However, there is still room to improve minority shareholder protection. The World Bank Doing Business Index provides objective measures of business regulations for local firms in 189 economies and selected cities at the sub-national level, and rankings are issued annually, with "protecting minority investors" included as 1 of 11 sets of indicators; whether shareholders can sue derivatively is a key question (with follow-up questions) for the assessment of this indicator. Based on the 2017 report, China

[49] Tang (n 34 above) p 473.

[50] Article 105 of the CCL 2013; see also Y Chen and J Du, "Regulatory Reform of Cumulative Voting in Corporate China: Who Were Elected and Its Impact" (Asian Finance Association (AsianFA) 2015 Conference, 28 January 2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2556157 (last visited on 6th June 2018); see also C Xi and Y Chen, "Does Cumulative Voting Matter? The Case of China: An Empirical Assessment" (2014) 15 *European Business Organization Law Review* 585.

[51] For example, the modification of the "Rules for General Meetings of Shareholders of Listed Companies and Guidelines on the Articles of Association of Listed Companies" which is expected to improve disclosure requirements and voting information for minority shareholders.

[52] In 2014, CSRC and the People's Bank of China jointly released the Rules for Bonds Statistics and issued a notification of the *Hirisun* Case, where we also witnessed the first case to require majority shareholders to compensate minority shareholders for their losses caused by the misrepresentation of listed companies. This proved to be an effective way for shareholders to seek remedies and a rewarding attempt at building up a compensation mechanism for minority shareholders in listed companies.

ranks 123rd in this indicator, in comparison with a position of 78th in the general ranking.[53] The indicator related to minority shareholder protection is noticeably weaker compared with other indicators evaluating how easy and safe it is to "do business" in China.

A number of studies have been addressing the improvement of corporate governance in response to troublesome practices in China, with many suggestions and recommendations to improve various values of corporate governance;[54] the protection of shareholders, including effective remedies for minority shareholders, has been a particularly important aspect.[55] Based on the empirical report by Protiviti/China and the Chinese Academy of Social Sciences, the "conflict of interests between majority shareholders and minority shareholders remains a major issue in the corporate governance of Chinese listed companies", regarded as one of the important risk indicators.[56] Other things China currently lacks include "a comprehensive set of legal rules that provide protection for outside investors" and "the ability

[53] World Bank Group, *Doing Business 2017: Measuring Regulatory Quality and Efficiency* (14th ed., Washington: World Bank, 2017).

[54] For example, see Q Liu, "Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants" (2006) 52 *CESifo Economic Studies* 415; Tan and Wang (n 42 above); Y Gao, "Corporate Social Performance in China: Evidence from Large Companies" (2009) 89 *Journal of Business Ethics* 23; HWC Yeung, *Chinese Capitalism in a Global Era: Towards a Hybrid Model* (Abingdon: Routledge, 2004); KLA Lau and A Young, "Why China Shall Not Completely Transit from a Relation Based to a Rule Based Governance Regime: A Chinese Perspective" (2013) 21 *Corporate Governance: An International Review* 577. R Mead, *International Management: Cross-Cultural Dimensions* (Oxford: Blackwell, 2005); R Morck and B Yeung, "Corporate Governance in China" (2014) 26 *Journal of Corporate Finance* 20; J Yang, J Chi and M Young, "A Review of Corporate Governance in China" (2011) 25 *Asian Pacific Economic Literature* 15.

[55] R Tomasic and N Andrews, "Minority Shareholder Protection in China's Top 100 Listed Companies" (2007) 9 *Australian Journal of Asian Law* 88, 110.

[56] Protiviti/China and Chinese Academy of Social Sciences, Corporate Governance Assessment Summary Report on the Top 100 Chinese Listed Companies for 2012 (2013) p. 9.

to implement effectively the existing laws that govern the operations of corporations and the securities market",[57] both hindering the provision of better remedies for shareholders in China. An effective derivative action mechanism for JSLCs in China is thus crucial for enhancing shareholder value, cultivating the soundness of corporate governance, restoring the confidence of domestic and international investors and establishing the sustainable development of capital markets in China.[58]

On a broad spectrum, the importance of derivative action is further evidenced in light of the rapid development of the stock market in China. Chinese stock exchange markets, including the Shanghai and Shenzhen Stock Exchanges, have grown to become the largest in Asia and the second largest globally, with 3,512 listed free-floating market capitalisations reaching a value of RMB 561.26 trillion by 30 January 2017.[59] A key characteristic of the Chinese capital markets[60] has been the extremely high percentage of small investors holding

[57] T Kato and C Long, "CEO Turnover, Firm Performance, and Enterprise Reform in China: Evidence from Micro Data" (2006) 34 *Journal of Comparative Economics* 796, 798; see also F Allen, J Qian and M Qian, "Law, Finance, and Economic Growth in China" (2005) 77 *Journal of Financial Economics* 57; F Jiang and KA Kim, "Corporate Governance in China: A Modern Perspective" (2015) 32 *Journal of Corporate Finance* 190; K Pistor and C Xu, "Governing Stock Markets in Transition Economies: Lessons from China" (2005) 7 *American Law and Economic Review* 184; Liu (n 54 above); H Zou, S Wong, C Shum, J Xiong and J Yan, "Controlling-Minority Shareholder Incentive Conflicts and Directors' and Officers' Liability Insurance: Evidence from China" (2008) 32 *Journal of Banking and Finance* 2636.

[58] Liu (n 34 above) p 117; DC Clarke, "Corporate Governance in China: An Overview" (2003) 14 *China Economic Review* 494, 502–503; S Lin and D Cabrelli, "Legal Protection for Minority Shareholders in China" (2013) 8 *Frontiers of Law in China* 266.

[59] CSRC data February 2018; available at http://www.csrc.gov.cn/pub/newsite/sjtj/ (last visited on 6th June 2018).

[60] Analysis surrounding the high percentage of small investors was based on a 2008 Report issued by the CSRC, which has not provided any updated reports since that date.

less than RMB 1 million (approximately 0.13 million Euro) in cash or share equivalent, accounting for 98.8 and 99.3 per cent of the total number of share capital in the Shanghai and Shenzhen Stock Exchanges, respectively.[61] With a large number of individual shareholders, the average turnover rate is understandably high, reaching 201.3 in 2013 and 240.3 in 2014.[62] In the light of the booming capital market, with a daily turnover of more than RMB 1.25 trillion and a trading volume of 1,296 million corporate clients and 3,715 million individual clients,[63] packed with poorly informed and unsophisticated individual investors, the problems of inadequate shareholder protection are becoming increasingly acute for Chinese regulators.[64] The rapid growth of the Chinese stock markets does require a more effective and rigorously monitored shareholder remedies mechanism that is fit for purpose in the growing financial market and for effective supervision by market participants.

Corporate governance-wise, derivative action has been introduced to China as a supplementary means of restricting corporate behaviour and the power of boards of directors. Indeed, during the Company Law 2005 legislation process, the professionalism and competitiveness of the directors on the boards were severely questioned. In the eyes of the legislators, derivative action as a potentially functional shareholder remedy to enforce directors' duties[65] would serve the purpose of enhancing corporate transparency and the accountability of boards of directors, so as to benefit companies and their shareholders in

[61] China Securities Regulatory Commission, China Capital Markets Development Report (2008) pp 269–270.

[62] The World Bank, Stocks Traded, Turnover Ratio of Domestic Shares (%), data available at http://data.worldbank.org/indicator/CM.MKT.TRNR (last visited on 6th June 2018).

[63] 2014 Annual Report (n 21 above) pp 14, 21.

[64] Huang (n 15 above) p 5.

[65] FX Hong, "Director Regulation in China: The Sinonization Process" (2011) 19 *Michigan State Journal of International Law* 502, 536–542; R Lee, "Fiduciary Duty without Equity: 'Fiduciary Duties' of Directors under the Revised Company Law of the PRC" (2007) 47 *Virginia Journal of International Law* 897.

general. [66] Using derivative action as a legal tool may be employed as a remedy of compensation, whereas successful lawsuits may confer monetary benefits to the company and impose financial penalties on wrongdoers.[67] On the basis of the above-stated concerns, the derivative action regime was introduced as a mechanism complementary to other structural as well as internal and external corporate governance devices, to better enforce directors' duties, ensure that directors pay attention to their legal duties[68] and to achieve fairness in corporate governance between controlling shareholders and minority shareholders. As described by Huang, the adoption of this mechanism was "a major development in Chinese company legislation" which was expected to have "far-reaching implications for corporate governance" in China.[69] These implications might be said to include additional enhancement of minority

[66] L Chun, *The Governance Structure of Chinese Firms* (Heidelberg and London: Springer, 2009); Yang *et al* (n 54 above); N Rajagopalan and Y Zhang, "Corporate Governance Reform in China and India: Challenges and Opportunities" (2008) 51 *Business Horizons* 55; Y Cheung, P Jiang, P Limpaphayom and T Lu, "Does Corporate Governance Matter in China" (2008) 19 *China Economic Review* 460; H Sami, J Wang and H Zhou, "Corporate Governance and Operating Performance of Chinese Listed Firms" (2011) 20 *Journal of International Accounting, Auditing and Taxation* 106; L Miles and Z Zhang, "Improving Corporate Governance in State-Owned Corporations in China: Which Way Forward?" (2006) 6 *Journal of Corporate Law Studies* 213; S Li, "China's (Painful) Transition from Relation-Based to Rule-Based Governance: When and How, Not If and Why" (2013) 21 *Corporate Governance: An International Review* 567; G Xu, T Zhou, B Zeng and J Shi, "Directors' Duties in China" (2013) 14 *European Business Organization Law Review* 57.

[67] R Kraakman, H Park and S Shavell, "When Are Shareholder Suits in Shareholder Interest?" (1994) 82 *The Georgetown Law Journal* 1773 (Discussion Paper No 133 Harvard Law School Cambridge, MA 02138, 1993).

[68] A Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (Oxford: Oxford University Press, 2007) pp 45, 52; see also A Keay, "The Ultimate Objective of the Company and the Enforcement of the Entity Maximisation and Sustainability Model" (2010) 10 *Journal of Corporate Law Studies* 35, 40–45; J Zhao, "A More Efficient Derivative Action System in China: Challenges and Opportunities through Corporate Governance Theory" (2013) 64 *Northern Ireland Legal Quarterly* 233.

[69] Huang (n 15 above) p 242.

shareholder protection, the provision of effective means against wrongdoing managing officers and directors of companies,[70] and the resolution of power imbalances between directors and shareholders and between minority and majority shareholders, to name but a few.

3. Shareholding Percentage Requirement

After discussing the significance of a well-designed eligibility threshold, this section goes on to examine a few doctrinal deficiencies in terms of shareholders' eligibility to bring a derivative action in the CCL, with a particular focus on the shareholding percentage requirement in JSLCs.

(a) Rational and Legislative Experiences for Imposing a Percentage Requirement

Shareholding percentage is not required as one of the elements qualifying shareholders to bring a derivative action in public companies in common law countries.[71] This is probably because of the case law-based tradition of common law countries, which allows more flexibility in law-making and judicial control, to avoid abuse of the derivative action mechanism. For instance, in the UK Companies Act 2006, court permission is required before a claim brought by a shareholder can even continue as a derivative claim, upon proving the existence of a *prima facie* case.[72] In the United States, taking the most influential Delaware corporate law practice as an example, a two-step test was established in the Supreme Court

[70] JV Feinerman, "New Hope for Corporate Governance in China?" (2007) 191 *The China Quarterly* 590, 605.

[71] For the UK law, see ss 260–263 of the Companies Act 2006. The United Kingdom makes no distinction between private and public companies in this regard.

[72] Section 261(2) of the UK Companies Act 2006; see also *Iesini v Westrip Holdings Ltd* [2011] 1 BCLC 498; *Abouraya v Sigmund* [2014] EWHC 277.

case of *Zapata Corp v Maldonado*[73] in reviewing the decision of the special litigation committee: first, the court "must inquire into the independence and good faith of the committee and the bases supporting its conclusions", and a company "should have the burden of proving independence, good faith and a reasonable investigation". Judicial control in common law countries purportedly restrains potential abusive usages of the derivative action mechanism, whereas civil law countries with a great respect for legislation would normally use *ex ante* procedural safeguards to achieve the same purpose, shareholding percentage requirement being a typical example.[74]

In Germany, the current law allows one or more persons holding shares constituting at least 1 per cent of the company's capital, or having a nominal value of at least 100,000 Euro, to file a derivative action in companies limited by shares.[75] South Korean law stipulates that the shareholding threshold for filing a derivative suit is 0.01 per cent in the case of listed companies.[76] As for non-listed companies, any shareholder who holds not less than one per cent of the total outstanding shares may demand that the company file an action against the directors to enforce their liability.[77] In Taiwan, the derivative action mechanism is only available to companies limited by shares, and any shareholder(s) who hold(s) three per cent or more of the shares may request the supervisors of the company to institute an action against a director(s).[78] This threshold is widely criticised by scholars as unnecessarily high

[73] 430 A 2d 779, 788 (Delaware 1981).

[74] A Cahn and DC Donald, C*omparative Company Law: Text and Cases on the Law Governing Corporations in Germany, the UK and the USA* (Cambridge: Cambridge University, 2010) p 602.

[75] Section 148(1) of the AktG 1965.

[76] Sections 191–13(1) of the Korean Securities and Exchange Act 1962 (amended in 1976 and 2002).

[77] Article 403 of the Commercial Act (Republic of Korea) 1963.

[78] Article 214 of the Companies Act (Taiwan) 2009; LY Liu, "The Derivative Action" (2004) 64 *Taiwan Law Journal* 156.

and pragmatically prejudicial against minority shareholders who wish to bring a derivative action.[79] Japan is one of the first countries in the civil law group not to have a quantitative shareholding requirement.[80] Empirical research demonstrated that 119 derivative actions were brought in listed companies in Japan during the period from 1993 to 2009, significantly more than the number of law suits in China.[81]

(b) Identifying the Differences in Application of Derivative Action between LLCs and JSLCs

In light of the requirements, reforms and criticisms in other jurisdictions, the one per cent shareholding threshold requirements enshrined in art 151 of the CCL 2013 seemingly

[79] WR Tseng and WWY Wang, "Derivative Actions in Taiwan: Legal and Cultural Hurdles with A Glimmer of Hope for the Future" in D Puchniak, H Baum and M Ewing-Chow (eds), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge: Cambridge University Press, 2012) p 215; Liu, *Ibid.*; H Wang, "The Derivative Action in Taiwan Company Law and Reform Suggestions 公司法中的代表诉讼制度的缺失与改进之道" in L, Liu (ed), *Commercial Monographs — Professor Lai Fiftieth Birthday Congratulations Proceedings* 商法专论- 赖英映照教授五十岁生日祝贺论文集 (Taipei: Yuanzhao Publishing, 1995) p 130.

