Derivative Actions in Chinese Company Law

SHAOWEI LIN

Wolters Kluwer
Law & Business

Derivative Actions in Chinese Company Law

Shaowei Lin

Wolters Kluwer
Law & Business

Published by:
Kluwer Law International
PO Box 316
2400 AH Alphen aan den Rijn
The Netherlands
Website: www.kluwerlaw.com

Sold and distributed in North, Central and South America by:
Aspen Publishers, Inc.
7201 McKinney Circle
Frederick, MD 21704
United States of America
Email: customer.service@aspenpublishers.com

Sold and distributed in all other countries by:
Turpin Distribution Services Ltd
Stratton Business Park
Pegasus Drive, Biggleswade
Bedfordshire SG18 8TQ
United Kingdom
Email: kluwerlaw@turpin-distribution.com

Printed on acid-free paper.

ISBN 978-90-411-5988-5

Printed and Bound by CPI Group (UK) Ltd, Croydon, CR0 4YY.

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.

Acknowledgements

This book is based on my PhD thesis I completed at the University of Edinburgh. In writing this thesis and subsequently this book, I have been fortunate to have benefitted from the assistance of a number of people who were kind enough to share their valuable time and expertise with me over the past five years. As such, I would like to take this opportunity to express my thanks and gratitude to all these colleagues and friends.

First and foremost, I would like to thank my PhD supervisors, Mr David Cabrelli and Dr Robert Lane. David has been supportive since the very start of my PhD adventure, and his invaluable guidance and patience made him more than a professor to me. He became my mentor who led me through the ups and downs of the tricky but thrilling process of writing a PhD thesis. Like David, Robert has always nurtured the quality of my thesis. His unquestionable sense of humour and inspiring approach has calmed my doubts time and again. I feel that I have also gained a friend in him over the course of my stay in Scotland. They will both be missed when I find myself back in China, not only for their academic support, but mostly for the unique student-professor relationship they have established with me.

I would also like to thank my two examiners - Professor Mathias Siems and Dr Remus Valsan, whose insight on my academic performance has made me more aware and better prepared for my future foray in the academia as an independent researcher.

Special thanks also go to my friends who have been so supportive through these trying times, particularly the flatmates (they know who they are!) at both in GDSA and Richmond Place. My life in England and Scotland would not be half as cheerful without their company.

I would also like to give my thanks to my colleagues at Southwest University of Political Science and Law (SWUPL), particularly Professor Zhao Wanyi, who was my former supervisor during my postgraduate and has been an inspiring and supportive mentor. Without his guidance, encouragement and help over the years, I would have never achieved this. Also, I am grateful to acknowledge that this book is supported by the programme of Talent Introduction Project at SWUPL.

I would especially like to thank my family who love and support me without reservations - I would not have made it this far without them. Above all, special thanks

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

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

Table of Contents

CHAPTER 1
Introduction

§1.01 THE NATURE OF THE DERIVATIVE ACTION

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

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

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

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

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

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

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

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

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

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