

Derivative Actions in Chinese Company Law

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About the Author

Shaowei Lin is a lecturer at Southwest University of Political Science and Law. He received his PhD degree at the University of Edinburgh. Before that, he obtained LLM degree from King's College London and MA degree in civil and commercial Law at Southwest University of Political Science and Law. His principal areas of interest lie within the various strands of commercial, corporate and trust law.

Preface

The enactment of derivative action was expected to be actively used by shareholders to protect their interests. In fact, it turned out that this reform effort seemed futile as the right to engage in such actions was rarely exercised. This raises a question about the role of derivative actions in China; namely, should a derivative action system play a key role in protecting shareholder interests? If the answer is positive, the next question is how such a system could be improved in order to effectively discipline management. The essence of this book is to try to address these issues.

This book argues that derivative action should and can play a key role in China's corporate governance. First, minority shareholders in China face double agency problems within the company and thus protective mechanisms must be put in place. Second, this book formulates its argument by demonstrating the ineffectiveness of market forces and other legal methods. As a consequence, derivative action ought to retain a central role in regulating the misbehaviour of controlling shareholders and managers.

After demonstrating the need to strengthen and improve derivative actions in China, this book starts to explore China's derivative actions system. It first examines derivative action cases before Company Law 2005. Despite the absence of a clear statutory basis for derivative actions in Company Law 1993, such cases have nevertheless appeared in the courts. After almost eight years of implementation, less than eighty cases were raised. Whilst this seems a good figure in comparison to other jurisdictions, closer examination shows this not to be the case. For example, the opacity of the demand requirement constitutes a barrier for shareholders wishing to exercise this right. More importantly, the funding rule of derivative actions is treated as the same with other forms of litigation. In view of the unique economic nature of the derivative action, a new funding rule for derivative action should be established.

After discussing why derivative actions should play a significant role in monitoring management and how they should be improved, this book argues that shareholders are increasingly willing to take this action to protect their rights and interests because of the establishment of commercial society and the existence of the traditional culture

of Legalist School. Also, the courts are more capable of dealing with derivative action cases because of the enactment of the Judges Law and the increasing recruitment of more qualified people to the judiciary. It is believed that the effectiveness of derivative action can contribute to foster good corporate governance in China.

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CHAPTER 1

Introduction

§1.01 THE NATURE OF THE DERIVATIVE ACTION

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

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

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

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

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

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

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

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

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

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