[80] Section 847(1) and 847(2) of the Companies Act (Japan) 2005 replaced s 267(1) with the old Japanese Commercial Code. Both sections allow any shareholder who held at least one share continuously for six months to demand a corporation act to enforce a directors' duties; MM Siems, "Private Enforcement of Directors' Duties: Derivative Action as a Global Phenomenon" in S Wrbka, S Van Uytsel and M Siems (eds), *Collective Actions: Enhancing Access to Justice and Reconciling Multilayer Interests?* (Cambridge: Cambridge University, 2012) p 93.

[81] M Nakahigashi and DW Punchniak, "Land of the Rising Derivative Action: Revisiting Irrationality to Understand Japan's Unreluctant Shareholder Litigate" in DW Puchniak, H Baum and M Ewing-Chow (eds), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge: Cambridge University Press, 2012) pp 128, 172–173. Other than the absence of a shareholding requirement, this may also be due to a number of other factors, of which low and fixed litigation costs are important. See MD West, "Why Shareholders Sue: The Evidence from Japan" (2001) 30 *Journal of Legal Studies* 351; Zhang (n 5 above).

constitute a barrier hindering the vast majority of shareholders, including individual and institutional shareholders, in JSLCs who wish to bring derivative actions as an effective remedy, proved by the drastic differences between derivative action cases in LLCs and JSLCs. We used the most authoritative legal search engine in China, *Bei Da Fa Bao*, and found that since the implementation of the CCL 2005, 126 cases have been accepted by the People's Court in which shareholder(s) brought derivative actions either individually or collectively.[82] The number of derivative action cases in LLCs in China is notably higher, or at least not considerably lower, than the number of derivative action cases in other jurisdictions.[83] In the meantime, the *Sanlian Shangshe* case in 2009 was the only case involving a shareholder in a JSLC bringing a derivative action. The question arises, therefore, why the mechanism has

[82] This includes 13 cases in 2006, 6 cases in 2007, 17 cases in 2008, 22 cases in 2009, 22 cases in 2010, 14 cases in 2011, 8 cases in 2012, 3 cases in 2013, 8 cases in 2014 and 13 cases in 2015.

[83] Based on the research of Professor Keay, since the enforcement of s 260 of the Companies Act 2006 on 1 October 2007, the regime of derivative action has not been used (data from a search of the Westlaw, Lexis and BAILII databases for three jurisdictions, namely England and Wales, Scotland and Northern Ireland). 22 derivative actions were instituted up to September 2015. After September 2015, there is one reported case in the period till June 2016: *Brannigan v Style* [2016] EWHC 512 (CH). Therefore, 23 derivative actions have been instituted up to June 2016. However, the popularity and effectiveness of the derivative action mechanism are decided by many factors. Obviously, unfair prejudice, based on s 994 of the Companies Act 2006, has proved to be a very popular mechanism in minority shareholder remedies and is argued to be a comprehensive barrier to instituting a derivative claim; see A Keay, "Assessing and Rethinking the Statutory Scheme for Derivative Actions under the Companies Act 2006" (2016) 16 *Journal of Corporate Law Studies* 39, 41 and 59–67. In Japan, according to Nakahigashi and Punchniak, 29 derivative actions were brought from 1993 to 2009 for unlisted companies; Nakahigashi and Punchniak (n 81 above) pp 172–173; 27 cases were bought on behalf of private companies among 31 cases from 2000 to 2005 according to Ramsay and Saunders; see IM Ramsay and BB Saunders, "Litigation by Shareholders and Directors: An Empirical Study of the Australian Statutory Derivative Action" (2006) 6 *Journal of Corporate Law Studies* 397, 420.

been scarcely used in JSLCs in China, considering that shareholders in LLCs in China seek to use the mechanism much more often.

In a logical manner, doubts have been thrown on the threshold applicable to JSLCs. For example, the percentage requirement prescribed in CCL has been heavily criticised by scholars thus far. The following sections contribute to this matter by way of an empirical analysis, and feasible alternatives are suggested as a result.[84]

(c) Data from the Chinese Stock Market and Practical Difficulties in Meeting the One Per cent Threshold

One should review the statistics in relation to the general scale and percentage of shareholding in China before commenting on whether the current one per cent shareholding percentage threshold is too high for shareholders in JSLCs. A report issued by the China Securities Investor Protection Fund Corporation in 2012 indicated that 52.27 per cent of surveyed investors invested less than RMB 100,000 in stocks, and 85.2 per cent of them invested less than RMB 500,000.[85] This study was continued by the Feng Hua Finance and Economic Consulting Firm (丰华财经) for their report in 2013, finding that 45.36 per cent of the surveyed investors invested less than RMB 50,000 in stocks and 75.1 per cent invested

[84] S Lin, *Derivative Actions in Chinese Company Law* (Netherlands: Kluwer Law International, 2015); Huang (n 15 above); J Deng, "Building an Investor-Friendly Shareholder Derivative Lawsuit System in China" (2005) 46 *Harvard International Law Journal* 347; W Cheng, "Protection of Minority Shareholders after the New Company Law: 26 Case Studies" (2010) *International Journal of Law and Management* 283; Z Zhang, "Shareholder Derivative Action and Good Corporate Governance in China: Why the Excitement Is Actually for Nothing" (2011) 28 *UCLA Pacific Basin Law Journal* 174; Zhao (n 68 above).

[85] A Survey of Securities Investors 2012 (2012 年中国证券投资者综合调查报告) p 43, available at http://www.sipf.com.cn/images/NewCH/zxdc/2013/03/01/EC3861DC3E3764896A8CB1DC5F4E94C7.pdf (last visited on 6th June 2018).

less than RMB 500,000.[86] More recently, a report published by the Shenzhen Stock Exchange disclosed that 84.4 per cent of the investors had invested less than RMB 500,000.[87] Finally, a report from the China Securities Depository and Clearing Corporation Limited (CSDC) indicated that 76.73 per cent of the surveyed investors invested less than RMB 100,000 and 95.15 per cent of them invested less than RMB 500,000.[88] Considering the fact that most of the listed companies have a market value of RMB 1 billion,[89] RMB 500,000 is a long way from 1 per cent of the market value. Therefore, the holders of these stocks, more than 84 per cent of the shareholders in listed companies based on the data from 2012 to 2015, do not have the right to bring a derivative action as an independent claimant under the current company law of China.

Furthermore, based on the shareholding distribution of A-shares [90] held by professional institutional shareholders in 2014, the breakdown of the shareholding percentage of seven groups of intuitional shareholders, including pension funds, Qualified Foreign Institutional Investors insurance companies, trusts, corporate annuities, securities firms (proprietary accounts) and securities firms (asset management schemes) in listed companies in China, was 0.61, 1.17 1.71, 3.87, 1.37, 0.14, 0.31 and 0.23 per cent, respectively. It is

[86] JFINFO, "A Survey of Individual Investors 2013" (2014) p 11, available at http://www.jfinfo.com/special/2013report.pdf (last visited on 6th June 2018) .

[87] Shenzhen Stock Exchange, "Annual Individual Shareholders Survey 2017, 2017 年个人投资者状况调查报告", available at http://www.szse.cn/main/aboutus/bsyw/39778315.shtml (last visted on 6th June 2018).

[88] J Coffee and DE Schwartz, "The Survival of the Derivative Suit: An Evolution and a Proposal for Legislative Reform" (1981) 81 *Columbia Law Review* 261, 312.

[89] China Centre for Market Value Management, The A Share Annual Report of China 2012 and 2013 (2012 年和 2013 年中国 A 股市值年度报告).

[90] A-shares are denominated in Renminbi; comparatively, B-shares are denominated in foreign currency (US dollars in the Shanghai Stock Exchange and Hong Kong dollars in the Shenzhen Stock Exchange).

reported by the CSDC that there are 289,900 institutional shareholders investing in 2,839 listed companies in China.[91] On average, more than 100 institutional shareholders, in various forms, are investing in an individual listed company. It is also likely that there will be more than one institutional shareholder investing in a company that belongs to one of the seven international shareholder groups mentioned above. Therefore, the likelihood is that a number of institutional shareholders will not qualify as a claimant for bringing derivative action either.

(d) Empirical Observations

The authors collected a set of original data in July 2016. This involved investigating the eligibility of the top 10 biggest shareholders from a sample of 800 listed companies in China in terms of bringing a derivative action.[92] The samples consist of 400 listed companies on the Shenzhen Stock Exchange and 400 on the Shanghai Stock Exchange. This empirical research was carried out using purposive sampling, with controls placed on the types of companies chosen for the survey in terms of nature and size, and we specifically looked for representative samples to make sure that the sample is correctly balanced. We identified the key index factors for JSLCs in terms of their key characteristics. As detailed below, we selected these samples on the basis of the following criteria: was it an SIE or not; the number of shareholders; total capitalisation; and industrial classification. The aim was to deliver a set of legitimate and comprehensive data that genuinely reflect the pattern of listed companies in China and lay a solid base for research on the shareholding percentage of the top 10

[91] China Securities Depository and Clearing Corporation Limited, "CSDC Monthly Report" (February 2016) p 2, available at http://www.chinaclear.cn/zdjs/editor_file/20160314173907448.pdf (last visited on 6th June 2018).

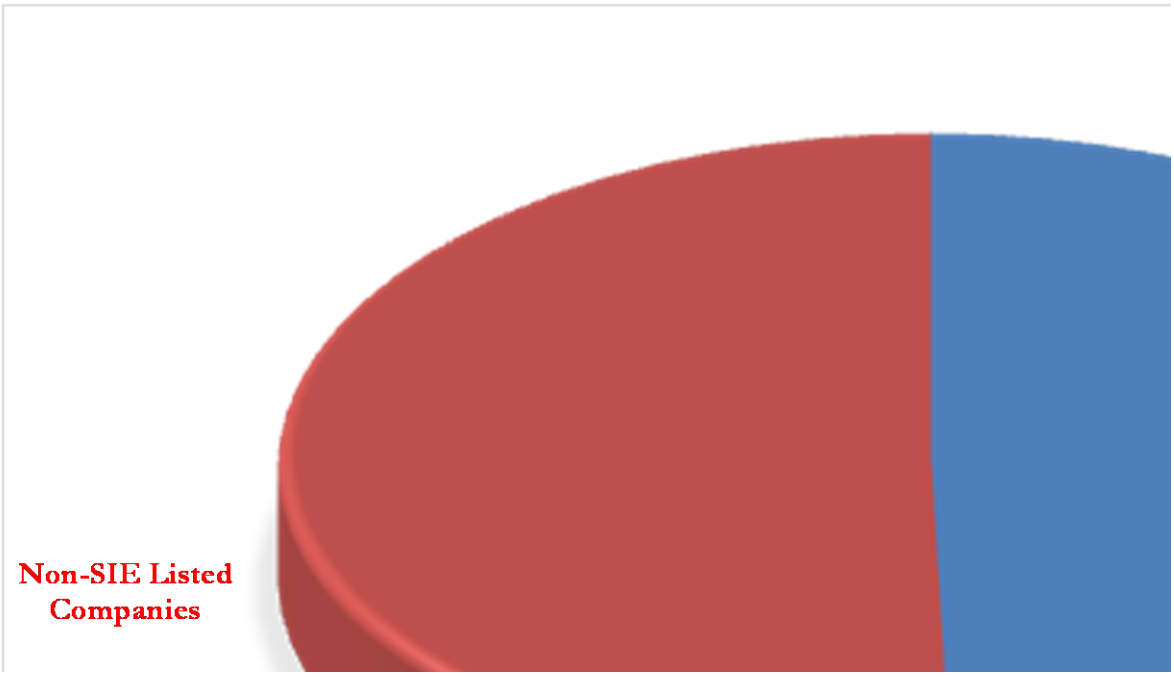
[92] The data were collected from 15 to 22 June 2016 and reflected the shareholding structures of sample companies as of these dates.

shareholders.[93] The top 10 shareholders were selected because the publicly available data on shareholding percentage were limited to this information.

The sample of 800 selected companies was composed of 396 listed SIEs and 404 listed non-SIEs (Figure 1), aiming to deliver a balanced view of the unique shareholding structure of SIEs in China and its implications for derivative action. As JSLCs in China consist of SIEs and non-SIEs, the selection of data is important for our research on the importance of derivative actions in both SIEs and non-SIEs in China, and the distinct position of non-SIEs in the corporate governance transformation to a more economic and market-oriented model. Figure 1 aims to show a clear and balanced view of the unique shareholding structure of SIEs in China and its implications for derivative action. The figure works well with Figures 2–5 to demonstrate that the sample selection method is convincing and coherent.

Figure 1: Balance of SIE and Non-SIE Listed Companies from the Sample of 800 Listed Companies

[93] This sample-selection methodology is preferred instead of investigating all listed companies as: (1) the massive number of listed companies adds to the pragmatic difficulty of a thorough investigation; (2) the shareholding structure, the number of shareholders and the number of listed companies constantly change with time; and (3) a random selection of samples would not reflect the industry attributes of listed companies and might lead to biased results on shareholding structures that are heavily influenced by the industries the companies engage in.



