is procedurally easier than in some other jurisdictions, procedural rules limit their effectiveness and use. To wit, the minimum shareholding requirement of 3 per cent of the total number of outstanding shares held for more than a year is excessive and prohibitory. This requirement far exceeds comparative requirements in Japan and the United States – the two jurisdictions that have most influenced Taiwan's legal philosophy, and which (unlike Taiwan) are global leaders in derivative litigation. In line with other advanced legal jurisdictions, we believe that the minimum shareholding requirement should be abolished and the holding period shortened to six months.

Taiwan's security for damages and court fees rules are also needlessly excessive. Though intended as a tool for reducing frivolous lawsuits, its actual effect is to discourage genuine derivative actions. Plaintiff shareholders already face an incentive problem, having taken on all the risks of the suit yet having to share the reward. The free-rider problem is immense. Security for damages and court fee rules exacerbate this problem by piling yet more risk onto prospective shareholder plaintiffs. Such rules are unreasonable and limit corporate oversight. They should also be eliminated.

Besides the excessive procedural hurdles, a number of cultural factors also play a role in limiting the derivative action. Chief among these are Taiwan's controlling shareholder system and legal culture. With power concentrated heavily among controlling-minority shareholders, other smaller minority shareholders are at a large disadvantage when pursuing derivative claims. In order to minimize the risk of self-dealing among controlling-minority shareholders, we recommend that the Company Act be amended to clarify the duties of directors and officers in their respective roles.

Effective shareholder-driven corporate governance standards also require a motivated legal services base to drive them. We salute the efforts of the Financial Supervisory Commission in extending the power of the SFIPC to derivative actions, and believe this innovative and unique body will play a major role in driving derivative actions in the years to come. Concurrent with this, we hope that an increase in derivative suits will clarify and define the derivative action, which will further incentivize the Taiwan legal services market to take on more derivative litigation and entrepreneurial risk.

6

Pathway to minority shareholder protection: derivative actions in the People's Republic of China

DONALD C. CLARKE AND NICHOLAS C. HOWSON*

I Introduction

In October 2005 China's national legislature passed a series of major amendments to the original Company Law of 1994, permitting, among other things, the first form of derivative lawsuit in modern Chinese history.[1] Effective from 2006, this innovation was designed to improve China's corporate governance system and provide a weapon against insider and controlling shareholder abuse in China's newly corporatized listed companies. The new mechanism was also consistent with a broader formal shift in the Company Law towards a greater emphasis on judicial power and ex post remedies, instead of ex ante supervision by administrative agencies. However, the derivative lawsuit was introduced into a political-economic order, and an accompanying legal system, that is barely three decades old with the nation's first Western-style corporate law not effective until 1995. Moreover, few of those who draft, administer, or adjudicate on the basis of corporate legislation have any appreciable business experience, the state at multiple levels remains a commanding presence as a regulator and a corporate shareholder, and genuinely private large companies are rare.

In this chapter, we look at the past and present of shareholder derivative actions in the PRC. Using a set of over fifty cases, we trace the gradual introduction of the derivative lawsuit into China's legal system

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[1] We hereafter refer to the original Company Law, passed in 1993 and effective in 1994, as the 1994 Company Law and to the revised version, passed in 2005 and effective on 1 January 2006, as the 2006 Company Law.

and its development after 1 January 2006. We find the design of the 2006 Company Law derivative lawsuit to be, in some respects, innovative and appropriate for Chinese circumstances: for instance, it includes parties other than standard insiders and fiduciaries as defendants, and thus permits 'horizontal' claims against controlling or oppressive shareholders. At the same time, we find certain design flaws, including standing-based obstacles placed in the way of plaintiffs, a lack of clarity regarding demand, demand excusal, and refusal, and an unnecessary distinction regarding the required wrong underlying derivative actions directed at corporate fiduciaries and 'others'. We also find robust use of the derivative lawsuit by plaintiffs and courts both before and after its formal recognition in law. This use seems to be almost entirely limited to the closely held form of corporation under PRC law, the limited liability company (*youxian zeren gongsi*) (LLC), with derivative lawsuits involving the widely held company limited by shares (*gufen youxian gongsi*) (CLS) virtually absent. This absence is particularly striking because the derivative lawsuit was included in the 2006 Company Law precisely in order to give minority shareholders in such CLSs a way to hold insiders and controlling shareholders accountable at law for rampant malfeasance.

II Economic and legal reform in the PRC and the derivative action

1 *Introduction: the derivative lawsuit and corporate governance in the Chinese context*

China's corporate governance experts and legislative drafters have long viewed the derivative lawsuit as a necessary part of that nation's effective corporate governance system. The actual implementation of a derivative lawsuit mechanism in China has implications going beyond mere corporate governance concerns, however. As we describe in more detail below, many corporate entities in the PRC are dominated by insiders who have – or represent – significant political power that exceeds their formal economic or management power. Leading directors and officers at large corporatized state-controlled enterprises are often Communist Party of China nomenklatura appointments or representatives of central government institutions. The same is true of insiders at enterprises controlled by local governments or subordinate Party levels. Moreover, even if insiders are not directly tied to the Party or state, they are often part of a system (*xitong*) of connected actors with overwhelming political and economic power. Thus, any legal mechanism that empowers minority shareholders to attack the misdeeds of such insiders also empowers weak political-economic actors to constrain or penalize vastly superior forces in Chinese society.[2]

2 *Corporatization and its effects*

The development of derivative suits in China cannot be understood in isolation from the political and economic history of the PRC over the past several decades.