Second, the sample involves companies which are representative of the target companies, namely JSLCs, in terms of the number of shareholders and total share capital. In other words, the distribution of the number of the companies based on different industrial classifications should match those of the entire target population. These two aspects are investigated in order to ensure that the poll represents a balanced and representative sample. As for the former, the distribution of the number of shareholders in the sample of 800 listed companies collected by the authors, as demonstrated in Figure 2, is consistent with the distribution of all listed companies in terms of shareholder numbers, based on data collected by EastMoney (东方财富) on 30 June 2016[94] regarding the number of shareholders in listed companies in China. As for the latter, the pattern of the total share capital collected and organised by the authors, demonstrated in Figure 3, is also consistent with the pattern based

[94] Obviously, the authors are aware that there are limitations to this matching exercise since there is a small timescale gap here, available at http://data.eastmoney.com/cmjzd/ (visited 11 August 2016).

on the data for the total capitalisation of listed companies collected and produced by Hexun Data (和讯数据).[95]

Figure 2: The Number of Shareholders in the Sample of 800 Listed Companies

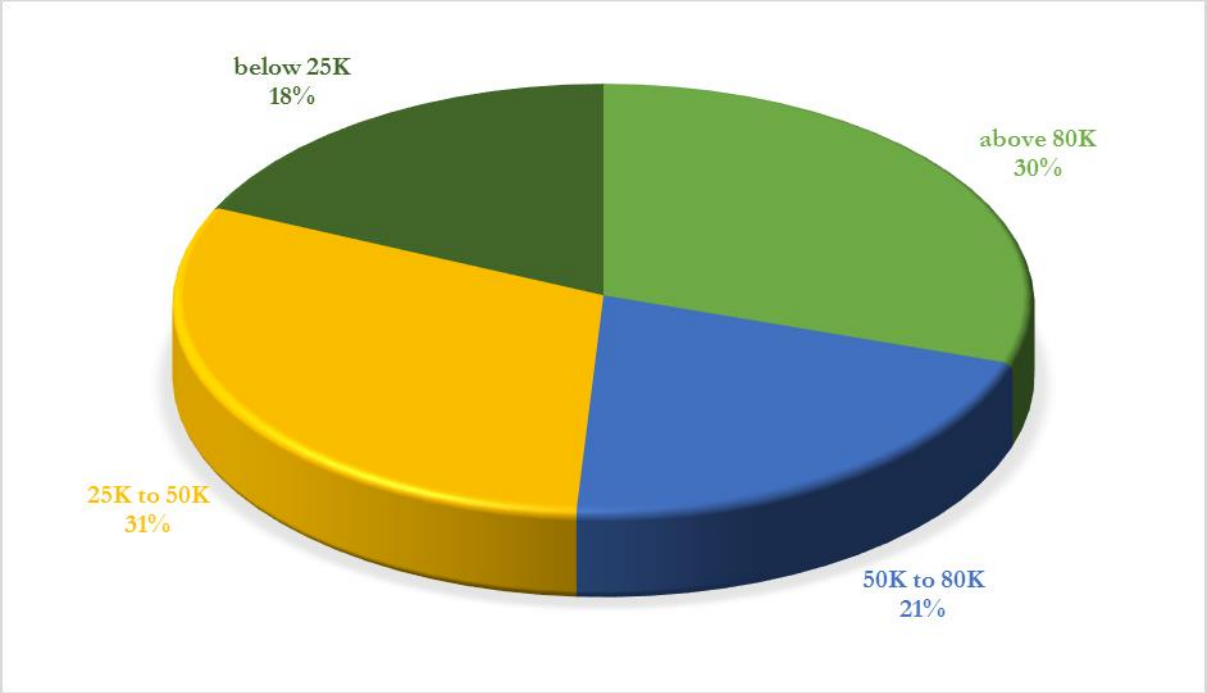
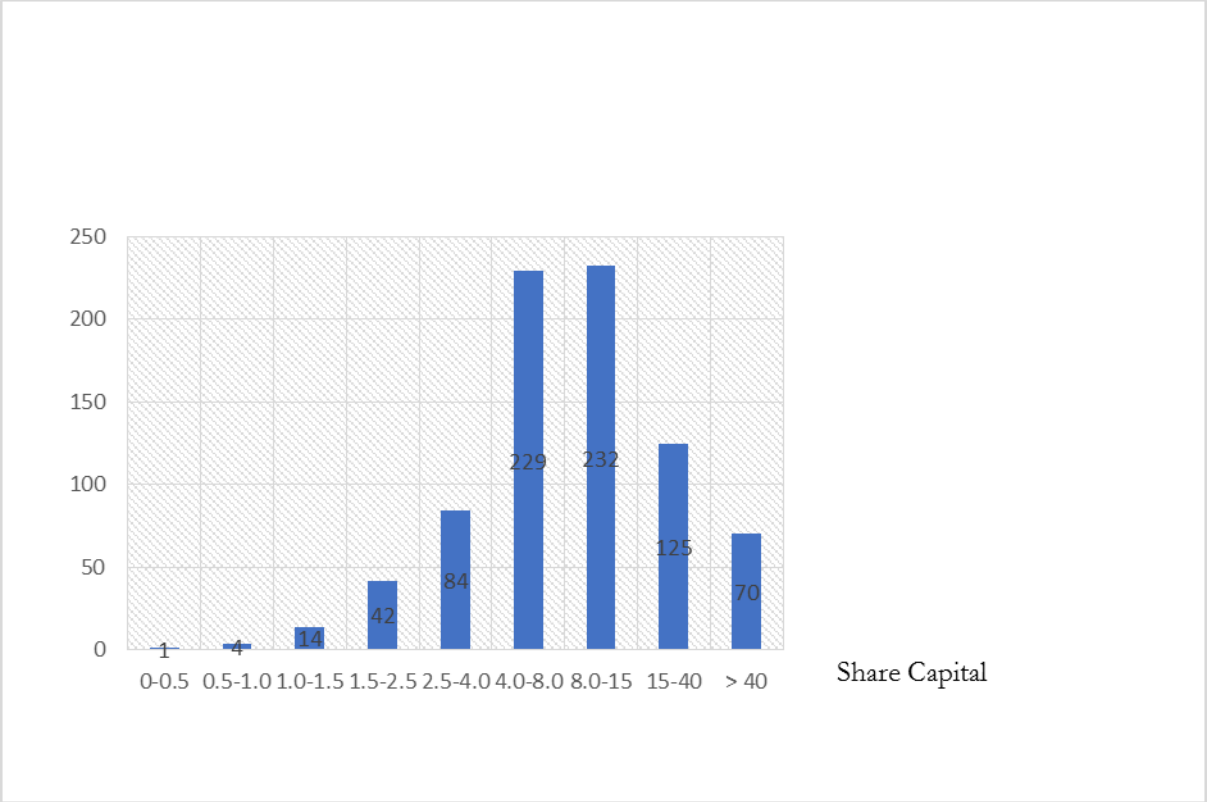


Figure 3: The Number of Companies Based on Different Shareholder Capital Ranges

[95] See http://datainfo.stock.hexun.com/ssgs/jbsj/gbfb.aspx (visited 11 August 2016).



Third, these samples, including both SIEs and non-SIEs, cover all industries with listed companies, including manufacturing, information technology and software, construction, scientific research and technical services, wholesale and retailing, transport warehousing and postal industries, mining, financial industry, education, electricity, heat, gas and water protection and supply and water conservation, environmental and public facilities management (Figures 4 and 5). The percentages of the sample companies in each industry are roughly consistent with the pattern of industry classification published by the National Equities Exchange and Quotations listed companies in the CSRC annual report.[96] We aimed to select a sample of 800 companies from all relevant types of industries to enhance the representativeness of our sample of all listed companies in a fair manner.

Figure 4: Industrial Classifications of Non-SIEs

[96] 2014 Annual Report (n 21 above) p 13.

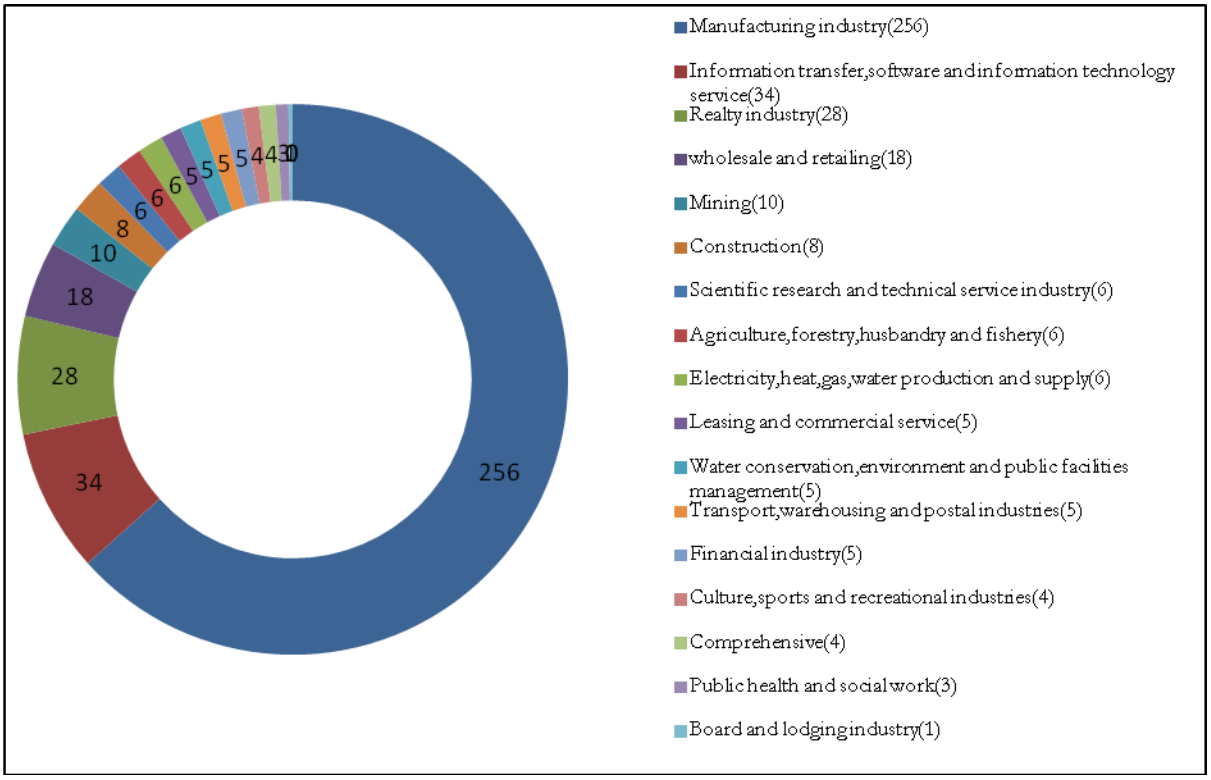
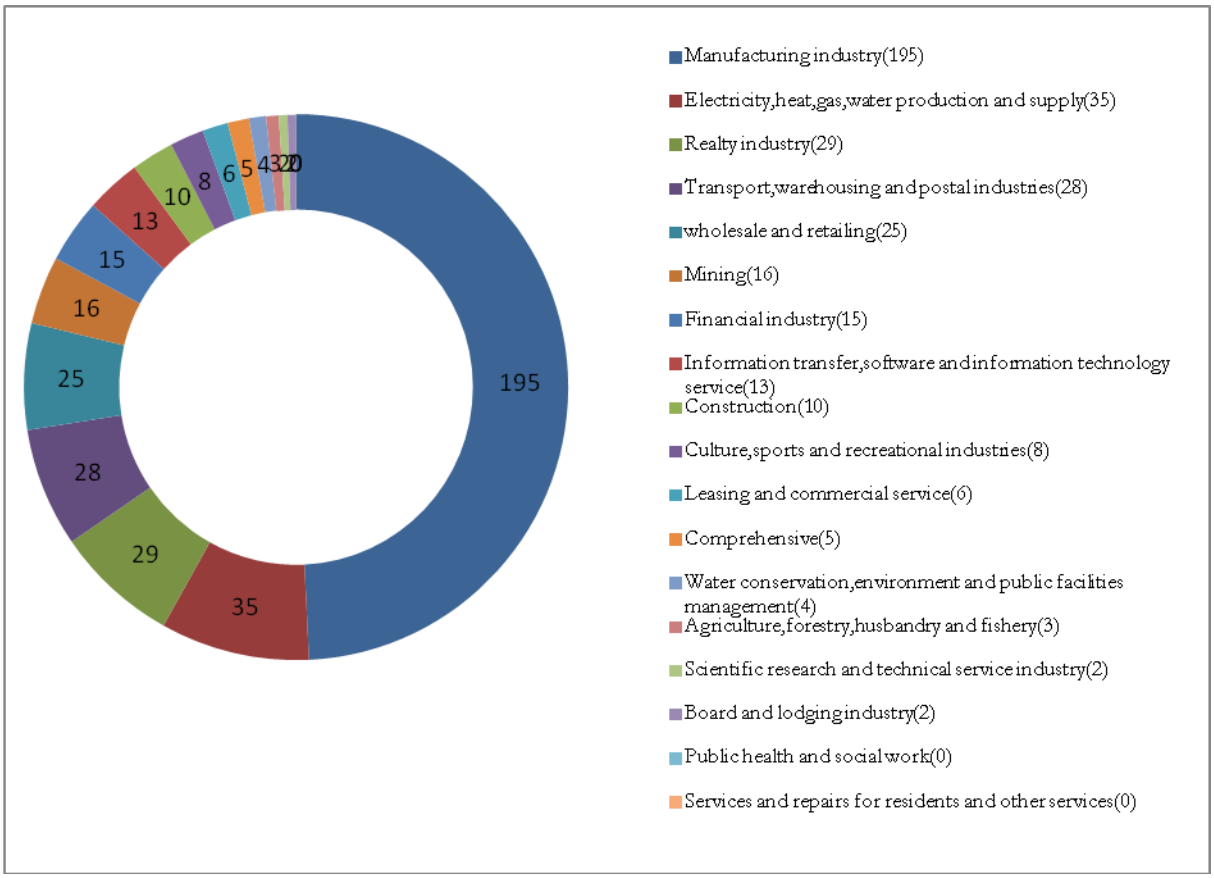

256
34
28
18
10
8
6
6
6
5
5
5
5
4
4
3
1
Manufacturing industry(256)
Information transfer,software and information technology service(34)
Realty industry(28)
wholesale and retailing(18)
Mining(10)
Construction(8)
Scientific research and technical service industry(6)
Agriculture,forestry,husbandry and fishery(6)
Electricity,heat,gas,water production and supply(6)
Leasing and commercial service(5)
Water conservation,environment and public facilities management(5)
Transport,warehousing and postal industries(5)
Financial industry(5)
Culture,sports and recreational industries(4)
Comprehensive(4)
Public health and social work(3)
Board and lodging industry(1)

Figure 5: Industrial Classifications of SIEs



The hypothesis was that if the current shareholding threshold prescribed in CCL does not hinder the use of the derivative action mechanism by minority shareholders in listed companies, which we assume have a dispersed ownership structure, the top 10 shareholders, or at least the majority of them, should not be barred by the shareholding threshold from bringing derivative actions due to their shareholding percentage.[97] A few questions were raised in order to investigate the soundness of the hypothesis, as well as the possibility of law reform: how many shareholders among the top 10 are entitled to bring derivative action, if they were to bring a lawsuit on their own? What is the average percentage shareholding? What if the percentage requirement were to be lowered to 0.5 per cent? What if the percentage requirement was lowered to 0.1 per cent?

The result of this quantitative research informs us that on average (as demonstrated in Figure 6), 52.10 per cent of the shareholders could bring a derivative action if the standing requirement was 1 per cent, 75.44 per cent if the standing requirement was 0.5 per cent and 99.44 per cent if the standing requirement was 0.1 per cent.[98] Drawing from this empirical study, it is logical to propose a lower shareholding percentage requirement for listed companies, to enable more minority shareholders to use the derivative action regime to protect their interests. More user-friendly eligibility criteria could significantly improve the enforcement of company law and thus contribute to good corporate governance.[99]

Figure 6: The Percentage of Top 10 Shareholders' Eligibility to Bring a Derivative Action and Different Standing Recruitments in Company Law

[97] Data on the top 10 shareholders' shareholding percentage is on file and available on request.

[98] Data available on request.

[99] Feinerman (n 70 above) pp 600–601.

(e) Difficulties in Collective Action

Some might argue that it is possible for two or more shareholders to bring a derivative action in a collective manner, since the law does allow "shareholders that hold an aggregate 1% or more" to bring such derivative actions.[100] However, it is not practically feasible to call for collective action among shareholders in JSLCs, especially listed ones, at least in China, where most minority shareholders are individual shareholders.[101] Organising a number of individual shareholders who are willing to bring a collective derivative action can be a very difficult process. In principle, individual shareholders of listed companies who propose to commence or intervene in a lawsuit may consult the central securities registry and the clearance agency to obtain details of other shareholders who may want to bring this litigation jointly. However, in practice it is very hard for them to acquire contact information because of privacy considerations. As a result, these shareholders almost invariably rely on the "last resort" of soliciting other shareholders publicly, which will damage the confidence of public investors in the company and could affect the reputation of the company.[102] Information asymmetry has proved in practice to be a major obstacle for joint derivative action claimants, who need to acquire sufficient information about their fellow shareholders. Therefore, it is clear that joint litigation is either impractical or harmful (or at least very difficult), which is against the purpose of the derivative action mechanism to protect the interests of the company.

[100] Article 151 of the CCL 2013.

[101] FX Hong and SH Goo, "Derivative Action in China: Problems and Prospectus" [2009] *Journal of Business Law* 376, 388.

[102] Liu (n 34 above) p 119; this also happens in cases in which shareholders try to protect themselves through direct litigation; see, for example, Xiuning Zhongjing Huadong Nonferrous Investment Co., Ltd. v. Zhang Yue Ning et al. (Nanjing Intermediate Court, 2014 No. 920); Jilin International Machinery Manufacturing Co., Ltd. v. Wang Xiansheng company (Changchun Chaoyang District Court, 2016 No. 2488); Zhang Ding v. Zhang Yong (Jinan Intermediate Court, 2016 No. 5133)

(f) Proposals for Changes and Difficulties in Transplanting Common Law Principles: UK Law as an Example

In light of the above-stated difficulties, Zhu and Chen proposed a legislative change, intending to replace the current shareholding percentage threshold with a share sum requirement with a focus on the value of the shares.[103] Presumably, the value of the shares here refers to market value rather than nominal value, an arbitrary figure bearing no relevance to the business reality. However, the fact that the market value of the shares floats with the market is likely to bring a lot of uncertainties and difficulties in enforcement, should this proposal be adopted. No alternative suggestion has yet been offered to address this potentially serious matter.

From a practical point of view, it is noted by Zhang, for instance, that a 1 per cent shareholding is a "substantial figure" in listed companies, and in China this figure is reached mostly by big block-holders,[104] many of whom are -state-controlled entities which were brought into corporate shareholding structures during the period of restructuring traditional state-owned enterprises for listing, and are in a strong rather than vulnerable position in comparison to directors, who are often appointed by government entities.[105] In order to address the concern that the shareholding percentage requirement may be a hurdle for shareholders in JSLCs, some scholars have suggested that China should follow the common law route and abolish the shareholding percentage requirement, claiming that any fixed minimum percentage or monetary value of shareholding is arbitrary, as the quantity of

[103] HC Zhu and GQ Chen, "China Introduces Statutory Derivative Action" *International Financial Law Review* (1 July 2005), available at http://www.iflr.com/Article/1984802/China-introduces-statutory-derivative-action.html (last visited on 6th June 2018).

[104] Zhang (n 84 above) p 194.

[105] *Ibid*.

ownership does not reflect the potential ability of minority shareholders to make valid and legitimate decisions and judgments.[106]

Derivative action in most common law jurisdictions is provided for in codified statutes. The courts' decisions to grant applications are always decisions made according to statutory criteria. Criteria need to be met before the court can authorise the initiation of a derivative action. Taking the United Kingdom as an example, derivative claims were delivered at common law for years until a statutory derivative proceedings scheme was introduced in the Companies Act 2006, following the approach extant in many Commonwealth countries[107] in order to promote simplification and modernisation of the law to improve its accessibility.[108] Keay argued that the primary characteristic of statutory shareholder derivative action is that the "courts are required to perform a gatekeeper role in order to exclude frivolous or unmeritorious cases".[109] Permission can be only granted if the shareholders who propose to bring a derivative action pass two stages successfully. These two stages are designed to enable the court to make decisions in an efficient manner about whether to give permission to proceed with the action in the absence of involvement from the company.[110] First, they have to establish a *prima facie* case on merit.[111] This stage of the permission process is designed to assess whether the company and the respondent should be put to the expense and inconvenience of considering and contesting the application for

[106] The "rationale underpinning the minimum shareholding strategy is flawed", Zhang (n 84 above) p 197.

[107] Such as Canada, Australia, New Zealand and Singapore.

[108] Shareholder Remedies (n 1 above) p 7 and para 6.4.

[109] Keay (n 83 above) p 40.

[110] These first two have been merged by the courts in some cases, such as *Bridge v Daley* [2015] EWHC 2121 (Ch); *Stimpson v Southern Private Landlords Association* [2009] EWHC 2072.

[111] Section 261(2) of the Companies Act 2006; see also *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch), [2011] 1 BCLC 498, [2010] BCC 420.

permission.[112] The court will therefore filter out cases that stand little or no chance of success and dismiss frivolous claim without company involvement at the earliest possible opportunity.[113]

If this stage proves successful, the case may proceed towards a second stage.[114] Here, the court must decide whether to grant permission by taking into account three criteria listed in s 263(2), including, for example, whether "a person acting in accordance with Section 172 (duty to promote the success of the company) would not seek to continue the claim".[115] Although no discretion should be given to the courts at this point, the court subsequently has discretion to decide whether to allow the claim to proceed if none of the criteria in s 263(2) apply. In the process of exercising this discretion, the court must take into account factors that are embedded in s 263(3) and 263(4).[116]

The court as the "gate keeper" and the discretion vested in the court regarding whether or not to proceed are seen as central issues under the new statutory procedures. However, we do have reservations in adopting this two-staged threshold in China, based on the following four reasons. First, commentators do not completely agree about the effectiveness of this approach. The criterion that the applicant has to act in good faith in

[112] *Langley Ward Ltd v Trevor* [2011] EWHC 1893 (Ch), [62].

[113] HL Deb 9 May 2006, vol 681, col 883 (Lord Goldsmith).

[114] A Keay and J Loughrey, "Derivative Proceedings in a Brave New World for Company Management and Shareholders" [2010] *Journal of Business Law* 151.

[115] Section 261(2) of the Companies Act 2006.

[116] Davies and Worthington, however, think that this is a third stage, where a number of factors are laid down which the court must take into account in deciding whether to give permission, such as whether the shareholder seeking to bring the claim is acting in good faith, possibilities of ratification and the likelihood of company pursuing the claim. See ss 263(3) and 268(2) of the Companies Act 2006; PL Davies and S Worthington, *Gower: Principles of Modern Company Law* (London: Sweet & Maxwell, 10th ed., 2016) pp 601–602.

bringing a derivative claim,[117] for example, is criticised as "uncertain and unworkable".[118] It is argued that the court needs to decide whether the benefit from a proposed litigation would be outweighed by the harm that it would potentially cause to the company, without full evidence verified by cross-examination.[119] The transplant should therefore be subject to more rigorous assessment of its fitness with comprehensive consideration of other path dependence factors, including a number of issues such as overburdened court systems, limited judicial resources, judges' skills and knowledge,[120] the limited knowledge of shareholders as natural persons and information asymmetries between minority shareholders and institutional shareholders.[121] As a matter of fact, only 56 per cent of Chinese judges hold degrees,[122] and many civil servants who are described as judges work in administrative roles.[123]

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[117] *Stimpson v Southern Private Landlords Association* [2009] EWHC 2072; [2010] BCC 387; s 263 (3) of the Companies Act 2006.

[118] A Reisberg, "Theoretical Reflections on Derivative Action in English Law: The Representative Problem" (2006) 3 *European Company and Financial Law Review* 69, 101 and 103.

[119] Contribution of Zhang Zhong quoted in J Loughrey, "Directors' Duties and Shareholder Litigation: The Practical Perspective" in J Loughrey (ed), *Directors' Duties and Shareholder Ligation in the Wake of the Financial Crisis* (Cheltenham: Edward Elgar, 2013) pp 229, 245.

[120] T Gong, "Dependent Judiciary and Unaccountable Judges: Judicial Corruption in Contemporary China" (2004) 4 *China Review* 33; W Gu, "The Judiciary in Economic and Political Transformation: *Quo Vadis* Chinese Courts?" (2013) 1 *The Chinese Journal of Comparative Law* 303.

[121] It is worth pointing out that among the 126 reported cases found through *Bei Da Fa Bao*, most are still brought by shareholders as natural persons, with only 19 cases involving company/institutional shareholders as claimants bringing derivative actions ("representative action" was the term used in the judgments), which are as follows: *Zhoushan City Civil Aviation Development Co, Ltd v Wang Yaqing* (2010 ZhouPuShan No 385); *Hunan Xianchu Interactive Media Company Ltd v Hu Jia* (2013 Chao MinChuZi No 02014); *Pingdingshan Blasting Equipment Franchise Co v Mao Zhenzhong* (2013 Zhan MinYiChuZi No 212); *Shandong Kangyuan Biological Breeding Ltd v Pan Gang* (2014 HuiShangChuZi No 234); *Shaanxi Institute of Experimental Medicine Pharmaceutical v Li* (2013 XianqinMinChuZi No 03451); *Pinghai Development Co, Ltd v Shanghai*

Second, the *prima facie* test has been made familiar by lawyers in the United Kingdom and some other common law countries and was seen as the primary test in applications for interim injunctions in most cases during the 20th century.[124] However, the test is not widely known and applied in China in relation to company law.

Third, the codified restatement of directors' duties, which reflect common law and equitable principles, is key for the understanding and enforcement of directive action in the

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Star Group Zhen City Real Estate Co, Ltd (2005 HuGaoMingsiShangChuZi 1; this case was concluded on 30 September 2007 and Company Law 2006 was applied); *Ningbo Yinzhou Xin'an Printing Co, Ltd v WeiDong Lu* (Su ZhongShangWaiChuZi No 0021); *UNISON Electro Dynamics (FAAF) LLC v B Co, Ltd* (2011 Hu YiZhongMinSiShangChuZi No S59); *Yiwu Harvest Investment Advisory Co, Ltd v Zhejiang NiuTouNgau Tau Style Ltd* (2012 ZheJinShangChuZi No 32); *World Leader Development Co, Ltd v Zhongcheng Lin* (2013 QuanMinChuZi No 939); *Nantong Hengxiang Co Ltd v XiangshuiHengxiang Co, Ltd* (2014 Su ShangZhongZi No 0012); *Siyang County TaHui Textile Co, Ltd v Jianfen Yu* (2013 Su ShangChuZi No 0140); *Pumuyuan Co, Ltd v Shanghai Fusheng Bean Products Co, Ltd* (2014 MinTiZi 170); *Chongqing Li Hao Development Co, Ltd v Jun Guo* (2011 Yu WuZhongFaMinZhongZi No 3948); *Beijing YiJinYuHui Technology Investment Ltd v Shen Wang* (2012 YiZhong Min ZhongZi 1751); *Xinjiang Wujiaqu Xinbao Agricultural Science and Technology Development Co, Ltd v HeJing County Hope Investment (Group) Co, Ltd* (2015 Xin MinErZhongZi No 29); *Nantong East River Real Estate Development Co v Yangzhou TongJi Real Estate Development Co* (2014 Su ShangZhongZi 00491); and *Shanghai Huayuan Health Venture Capital Co, Ltd v Sheng Qiu Cheng* (2014 Hu ErZhongMinSiShangZhongZi S543).

[122] Jingwen Zhu (ed), *China Legal Development Report 中国法律发展报告：数据库和指标体系* (Beijing: Renmin University Press, 2007) p 34.

[123] The Economist, Legal Reform: Judging Judges (24 September 2015) available at https://www.economist.com/china/2015/09/24/judging-judges (last visited on 6th June 2018).

[124] *Hoffman-La Roche (F) & Co v Secretary of State for Trade & Industry* [1975] AC 295, 338 and 380; see also C Gray, "Interlocutory Injunctions since Cyanamid" (1981) 40 *Cambridge Law Journal* 307; P Carlson, "Granting an Interlocutory Injunction: What Is the Test" (1982–1983) 12 *Manitoba Law Journal* 109.

United Kingdom and other common law countries.[125] It is indeed the fact that the concept of fiduciary duties, including the duty of loyalty and the duty of care, is explicitly stipulated in CCL,[126] with codification of a number of misconducts in terms of the violation of duties by directors.[127] However, the successful application and enforcement of the approach is heavily dependent on judicial discretion about when this inclusive and flexible principle may be applied to individual cases, so the nature and scope of the duty may be constantly refined and enriched by precedential ruling by judges.[128] This makes it problematic to transplant this common law approach to jurisdictions with a civil law background, with difficulties in making the principle a workable one in judicial practice.[129] This is demonstrated by the empirical research of Xu *et al* and historical evidence from Japanese transplantation.[130]

Fourth, the use of derivative action in the United Kingdom also depends on its relationship with the remedy of unfair prejudice, embedded in s 994 of the Companies Act 2006 without court authorisation. The notion of "unfair prejudice" does not have an equivalent in CCL in terms of shareholder rights in bringing a lawsuit.[131]

The imposition of a fixed and lowered threshold figure for listed companies seems necessary at least at the current time in China, for its effect in avoiding excessive litigations

[125] S Watkins, "The Common Law Derivative Action: An Outmoded Relic" (1999) 30 *Cambrian Law Review* 40; JL Yap, "Whither the Common Law Derivative Action" (2009) 38 *Common Law World Review* 197.

[126] CCL 2013 art 147.

[127] *Ibid*., art 148.

[128] Xu *et al* (n 66 above) p 87.

[129] *Ibid.*

[130] The loyalty duty has not been applied separate by Japanese courts; see H Kanda and CJ Milhaupt, "Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law" (2003) 51 *American Journal of Comparative Law* 887.

[131] Siems (n 80 above) p 101.

or malicious lawsuits. Given that the above-discussed empirical study results indicate that a modification from a 1 per cent threshold to a 0.1 per cent threshold would render roughly 99 per cent of the top 10 shareholders in listed companies (ranked in terms of their shareholding percentage) eligible to bring derivative actions, the authors suggest lowering the current shareholding requirement to at least 0.1 per cent of the total shareholding of the company, to enable an adequate number of minority shareholders in listed companies to use the mechanism to protect their interests, to use their collective powers in the company's best interests and, most importantly, to mitigate the potential risk of frivolous lawsuits.

(g) 0.1 Per cent Proposal and the Balance between Voices and Exits

Another legitimate question that needs addressing is whether a shareholder who owns 0.1 per cent of the company share in a JSLC would have incentive to sue in the interests of the company in his own name. It is crucial to point out that even under the proposed new threshold of 0.1 per cent of shareholding, those shareholders who are eligible in JSLCs are not small shareholders or minority shareholders. Based on our empirical data, 7.65 per cent of the top 10 shareholders fall within the shareholding percentage range of 0.1–0.2 per cent. As we mentioned earlier, the CSDC concluded that 76.73 per cent of the surveyed investors had invested less than RMB 100,000. It would be difficult to imagine that these shareholders would have incentives to bring a derivative action. However, considering the 91 million *gu min* (data from July 2015), it is highly unlikely that these shareholders would fall in the category suggested by us based on a threshold shareholding percentage of 0.1 per cent. Moreover, regarding individual shareholders, only a small portion of shares in listed companies are held by them, with average ownership equalling 2.38 per cent for all individual shareholders, and it is very unlikely that they will hold 0.1 per cent of the shares in

any company.[132] We are convinced that shareholders(s) who own(s) 0.1 per cent have sufficient self-interests in the outcome of litigation to conduct a truly adversarial lawsuit.

Furthermore, it is important to clarify the rationale for giving adequate standing to members while dissatisfied shareholders in a listed company could use the "exit strategy" by leaving the company. It is clear that derivative actions may entail possible benefits in two ways. First, Reisberg summarised two main purposes of derivative action, including deterrence of mismanagement and compensating the company and its shareholders for harm caused.[133] The recovery involved *ex post* liability and it may only be made after the derivative action is brought. Therefore, despite the fact that the shareholders could choose to sell their shares, the damage has taken place and the interests of the company and the shareholders have been harmed, and they are entitled to the financial benefit of compensation. Lin argued that the selling of shares in this scenario does not mean that they are not affected by the alleged wrongdoing, since the value of shares may have been affected by this wrongdoing and thus the value of the shares, as the property of the shareholders, has reduced.[134] Selling the shares, in this sense, would lead to immediate loss without having their voice heard for remedy and compensation.

Second, as the "shareholder engagement", "long-term economic interests" and "long-term investment culture" have been emphasised post-financial crisis 2008,[135] it may not

[132] OECD Survey (n 31 above), p 5.

[133] Reisberg (n 68 above) p 51.

[134] S Lin, "A New Perspective on China's Derivative Actions: Who Is Best Suited to Assessing Derivative Actions?" (2016) 27 *International Company and Commercial Law Review* 1, 3.

[135] See, for example, Financial Reporting Council, The UK Stewardship Code (September 2012); Association of British Insurers, Improving Corporate Governance and Shareholder Engagement; The Investment Association,

always be rational to use an "exit strategy" as an option. Despite the fact that it is difficult to find an optional mix of exit and voice, Hirschman famously argued that "exit" and "voice" work best together, and voice plays a crucial role in understanding how organisations actually work.[136] This may also apply to shareholders when they are faced with the option of getting their voice heard by bringing derivative actions when they perceive that firms are demonstrating a decrease in quality, or such actions would benefit the company (and their members).

(h) Accessibility and Incentives for Institutional Investors to Bring Derivative Actions

Existing research has supported the argument that altering the shareholding threshold will likely improve the accessibility of the derivative action mechanism for shareholders, which is the major legislative aim of Chinese law drafters.[137] Therefore, a proposal for a lower threshold in relation to the shareholding percentage and period will be made to make derivative action in China more effective and to ensure that the regime is utilised more systematically in JSLCs instead of being mere window-dressing. Moreover, since China has chosen to adopt a statutory derivative action mechanism in current legislation, it is necessary for the mechanism to be user-friendly for shareholders who are genuinely willing to initiate

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Supporting UK Productivity with Long-Term Investment: The Investment Association's Productivity Action Plan (March 2016); New York Stock Exchange Commission on Corporate Governance (2010).

[136] AO Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organization and State* (Cambridge: Harvard University Press, 1970); see also J Fox, "Exit, Voice, and Albert O Hirschman" *Harvard Business Review* (12 December 2012).

[137] Huang (n 25 above); Lin (n 84 above).

law suits on behalf of companies. It is particularly relevant for institutional shareholders in China with strong motivation to engage in corporate governance.[138]

Compared with countries with mature financial markets, it may seem worrying that institutional shareholders in China have demonstrated a less active level of involvement in corporate governance[139] to promote private enforcement. It is undeniable that there are means other than derivative action for institutional shareholders to monitor and evaluate directors' performance, ranging from the threat of diverting their shares to the active use of their voting power in board elections and proxy contest.[140] They are becoming increasingly active in governing their portfolio companies;[141] this is particularly the case for securities investment funds. In particular, the existing literature seems to suggest that in general they prefer behind-the-scenes private engagements such as voting;[142] presenting proposals at shareholders' meetings and ongoing dialogues in public, activist engagements and courtroom

[138] Jiang and Kim (n 57 above); B Gong, *Understanding Institutional Shareholder Activism: A Comparative Study of the UK and China* (Abingdon: Routledge, 2014); Z Chen, B Ke and Z Yang, "Minority Shareholders' Control Rights and the Quality of Corporate Decisions in Weak Investor Protection Countries: A Natural Experiment from China" (2013) 88 *The Accounting Review* 1211.

[139] B Gong, "The Limits of Institutional Shareholder Activism in China and the United Kingdom: Some Comparisons" in R Tomasic (ed), *Routledge Handbook of Corporate Law* (Abingdon: Routledge, 2017).

[140] W Wu, SA Johan and OM Rui, "Institutional Investors, Political Connections, and the Incidence of Regulatory Enforcement Against Corporate Fraud" (2016) 134 *Journal of Business Ethics* 709, 712.

[141] C Xi, "Institutional Shareholder Activism in China: Law and Practice (Part 1)" (2006) 17 *International Company and Commercial Law Review* 251.

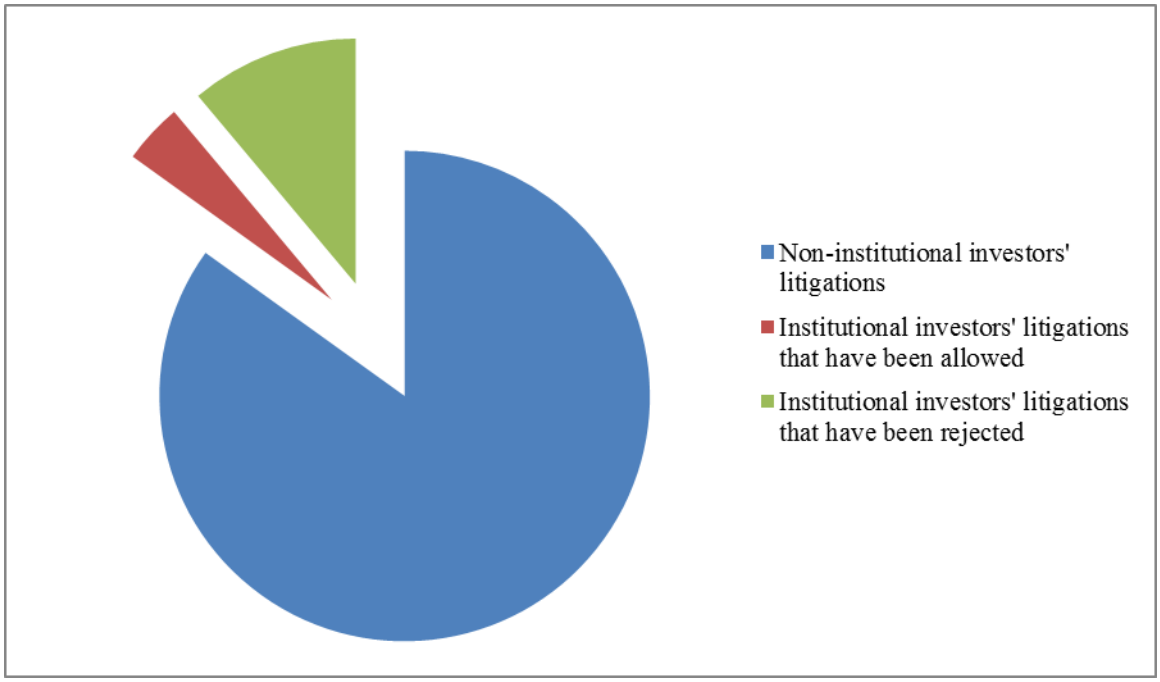
[142] Y Zeng, Q Yuan and J Zhang, "Dark Side of Institutional Shareholder Activism in Emerging Markets: Evidence from China's Split Share Structure Reform" (2011) 40 *Asia-Pacific Journal of Financial Studies* 240, 259.

confrontations are regarded as the very last resort.[143] Our empirical research specifically identified some characters of institutional investors' derivative action. As discussed above, since the implementation of the CCL 2005, 126 cases have been accepted by the People's Court when shareholder(s) brought derivative actions either individually or collectively. Among these derivative action cases we identified, there were 19 in which institutional shareholders acted as claimants.[144] We further found that only 5 out of these 19 cases were allowed (including those that were fully or partly accepted), while the rest were rejected due to reasons such as shareholders failing to make a request to the supervisors first (*Hunan Xianchu*, *Nantong Hengxiang*, *UNISON* and *Pumuyuan*), alleging both direct action and derivative action in one case (*Chongqing Li Hao*), claimants with conflicts of interests (*Yiwu Harvest*, *Pumuyuan* and *UNISON*), directors acting within the authorisation specified by the articles of association (*Yiwu Harvest* and *Siyang*), directors fulfilling their duty of care (*Siyang*) or failing to prove damages (*Pinghai* and *Nantong East River*). The status of derivative actions in China litigated by institutional shareholders is dominated in Figure 7.

Figure 7: Status of Institutional Investors' Derivative Action

[143] Xi (n 141 above) p 253; see also S Estrin and M Prevezer, "The Role of Informal Institutions in Corporate Governance: Brazil, Russia, India, and China Compared" (2011) 28 *Asia Pacific Journal of Management* 41.

[144] We identified 19 cases involving company/institutional shareholders as claimants bringing derivative actions ("representative action" was the term used in the judgments). See note 121 for the 19 cases.



Looking at the causes of these 19 actions, they include matters such as appropriating the company's funds (*Hunan Xianchu, Nantong Hengxiang, Nantong East River, Beijing YiJin* and *UNISON*), taking loans from the company (*Xinjiang Wujiaqu Xinbao, Shanxi Pharmaceutical*), exclusion from management (*UNISON* and *Nantong Hengxiang*), taking over the company stamp or financial accounts (*Chongqing Li Hao, Nantong Hengxiang* and *Shanghai Huayuan*), failing to pay capital contributions *(Pinghai* and *Pumuyuan*), failing to fulfil obligations under the shareholders' agreement (*Zhoushan Aviation*), undervalued transfers (*Siyang*) and unfair competition (*Beijing YiJin*). It is worth highlighting that most actions (with three exceptions) aimed to settle a deadlock between two shareholders or two "camps" of shareholders, and the actions were usually brought by minority shareholders against majority shareholders or directors appointed by majority shareholders.[145]

[145] One case was filed by the majority against a minority shareholder, where the majority was a foreign investor excluded from the management (UNISON); one case was filed by the majority shareholder against the director (Siyang), and the other case was filed by the supervisory board against the directors who allegedly have competed with the company and diverted the company's funds (Beijing YiJin).

It may also be observed that the derivative action mechanism has not been widely used for institutional shareholders to bring lawsuits against directors, supervisors or senior officers. The cases have all happened in LLCs where no shareholding period and percentage threshold are required.

The lack of cases and incentives for institutional shareholders to initiate derivative proceedings may be the result of various intuitional, legal and reputational constraints. For instance, constraints may rest on traditional Chinese culture, which did not encourage litigations, since the strongly and deeply rooted system of conventional Confucian ethics declared that "the most important thing was to avoid litigation" for the cultivation of personal virtue in promoting good and humane governance.[146] The reluctance of institutional shareholders to intervene may also be partly attributable to the regulatory threshold, with shareholding percentages and periods required for eligibility to bring derivative actions, as well as other legal constraints. Another important issue relates to the incentives for initiating such actions and the potential reputation costs related to this litigation. In the following section, we will address why derivative action should be further developed and encouraged on Chinese soil despite the existence of these constraints.

The first institutional constraint may rest on the belief that cultural values deeply affect the choices of dispute resolution means in Chinese society.[147] The Confucian injunction to maintain long-term relationships between people and harmony with others may discourage litigations, with the law used as a vehicle for promulgating policies for the

[146] Confucius, Analects 12.13 and 13.3. See also L Miles, "The Application of Anglo-American Corporate Practices in Societies Influenced by Confucian Values" (2006) 111 *Business and Society Review* 305.

common good rather than resolving disputes among private parties.[148] Following this philosophy may undermine the use of shareholder litigation, like other litigations, to avoid conflicts and maintain Confucian virtues. Instead, the mediation of disputes would be encouraged.

However, contemporary arguments in the context of the economic and legal framework in China suggest a different trajectory. For example, the legalists believe that a nation's cohesion can be secured by the application of strict legislation, together with harsh and legitimate punishment.[149] Adopting strict laws has contributed substantially to social stability and the settlement of disputes in China.[150] With the emergence and development of the rule of law in China as a self-sustaining principle in line with the goals for market-led economic growth,[151] it is no longer unusual to resolve disputes through litigation in the current commercial and economic climate. As pointed out by Lin, there is an interaction between culture and derivative action, and the commercial culture promoted by Chinese recent economic development indicates that shareholders, especially institutional shareholders, would not hesitate to bring an action if it is necessary to do so.[152]

The second institutional constraint arguably rests on the inability of the underdeveloped judiciary system in China to accommodate the increasing volume of

[148] HW Liu, "An Analysis of Chinese Clan Rules: Confucian Theories in Action" in AF Wright (ed), *Confucianism and Chinese Civilization* (Stanford: Stanford University Press 1964) pp 16, 29–30.

[149] C Wang and NH Madson, *Inside China's Legal System* (Oxford: CP Chandos Publishing 2013) p 35.

[150] S Lin, "Private Enforcement of Chinese Company Law: Shareholder Litigation and Judicial Discretion" (2016) 4 *China Legal Science* 73, 80.

[151] D Chen, S Deakin, M Siems and B Wang, "Law, Trust and Institutional Change in China: Evidence from Qualitative Fieldwork" (2017) 17 *Journal of Corporate Law Studies* 257, 287.

[152] Lin (n 84 above) pp 138–139.

litigations. Issues such as overburdened court systems, limited judicial resources and judges' skills and knowledge[153] could all be potential worries and obstacles here. In fact, Chinese judges still lack experience and knowledge,[154] and judicial decisions are not the source of law.[155] Problems such as this lack of expertise and the absence of case law to help judges make decisions make derivative actions in China far from useful, compared with ordinary suits. These factors may discourage shareholders from bringing derivative actions.

While acknowledging the judicial difficulties, it is also worth pointing out that China has been making considerable strides in building a more competent and professional judiciary with the enactment of Judge Law and the rigorous National Bar Exam[156] to gather the most talented people (*rencai*) for the legal profession.[157] Many improvements have been made including diminished local protectionism, increased professionalism and the improved enforcement of commercial cases, due to multiple factors such as the increasingly diversified economy, streamlined court procedures, the improved judicial system and adequate

[153] See works referred to in note 120.

[154] Zhu (n 122 above).

[155] J. Dainow, "The Civil Law and the Common Law: Some Points of Comparison" (1967) 15 *American Journal of Comparative Law* 419, 425..

[156] M Jia, "Chinese Common Law? Guiding Cases and Judicial Reform" (2016) 129 *Harvard Law Review* 2213, 2213–2214.

[157] J Pan, "On the Relationship between Undergraduate Legal Education and the Judicial Exam 论司法考试与大学本科法学教育的关系" (2003) 21 *Law Review 法学评论* 147; see also J Huang, "Cultivating High-Quality Qualified and Talented People with Moral Integrity and Ability 培养德才兼备的高素质法治人才" (2 September 2017), available at http://theory.people.com.cn/n1/2017/0809/c40531-29459887.html (last visited on 6th June 2018).

funding.[158] These positive aspects may encourage qualified shareholders in JSLCs to bring actions, giving them more confidence in the fairness of judgments and the efficiency of enforcement measures. If there is an increased number of derivative actions as the result of the proposed more relaxed "unnecessary"[159] threshold in this article, it may be confidently claimed that "there are sufficient judicial resources to deal with this increase in shareholder litigation", partly indicated by a healthy and comparatively higher ratio of one judge to every 48,000 people.[160] The attitude of the Chinese courts towards shareholder litigation has become increasingly friendly towards shareholders since the Supreme People's Court issued its Second Circular to lift the restriction on accepting cases in 2002.[161]

Additionally, the guiding case system was introduced as a novel attempt to benefit from the advantages of both the common law and civil systems. The Supreme People's Court of China has converted 92 judicial opinions into what are intended to be *de facto* binding decisions, which local courts at all levels may refer to when making decisions on similar cases since January 2012.[162] This will potentially bring benefits by enhancing faith in the

[158] X He, "Rule of Law in China: Chinese Law and Business: The Enforcement of Commercial Judgments in China" (The Foundation for Law, Justice and Society in collaboration with The Centre for Socio-Legal Studies, University of Oxford, 2008).

[159] Lin (n 84 above) p 139.

[160] *Ibid.*

[161] RH Huang, "Private Enforcement of Securities Law in China: Past, Present and Future" in RH Huang and NC Howson (eds), *Enforcement of Corporate and Securities Law: China and the World* (Cambridge: Cambridge University Press, 2017) pp 138 and 141.

[162] The Supreme People's Court of China's Guiding cases, available at http://www.court.gov.cn/fabu-gengduo-77.html (last visited on 6th June 2018).

judiciary in China.[163] Although no cases have been converted to authoritative judicial opinions concerning derivative action, partly due to the shortage of cases involving JSLCs as the result of the high threshold and litigation fee, Chinese judges are practically accustomed to search similar cases reported in *Bei Da Fa Bao* and "China Judgements Online"[164] for reference before making judgments, which has been helpful in terms of ensuring judicial consistency in China.

One of the biggest legal constraints for shareholders, including institutional shareholders, in bringing derivative actions is the litigation fee.[165] The legislative legal basis of the costs of derivative action in China rests on Civil Procedure Law 1992, Measures for the Administration of Attorneys' Fee 2006. The usual rule is that the losing party will be ordered by the court to pay the winning party's "case acceptance fee", the fee charged by the court that tries the case, while each party pays its own attorney's fees and other expenses.[166] From September 2017, in order to make sure that litigation costs are tailored to a level that does not further discourage shareholders from bringing these actions so that the scheme can "reach its full potential",[167] 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 (Provision IV) were introduced to address the question of whether the claimant shareholder may be reimbursed for their expenses. It is stipulated that the courts should support the indemnity

[163] R Li, "Case-Law Adopted by China?" (UK Constitutional Law Associations, 26 January 2012), available at https://ukconstitutionallaw.org/2012/01/26/ruiyi-li-case-law-adopted-by-china/ (last visited on 6th June 2018).

[164] China Judgements Online (中国裁判文书网), available at http://wenshu.court.gov.cn/(last visited on 6th June 2018). This is based upon unreported interviews with three judges in City X.

[165] Zhao (n 68 above) p 243.

[166] Article 29 of the Measure on Payment of Litigation 诉讼费用交纳办法 2007.

[167] Huang (n 15 above) p 248.

claims of shareholders who successfully bring a lawsuit on behalf of a company, allowing them to claim for attorneys' fees, investigation fees, assessment fees, notary fees and other reasonable costs incurred during the litigation.[168] Since the "dearth of public company derivative suits can be mainly attributed to the restrictive standing requirement and the prohibitive litigation costs issues",[169] the most significant problem for derivative actions among JSLCs would be the shareholding percentage and period threshold if art 26 of Provision IV can be effectively enforced in China. Furthermore, Huang made it clear through empirical study that the availability of "the risk agency fee has facilitated the bringing of securities civil suits and has led to the emergence of many entrepreneurial lawyers in China".[170] Referencing experience in the United States,[171] the increase and popularity of entrepreneurial lawyers may also lead to an increase in derivative action in China with the enforcement of Provision IV, leaving the shareholding period and percentage as an unnecessary threshold awaiting urgent attention to encourage eligible shareholders to resolve disputes through this mechanism.

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[168] Article 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）.

[169] Huang (n 25 above) p 654.

[170] Huang (n 161 above) p 146.

[171] JC Coffee, "The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action" (1987) 54 *The University of Chicago Law Review* 887; JR Macey and GP Miller, "The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform" (1991) 58 *The University of Chicago Law Review* 3, 4. M Gilles and GB Friedman, "Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers" (2006) 155 *University of Pennsylvania Law Review* 103.

The reputational constraint has also been referred to when discussing the inactivity of institutional investors. While private engagement approaches such as voting and resolutions normally target the misconduct or performance of the board of directors as a collective body, derivative actions involve a "personal attack on specific directors".[172] This may lead to a negative impact on the "*guanxi*" between the attacked directors and the institutional shareholders[173] and may put companies' reputations at risk by sending a signal to the public that they have been poorly managed. As a result, some argued that intuitional shareholders may be cautious about using the derivative action mechanism as an activism strategy.[174]

However, one is tempted to argue that this may be an arbitrary conclusion without a detailed analysis of the compensation and deterrence functions of derivative action.[175] The procedural rule of demand surrounding derivative actions has been adopted to strike a balance between improving shareholder remedies and preventing vexatious suits, which is particularly relevant for public companies.[176] Shareholders are not entitled to file a lawsuit directly to the court to remedy an alleged harm without first making a written demand to the (board of) directors or the (board of) supervisors.[177]

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 issues

[172] Gong (n 138 above) p 164.

[173] A Keay and J Zhao, "Accountability in Corporate Governance in China and the Impact of Guanxi as a Double-Edge Sword" (2017) 11 *Brooklyn Journal of Corporate, Financial & Commercial Law* 377.

[174] Gong (n 138 above) p 165.

[175] JD Cox, "Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures" (1984) 52 *George Washington Law Review* 745.

[176] Huang (n 25 above) p 652.

[177] Article 151 of the CCL 2013.

such as the cost of the proceedings and potential damage to the company's reputation before making a decision as to whether to pursue actions in court. In other words, this procedural requirement is "a nod to the principle of exhaustion of intra-corporate remedies",[178] emphasising that an opportunity should be given to the company before the intervention of the Court because the company is the party that has suffered directly. If a company has other possible approaches to solve the problem, there is no need to resort to judicial resources if the wrong may be corrected by itself; this may also benefit the company.[179] The demand rule is helpful for companies and their shareholders to make sure that they initially exhaust internal remedies. Therefore, concerns for corporate reputation have been mitigated. Considering the screening process carried out by the director, the supervisor, the board of directors or the supervisory board, who have access to the resources of the company as well as information about the directors' conduct and decisions,[180] it is questionable to stipulate the shareholding percentage and period requirements at an exorbitantly harsh level.

Although the fundamental interests of shareholders, especially those of institutional shareholders, would be successful and profitable investments rather than becoming mired in litigation, it could be argued that shareholders' incentives to engage in litigation would likely increase with the dynamic cultural, judiciary and legal framework transformation in China. With clarification of litigation fee-related issues through 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), the trajectory of the popularity of derivative actions may rise; this

[178] Lin (n 84 above) p 114.

[179] DA Demott, "Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions" (1986–1988) 11 *Sydney Law Review* 259, 262.

[180] DR Fischel, "The Demand and Standing Requirements in Stockholder Derivative Actions" (1976) 44 *University of Chicago Law Review* 168, 171.

was the Japanese experience, another jurisdiction that was also influenced by cultural constraints such as Confucian philosophy, with fundamental change starting from the *Nikko Securities* case decisions by the Tokyo High Court. This change in Japan came as an unexpected shock,[181] and this could also occur in China.

4. Shareholding Period Requirement

Apart from the shareholding ownership percentage requirement, shareholders in JSLCs are also required to hold their shares for more than 180 consecutive days to be qualified as claimants for derivative action.[182] This 180-day rule was further clarified by the Supreme Court in 2006, stating that "the shareholding period of at least 180 days in succession specified in Article 151 of the Company Law shall have elapsed by the time the shareholder(s) institute(s) a suit in the people's court".[183] This means the criteria of shareholder must have held one per cent of the shares at the time the action is initiated. The CCL does not require that the shareholders bringing the action must have been shareholders at the time the cause of action arose, and the US-origin "contemporary ownership rule"[184] was rejected. These requirements are very similar to those embedded in the old Japanese Commercial Code.[185] The provision is retained with an additional urgency requirement in the New Japanese Commercial Law, as an exception to bring derivative actions in urgent circumstances where

[181] T Fujita, "Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision" in H Kanda (ed), *Transforming Corporate Governances in East Asia* (Abingdon: Routledge, 2008) pp 13, 17; see also Nakahigashi and Puchniak (n 81 above).

[182] Article 151 of the CCL 2013.

[183] Article 4 of "Supreme People's Court Regulations on the Application of Company Law of the People's Republic of China 2006: First Volume".

[184] *Hawes v City of Oakland* 104 US 450 (1881); see also Delaware General Corporation Law s 327.

[185] Article 267 of the Japanese Commercial Code 1950 (a continuous ownership of six months).

failure to bring such a suit immediately could result in irreparable damage to the company's interests.[186] CCL transplanted this Japanese approach. Additionally, it is the duty of a party to an action to provide evidence in support of his allegations according to Chinese Civil Procedure Law.[187] Thus, it is the duty of the claimant, namely the shareholder(s), to provide that he, she or they have held their shares uninterrupted for 180 consecutive days. This does not come as a surprise, given the fact that to a certain extent China's company law framework was modelled on that of its civil law neighbour countries and regions.

In terms of the function of the shareholding period requirement and its exceptions, Hong and Goo hold a double-edged view and describe these as requirements that are "really helpful to deter unmeritorious suits given the heavy caseload in Chinese courts" from a positive side, but from the negative side they could "cause further loss to the company because the plaintiff shareholders have to wait for six months to bring the action without any exceptions".[188] They also think this transplant is "disappointing due to the ineffectiveness and problems of the Japanese approach",[189] and the equivalent of the six-month shareholding period requirement in Japan has been criticised for its arbitrariness.[190]

The shareholding period requirement was introduced to avoid malicious litigation and unnecessary distractions for directors, supervisors and senior managers in dealing with claims.

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[186] Article 847(5) of the Japanese Commercial Code amended 1993.

[187] Article 64 of the Civil Procedure Law 1991.

[188] Hong and Goo (n 101 above) p 388.

[189] *Ibid*.

[190] MD West, "The Pricing of Shareholder Derivative Actions in Japan and the United States" (1994) 88 *Northwestern University Law Review* 1436, 1447; see also S Kawashima and S Sakurai, "Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms" (1997) 33 *Stanford Journal of International Law* 9.

It will avoid shareholders purchasing shares for the purpose of bringing litigation. It will also mitigate the risk that claimants may abuse derivative actions to threaten the plaintiff for shareholders' own personal interests and illegitimate purposes. The emphasis here is on the length of the shareholding period, which has advantages in the clarity and convenience in application. However, it is a shame that there is no linkage between the shareholding period requirement and the timing of the directors' infringement. This may contradict the purpose of imposing a shareholding period requirement in terms of avoiding people buying shares in order to bring a suit. Commentators have therefore suggested transplanting the US contemporary ownership model in order to remedy this defect.[191]

As mentioned at the beginning of this section, the contemporary ownership rule was rejected in the revised CCL enforced in 2006. The reasons for the rejection, according to the explanation of the highest court on 10 May 2006, are as follows. First, the complexity of corporate misconduct and difficulties in defining the start date of directors' infringements make it very costly for courts to apply the model in practice. Second, the mechanism should be compatible with corporations' institutional development and judicial understanding of the derivative action system as shareholder's remedies with an accumulation of cases. It was argued that the underdevelopment of derivative action makes stringent restrictions on such actions unnecessary, and a positive attitude should be adopted so that the mechanism may be conducted in a way that improves corporate governance and promotes shareholders' awareness of executing their rights.[192] However, after 11 years of enforcement, the trajectory

[191] N Chen, *Research on Derivative Action* 派生诉讼制度研究 (Beijing: Intellectual Property Publishing, 2013) pp 150–151.

[192] Press Conference on "Provisions on Several Issues Concerning the Application of Company Law "(最高法举行适用公司法若干问题的规定《解释》发布会), available athttp://www.scio.gov.cn/xwfbh/qyxwfbh/Document/1562030/1562030.htm (last visited on 6th June 2018).

of the quantity of cases involving JSLCs is rather disappointing and the application of the mechanism in LLCs has built experience in applying and referencing the tool in practice. Therefore, this may be a good opportunity to reconsider the feasibility and merits of adopting the rule.

The contemporary ownership model requires that the demanding party was a shareholder at the time the cause of action arose. It may function as a more shareholder-friendly threshold than the 180 uninterrupted days and deals with issues such as impracticability and the unreasonable length of time for individual shareholders. The requirement could be applied in the courts for the "prevention of strike suits and speculative litigation".[193] On the other hand, the rule has also been criticised[194] for being unfair to shareholders who detect directors' misconduct giving rise to a lawsuit only after becoming shareholders.[195] However, linking the committing of the alleged wrong to share ownership seems to be more shareholder-friendly than the 180-day period, while both mechanisms may not only avoid malicious litigation but also ensure that the plaintiff has sufficient self-interest in the outcome of the litigation to conduct a truly adversarial proceeding.[196] The change is consistent with the purpose of removing legal procedural hurdles and building an investor-friendly and enabling shareholder lawsuit system in order to protect "its numerous unsophisticated public investors effectively".[197]

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[193] JD Cox and TL Hazen, *Corporations* (New York: Aspen Publisher, 2nd ed., 2003) pp 425–428.

[194] This argument is similar to Liu's criticism of the 180-day shareholder period threshold, which will be explored in the next paragraph.

[195] Deng (n 84 above) p 376.

[196] WM Fletcher, Cyclopedia of the Law of Private Corporations (London: Forgotten Books Reprinted in 2018) Sections 5908 and 5981.1.

[197] Deng (n 84 above) p 351.

From a practical point of view, this standard of 180 days, together with thresholds on shareholding ownership, may seriously hinder the initiation of derivative suits in JSLCs. The duration requirement hinders shareholders from using the mechanism "in time" to stop the misconduct of directors and protect the interests of the company. Shareholders have to wait until the 180th day before they bring a lawsuit, even if they are convinced that the director has breached their duties. Liu discussed the irrationality of the shareholding period requirement in a hypothetical scenario. A shareholder purchases shares on the first day and detects evidence of the directors' misbehaviour on the second day.[198] Even if the shareholder holds more than 1 per cent of the shares, they still need to "wait for" 178 days before they can bring a derivative action. During this 178-day period, they may witness additional misconducts from the board and reductions in the share price.[199] However, what they are able to do in response to these misbehaviours is limited to encouraging the supervisory board or independent directors to start an investigation, encouraging eligible shareholders to bring lawsuits or using mass media to put directors under pressure.[200] These approaches are only likely to be successful if those shareholders who are not eligible are influential, and the whole process can also be rather time-consuming, which may even take longer than 180 days. Lin further argued that these appeals may be ignored, and not all shareholders are able to access or use the media under such scenarios to put pressure on management.[201]

Obviously, arguments of "exit remedies" may also be relevant here. In addition to the discussions presented in s 3.7, the exit strategy would not solve the fundamental problems to do with shareholders recovering damages and deterring directors from misbehaviour. Besides,

[198] The example provided here might be rare or extreme in daily life. However, it is entirely possible.

[199] J Liu, *Modern Corporation Law 现代公司法* (Beijing: Law Press, 3rd ed., 2015) pp 408–409.

[200] *Ibid*.

[201] Lin (n 84 above) pp 109–111.

some shareholders may simply wish to stay with the company in which they hold shares for a number of reasons, such as their belief in the company's prospects in the long term, and the fact that "exit remedies" contradict shareholders' intentions to invest in good faith, their willingness to engage in sustainable investment and their need to have their voices heard by challenging wrongdoers in order to hold them accountable.

In relation to the secondary sources and with reference to recent data, Li argued that the consecutive 180-day requirement would constitute a barrier for healthy derivative actions due to the quick turnover in China,[202] which was demonstrated by Jin's survey in which the average shareholding period in Chinese listed companies is four months.[203] Peng claimed that 180 days is too long for individual shareholders in JSLCs, especially for listed ones, since the majority of individual shareholders invest for the profit available by selling their shares rather than for claiming dividends.[204] She contended that the "harsh" shareholding period threshold would not benefit the effectiveness of the derivative action mechanism at its very early stage in China.[205] It has been reported by the CSRC, taking the survey in 2015 as an example, that the average holding period is approximately 44 days for individual shareholders in listed

[202] X Li, *Shareholder's Derivative Action from the Company Law Perspective: A Comparative Study of England, US, Germany and China 公司法视角下的股东代表诉讼: 对英国, 美国, 德国和中国的比较研究* (Beijing: Law Press, 2009) p 281.

[203] X Jin, *Shareholding Structure and Corporate Governance in Chinese Listed Companies 上市公司股权结构与公司治理* (Beijing: China Finance Publishing House, 2005).

[204] X Peng, "Study on China's Shareholder Derivative Action System 我国股东派生诉讼制度研究" (2011) 5 *Hebei Law Science 河北法学* 150, 151.

[205] *Ibid.*

companies.[206] Looking at data for the Shenzhen Stock Exchange only, in 2012 the average holding period was approximately 39.1 days for individual shareholders in listed companies.[207] From these two sets of data, the 180-day requirement apparently excludes the majority of the individual shareholders in listed companies. Therefore, the 180-day threshold creates an artificial barrier for individual shareholders.

Indeed, for individual shareholders, the investment incentives of a large proportion of shareholders have been shown to be short-term and oriented by statistics. These investors, who have the goal of immediate returns, are normally ignorant about the details and strategies of the companies and vote with their feet.[208] With limited information and insufficient incentives, it is extremely unlikely that these short-term trading shareholders would bring a derivative lawsuit against boards of directors and challenge their decisions.[209] Furthermore, the concept of "avoiding litigation" is deeply rooted in people's minds based on the belief of "turning big problems into small ones and small problems into no problems at all".[210] In a social relationship like this, people sometimes choose to tolerate problems even if their

[206] B Zhu, "CSRC Claimed that the Profit of Institutional Shareholders Increase with Shareholding Period 证监会就机构股东的持股时间的研究" *Securities Daily* (20 June 2016).

[207] X Hu, "Characteristic of Investors Structural and Behavioural Changes Shenzhen' Shows the Average Shareholding Period: Individual and Institutions Shareholders Own Their Shares for 190.3 days 39.1 Days Respectively《深市投资者结构和行为变化特征》显示投资者平均持股：个人 39.1 天 机构 190.3 天" *Securities Times (证券时报)* (8 May 2013).

[208] X Jia and R Tomasic, *Corporate Governance and Resource Security in China: The Transformation of China's Global Resources Companies* (Abingdon: Routledge, 2010) p 63.

[209] It is not just the case in China that small shareholders in listed companies are very unlikely to abuse the mechanism of derivative action, see RB Thompson and RS Thomas, "The Public and Private Faces of Derivative Lawsuits" (2004) 57 *Vanderbilt Law Review* 1747, 1784–1785.

[210] The Chinese version of this proverb is 大事化小, 小事化无.

interests are jeopardised. Therefore, under the current investment and legal environment, it is very hard for individual Chinese shareholders to file a lawsuit for the interests of the company and other shareholders. Even if they could, there remains the problem of their incentives to do so.

However, even in light of the fact that minority shareholders are unlikely to bring a derivative action in China, the legislation itself should not put individual shareholders in an even more disadvantaged position by making it hard or impossible for individual shareholders to use the tool to question decisions of the board. Individual shareholders currently encounter particular difficulties when they seek redress against JSLCs. With limited information and incentives, the tool has only been used once in the last 11 years, but scandals such as Wanke and Geli demonstrated the strong necessity of shareholder litigation and supervision in listed companies in China; this is particularly important for those who are non-controlling shareholders.[211] At the same time, the lack of cases in JSLCs is partly due to the availability of information and difficulties in applying shareholder remedy mechanisms such as derivative action in practice. Practice suggests that the "burden" of self-regulation, the investigatory power of the CSRC and indeed criminal and administrative laws are insufficient to cope with fraud or mismanagement that may occur in JSLCs. A logical response here would thus be the necessity of proposing changes in the current company law in order to make derivative action more accessible for individual shareholders, focusing on less demanding shareholding period requirements for JSLCs.

With the emphasis on shareholder protection, especially on the lack of voice, information and bargaining power, derivative action, as a system for shareholder remedy,

should be designed in an enabling rather than hindering manner and should give access to shareholders who sincerely care about corporate performance and directors' decisions and behaviours. Derivative action is one of the most ingenious accountability mechanisms for larger formal organisations, and supervisors and accountees should include shareholders beyond powerful and well-informed ones. From the perspective of the sustainable development of derivative action in China, Wang argued that the shareholding period requirement should be abolished considering its very intermittent usage for shareholders in JSLCs after the enforcement of CCL 2005.[212] He argued that a shorter or no shareholding period threshold would not only allow more shareholders to join the ranks to supervise directors but also reaffirm shareholders in their remedies, which is particularly important in China with its immature corporate governance and unbalanced structural shareholding ownership.[213] Reformers have made some agreements according to which a different timeframe should be introduced in listed companies and JSLCs, with three months for shareholders in non-listed JSLCs and an even shorter period for listed companies.[214] The reason for the different treatment rests on the incentives for investment. It is claimed that the investment purpose for minority shareholders in JSLCs, especially listed companies, is to make a profit through stock market transactions. They tend to stay in the market for shorter

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[211] Z Liu, "If Baoneng Could Successfully Remove the Directors of Wanke, Geli Will Unfortunately Face the Same Destiny 若宝能罢免万科董事成功 格力也会遭遇同样命运" *Sina Finance* (28 June 2016), available at http://finance.sina.com.cn/stock/s/2016-06-28/doc-ifxtmweh2639028.shtml (last visited on 6th June 2018).

[212] G Wang, "Derivative Action Mechanism in China and Some Reform Proposals 试论我国股东派生诉讼制度及其完善" (2015), available at http://www.66law.cn/lawarticle/12767.aspx (last visited 6th June 2018).

[213] *Ibid.*

periods of time with the purpose of getting an immediate return from their investment. Although the authors agree with the reason for shortening the shareholding period requirement, the "half price" approach, proposing a three-month period instead of six months, seems to be random with little theoretical and empirical support. As discussed above, this standard seems to be arbitrary, and it is difficult to set an exact bar for the shareholding period. A shorter or abolished shareholding period regimen seems to be the way forward.

A comparatively new legislative approach in Germany, a civil law country, may give us some insightful suggestions, considering that China drafted its corporate law in a hybrid manner, employing rules and institutions borrowed from Germany and the United States.[215] The approach adopted in German corporate law in the new s 148 of the AktG in 2005 by the Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts in Germany sets the threshold for shareholders in JSLCs at only a shareholding percentage or quantity requirement for JSLCs (0.1 per cent shareholding percentage in China as proposed in Section 3), with no requirement in terms of the shareholding period.[216] In addition, if the legislators in China are convinced of this approach for Chinese JSLCs, the rule that requires the shareholders to have held the shares before they learned about the alleged breaches of duty or

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[214] X Wang, "Plaintiff Standing in Shareholder Derivative Actions" (股东代表诉讼的原告资格问题) *People's Court Daily* (人民法院报) (28 January 2004) p 4; available at http://www.iolaw.org.cn/showNews.asp?id=4635 (visited 21 August 2016).

[215] See Wang (n 23 above) p 26; see also MM Siems, "Legal Origins: Reconciling Law & Finance and Comparative Law" (2007) 52 *McGill Law Journal* 55; Teemu Ruskola, "Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective" (2000) 52 *Stanford Law Review* 1599.

[216] It is required in s 148(1) sentence 1 of AktG that a shareholder or shareholders who together hold 1 per cent of the statutory capital or shares with a par value of EUR 100,000 may file a petition for the right to assert the claims of the company for damages mentioned in s 147(1) sentence 1 in their own name.

alleged damage from a publication should also be adopted to avoid malicious litigation, as justified in Section 4.[217]

5. Experiences from Other Jurisdictions

The imbalance in derivative actions between LLCs and JSLCs in China has not been evident in every jurisdiction. Obviously, more well-adjusted figures in other jurisdictions could be regarded as the result of multiple factors. Therefore, the figures for derivative actions in public companies in other jurisdictions should not be exclusively regarded as the result of an absence of or lower shareholding period/percentage. However, considering the sharp difference in the figures between LLCs and JSLCs in China, the relatively high shareholding percentage requirement may have a causal link with the unpopular application of derivative action in JSLCs in China. In this section, factors such as mitigated thresholds through legal reforms, litigation costs and court permission as thresholds will be discussed in a few jurisdictions' context to offer the reader a more comprehensive view of the hurdles and incentives for initiating derivative actions. It is not feasible and not the theme of the article for the authors to illuminate every reason for the comparative popularity of this mechanism in other jurisdictions. The mechanism of derivative action is designed, in public companies, to work with securities markets, under conditions of media scrutiny and public enforcement to protect the interests of companies through the empowerment of shareholder voices.[218] If a jurisdiction chooses to introduce the mechanism, efforts should be made to make it work effectively in both LLCs and JSLCs.

In Japan, where the shareholding percentage is not a requirement for bringing a derivative action, derivative actions involving publicly held companies have been more

[217] Section 148(1) 1 of the AktG.

[218] KB Davies, "The Forgotten Derivative Suit" (2008) 61 *Vanderbilt Law Review* 388, 450.

numerous than those involving closed companies since 1993.[219] It is reported that 119 derivative actions were brought against listed companies in Japan from 1993 to 2009.[220] This increase could be the consequence of multiple factors. For instance, the derivative claim cost is fixed to be 13,000 Yen for the target of the litigation that does not exceed 1.6 million Yen, by deeming derivative actions to be non-property claims.[221] Historically, the sliding scale system has proven to be a barrier to shareholder derivative claims in Japan.[222] In addition to the cost issue, the elevated success rate after 1993 (before this date it was very low, with only a single case where the plaintiff won) and enhanced awareness of shareholders' rights are also regarded as reasons for the popularity of actions, including actions in public companies.[223]

In Korea, a shareholder requirement of 0.01 per cent is regarded as "low enough" to ensure that derivative suits are feasible.[224] It has been reported that over half of the 55 derivative actions filed in Korea between 1997 and 2010 involved public companies.[225]

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[219] Kawashima and Sakurai (n 190 above).

[220] Nakahigashi and Punchniak (n 81 above) pp 171–173.

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

[222] M Blomstrom and S La Croix, *Institutional Change in Japan* (Abingdon: Routledge, 2006) p 241; see also West (n 190 above).

[223] Oda (n 9 above) p 337.

[224] BS Black, BR Cheffins and M Klausner, "Shareholder Suits against Korea Directors" in HJ Kim (ed), *Korean Business Law* (Cheltenham: Edward Elgar, 2012) pp 27 and 41.

[225] HJ Rho and KS Kim, "Invigorating Shareholder Derivative Actions in South Korea" in DW Puchniak, H Baum and M Ewing-Chow (eds), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge: Cambridge University Press, 2012) p 186; internationally, 0.01 per cent is still considered a major impediment to derivative litigation — see K Kim and M Choi, "Declining Relevance of Lawsuits on the

In common law countries, directors of public companies may be involved as defendants in derivative actions. Provisions for the creation and procedures of statutory derivative action have been enacted in these countries. Just as in Japan, many reasons could contribute to the number of derivative action cases. In the United States, many cases involve public companies, based on the empirical research of Thompson and Thomas.[226] Derivative actions against listed firms have been regarded as a common issue historically, based on research on a sample of 535 public corporations.[227] The high percentage of settlement in the United States due to the structure of indemnification rights and insurance coverage is another reason for the popularity of derivative suits in the United States. Furthermore, derivative action in the United States is argued as a lawyer-driven (litigation market-oriented) mechanism. They do not normally have any shares in the company, and therefore it is irrational to have lawyers initiating actions based on financial incentives.[228] The general rule in the United States is that each party is responsible for his own attorney's fees. Irrespective of the result of the action, both parties bear their own legal costs under the US Rules of Civil Procedure.[229] Moreover, the "contingency fee arrangement" is regarded as common practice,

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Validity of Shareholder Resolution in Korea" in Holger Fleischer, Hideki Kanda, Kon Sik Kim and Peter Mülbert (eds), *German and Asian Perspectives on Company Law* (Tübingen: Mohr Siebeck, 2016) pp 218, 241.

[226] Thompson and Thomas (n 209 above); see *Caremark International Inc Derivative Litigation*, 698 A2d 959 (Del Ch 1996); *Re The Walt Disney Company Derivative Litigation*, 825 A2d 275 (Del Ch 2003); *Re Oracle Corp Derivative Litigation*, 824 A2d 917 (Del Ch 2003); *Re The Walt Disney Company Derivative Litigation*, 906 A2d 27, 62-67 (Del 2006).

[227] R Romano, "The Shareholder Suit: Litigation without Foundation?" (1991) 7 *Journal of Law, Economics, and Organization* 55.

[228] JC Coffee, "Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working" (1983) 42 *Maryland Law Review* 215, 233; see also Macey and Miller (n 171 above) 1, 45.

[229] *Alyeska Pipeline Service Co v Wilderness Society* 421 U.S. 240 (1975).

where the fees are fixed at a percentage not higher than 30 per cent of the amount of the damages claimed as the result of a successful litigation.[230]

In the limited evidence from the United Kingdom, three cases, namely *Bridge*,[231] *Eckerle v Wickeder Westfalenstahl GmbH*[232] and *BNP Paribas SA v Open Joint Stock Company Russian Machines*,[233] have involved public companies. The relatively healthy ratio with public companies may also have a connection with many factors, such as litigation costs. The "indemnity order" established that a company should indemnify a shareholder defendant in a derivative suit since the shareholder acts on behalf of the company and the company is the direct beneficiary, even, in fact especially, where the litigation is ultimately unsuccessful.[234] The decision is reflected in the Civil Procedure Rule where the court has the power at a permission hearing to order the company to indemnify the successful shareholder in relation to his costs.[235] The cost of a proposed action is regarded, in the United Kingdom, as a practical hurdle and a major disincentive to launching a derivative action.[236] The Law Commission also asserted that the inclusion of the power to provide for an indemnity was a significant incentive to shareholders to initiate proceedings.[237] In Australia, 4

[230] Articles 11–13 of the Measures for the Administration of Attorneys' Fee 2006.

[231] *Bridge* (n 110 above).

[232] [2013] 3 WLR 1316 [2014] BCC 1.

[233] [2011] EWHC 308 (Comm); in this case, the first defendant, Open Joint Stock Company Russian Machines, and the second defendant, Joint Stock Asset Management Company Ingosstrakh-Investments, are both Russian companies.

[234] *Wallersteiner v Moir (No 2)* [1975] QB 373 AT 392.

[235] Civil Procedure Rules 19.9E.

[236] A Dignam and J Lowry, *Company Law* (Oxford: OUP, 9th ed., 2016) pp 196–197.

[237] Law Commission, "Shareholder Remedies" (Consultation Paper No 142, Law Commission, 1996) para 18.1.

of the 31 concerned companies were publicly held companies during the period from March 2000 (the introduction of Pt 2E1A) to 12 August 2005.[238] Again, many issues could also be involved here, including, for example, the broader range of applicants; former members and officers of the company are allowed to bring derivative proceedings as well as members.[239]

6. Conclusion

The mechanism of derivative action is one of the most important legal tools, working side by side with statutory oppression remedies,[240] and it has been a staple of corporate law in most common law jurisdictions.[241] Overall, the CCL 2005 introduced

[238] Ramsay and Saunders (n 83 above) p 420.

[239] Section 236 of the Australian Corporations Act 2001.

[240] Article 20 of the CCL 2013. When the first company law was introduced in China in 1993 as a result of the economic reconstruction that placed the reform of state-owned enterprises at the top of the agenda, Western concepts were introduced including private ownership, the ownership of shares and the diversification of enterprise ownership; see OK Tam, *The Development of Corporate Governance in China* (Cheltenham: Edward Elgar, 1999) p 1.

[241] C Hawes, "The Chinese 'Oppression' Remedy: Creative Interpretations of Company Law by Chinese Court" (2015) 63 *American Journal of Comparative Law* 559; see, for example, s 994 of the Companies Act 2006 (the wording of the UK oppression remedy was broadened, in the 1990s, to encompass unfair prejudice); B Hannigan, "Drawing Boundaries between Derivative Claims and Unfairly Prejudicial Petitions" [2009] *Journal of Business Law* 606; J Payne, "Shareholders' Remedies Reassessed" (2004) 67 *Modern Law Review* 500; J Payne, "Section 459–461 Companies Act 1985 in Flux: The Future of Shareholder Protection" (2005) 64 *Cambridge Law Journal* 647; H McVea, "Section 994 of the Companies Act 2006 and the Primacy of Contract" (2012) 75 *Modern Law Review* 11123; *Hamilton v Brown* [2016] EWHC 191 (Ch); *Re Migration Solutions Holdings Ltd* [2016] EWHC 523 (Ch); *Flanagan v Liontrust Investment Partners LLP* [2016] EWHC 446 (Ch); *Apex Global Management Ltd v FI Call Ltd* [2015] EWHC 3269 (Ch); *Re Charterhouse Capital Ltd* [2015] EWCA Civ 536; [2015] BCC 574; [2015] 2 BCLC 627; *Graham v Every* [2014] EWCA Civ 191, [2014] BCC

the derivative regime into China as a notable improvement to the previous version of company law, hoping that it would contribute to corporate governance and establish an investor-friendly legal and business environment.[242] However, this regime is far from perfect, and this article attempts to point out its inaccessibility by clarifying some thorny issues regarding the eligibility of shareholder claimants. The standing requirements applying exclusively to JSLCs are, from our research, a double-edged sword as they deter meritorious litigation even as they also prevent vexatious suits. The most important element of the standing requirement is to locate an appropriate level that makes derivative action effective, applicable and functional. This differential treatment was based upon the consideration that the "plight of minority shareholders in the limited liability company is generally graver than that of their counterparts in the joint stock limited liability company".[243] After all, the derivative action scheme was originally introduced to be an effective weapon to deter misconduct among management personnel, rather than just being window dressing for JSLCs or a useful mechanism for LLCs alone.

Thus far, the limited use of the mechanism in JSLCs requires us to reconsider the sense and appropriateness of this bar on the qualification of a claimant in JSLCs. Analyses reveal that most of the derivative lawsuits to date have involved private companies. In the meantime, it is hard for shareholders to invoke this action in JSLCs, especially in listed ones. While some doubt the willingness of institutional investors to initiate derivative action in JSLCs, our analysis has shown that conventional institutional, legal and cultural barriers for

376, [2015] 1 BCLC 41; *Re Coroin Ltd* [2013] EWCA Civ 781, [2014] BCC 14, [2013] 2 BCLC 583; *Baker v Potter* [2004] EWHC 1422 (Ch), [2005] BCC 855.

[242] Feinerman (n 70 above).

[243] Huang (n 15 above) p 237.

institutional investors to actively engage in litigations are diminishing, and their incentives to engage in derivative action would likely increase in the future with the dynamic cultural, judiciary and legal framework transformation in China. Our empirical analysis further discovered that the shareholding percentage threshold imposed by art 151 of CCL 2013 has been a big barrier in this regard, pragmatically and problematically excluding a large proportion of even the top 10 shareholders. Modifications of the shareholding ownership percentage and the shareholding period in China are proposed with the aim of making the derivative action mechanism more effective, by making the threshold more rational and consistent considering the current securities market structure in China.[244]

A proposal of at least 0.1 per cent shareholding percentage and a revised or even abolished shareholding period requirement with a contemporary ownership rule is suggested in order to make derivative action in China more effective and to ensure that the regime is utilised more systematically in JSLCs instead of being mere window dressing. The goals of this proposed enlarged provenance of shareholder claimants for derivative action are consistent with the initial legislative purpose of imposing thresholds for shareholders in JSLCs. The proposed changes to the qualification requirements will entitle and encourage more participation from shareholders to challenge and inspect directors' (mis)conducts and decisions, and they will be more likely to be responsible and act in a fiduciary manner.[245] As a result, the boards are expected to be more accountable to their companies. It is believed that these suggested reforms will not only promote the suitability and enabling character of CCL but also enhance corporate governance values such as fairness, accountability and

[244] Chapter 2 of Group of Twenty /The Organisation for Economic Co-operation and Development , Principles of Corporate Governance 2015.

[245] It needs to be reaffirmed that the authors agree that overly-relaxed *locus standi* requirements will generate malicious litigation and unnecessary distractions for the board and senior officers.

effectiveness. The eligibility-related problems identified and discussed in this article are timely, important and urgently need to be addressed by legislators in order to make derivative actions into a useful and functional mechanism for shareholders in JSLCs. The pragmatic impact of lowered thresholds would merit more empirical research, particularly if the reform suggestions in this article are adopted by the government.

Based on other jurisdictions' experiences and empirical analyses on the situation in China, one sees the goal of the proposed reform of derivative action as to maintain a suitable balance between improving shareholder remedies and preventing vexatious suits, particularly in relation to public companies.[246] A rational and balanced threshold (lower than current levels, as we will suggest in this article) will deter immoral malfeasance by directors and hold them accountable for corporate decisions. A more effective and enabling derivative action mechanism will also put less pressure on the CSRC, which uses its regulatory powers to facilitate the settling of compensation issues out of court through administrative sanctions.[247] Coupled with proposed changes in law, it might also be helpful to set up a "China's Investor's Association" to provide investor education and support investor litigation, financed by a public fund to ensure its independence and impartiality, so that the shareholders in China will be better equipped with knowledge and information concerning how and why to bring such actions.[248]

[246] Huang (n 25 above) p 652.

[247] RH Huang, "Rethinking the Relationship between Public Regulation and Private Litigation: Evidence from Securities Class Action in China" (2018) 19 *Theoretical Inquiries in Law* 333, 353–357.

[248] J Liu, "Improving Investor-Friendly Legal Environment in Chinese Capital Market" in RH Huang and NC Howson, *Enforcement of Corporate and Securities Law: China and the World* (Cambridge: Cambridge University Press, 2017) pp 162 and 175.