The early stages of post-Mao economic reform saw efforts by policy makers to reform traditional state-owned enterprises – enterprises that were plagued by low productivity, unresponsiveness to economic signals, and waste. The traditional SOE was not simply a corporation wholly owned by a single shareholder, the state. Instead, it is more aptly seen as a division or aggregation of productive assets within the loosely organized firm of China, Inc. It had managers who could move up a bureaucratic hierarchy into progressively more politically powerful positions. The traditional SOE did not issue any ownership interests in itself, much less something like stock or transferable equity interests. Moreover, the 'control' interest in SOEs (e.g., the right to appoint management and appropriate profits) was not necessarily in the hands of the same administrative body representing the central state – or not necessarily at the central level. SOEs could be effectively controlled by subordinate units of government at or above the county level even if they were formally subject to the control of a central line ministry.

The policy of corporatization essentially sought to abolish the traditional SOE *as an organizational form* by converting SOEs into some form of company authorized under and governed by the PRC Company Law: (1) a CLS, the approximate equivalent of a Delaware corporation or the German *Aktiengesellschaft*; (2) an LLC, intended for a much smaller and more closely knit group of investors; or (3) a wholly state-owned LLC, a special type of LLC that is wholly owned by a state agency and has no shareholders' meeting (effectively, an SOE given 'enterprise legal

[2] An excellent example of the forces at play is *Shen Guantong, Yang Yongxin, Ni Amao and Lu Zhuqin representing 165 other shareholders* v. *Shaoxing County Materials General Company Assets Liquidation Small Group re: Zhejiang Golden Bridge Co., Ltd and Shaoxing County People's Government*, Zhejiang Province Shaoxing Municipal Intermediate People's Court (2003), *shao zhong min er chu zi* no. 253 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?gid=117490027) [*Zhejiang Golden Bridge CLS 2003*].

person' status as a subspecies of LLC). In most cases, this process did not involve privatization or withdrawal of the Party/state from the economy, because a controlling share of the stock in the converted enterprise went to non-private entities. Even after two decades, the Party/state, at the central and local levels, remains firmly committed to retaining control over enterprises in many sectors. This is true for both the usual suspects for state control – national-security-related industries, natural monopolies, sectors providing important public goods and services, and important enterprises in pillar industries and the increasingly supported high-technology sector – and other enterprises that are profitable for insiders or local-level control parties, and can be promoted with public investment. In particular, this strategy of corporatization without privatization coupled with the maintenance of central and local state control has determined the ownership, control and governance structures in China's listed companies, whether listed on China's domestic exchanges, in Hong Kong or internationally. Control by a single state shareholder is quite common in Chinese listed companies. A study of corporate governance conducted in 2002 by the China Securities Regulatory Commission and the State Economic and Trade Commission found that, of 1,051 controlling shareholders in the 1,175 listed companies studied, 77 per cent could be considered 'of a state nature' (*guojia xingzhi*) while in 390 companies a single state shareholder held over a half of the shares.[3]

This pattern of ownership and control has important implications for China's corporate law and corporate governance regime in general and the derivative lawsuit in particular. First, the state's policy of maintaining a full or controlling interest in enterprises in various sectors leads to a fundamental dilemma in Chinese corporate governance. The state wants the enterprises it controls absolutely and owns partially to be run efficiently, but not solely for the purpose of shareholder wealth maximization. A necessary element of the state control of an enterprise is the use of that control for purposes other than the maximization of its wealth as a shareholder – purposes such as the maintenance of urban employment levels, direct control over sensitive industries, effective price control in a given sector, politically motivated job placement, or the extraction of

[3] The study is reported by P. Qi, '*Guojia jing mao wei fuzhuren Jiang Qiangui: zuo shangshi gongsi chengxin fuze de konggu gudong*' ['SETC vice chairman Jiang Qiangui: be a sincere and responsible listed company controlling shareholder'] (2003), *Jingji Ribao* [*Economic Daily*], 29 January.

profits for politically privileged insiders. In using its control for these purposes, however, the state openly – and not necessarily fraudulently (for that see below) – exploits minority shareholders, who have no other way to benefit from their investment. As long as state policy requires the state to remain an active controlling investor in firms of which it is not the sole shareholder, meaningful legal protection for minority shareholders will mean either constraints on the state's ability to do precisely those things for which it has retained control, or else a de facto separate legal regime (at least as far as minority shareholder rights are concerned) for enterprises in which the state is the dominant shareholder. A separate legal regime would require the maintenance of a strict boundary between state-controlled companies, on the one hand, and other companies, on the other, however – a boundary that it was precisely the ambition of the corporatization policy and the promulgation of the Company Law to erase. The failure to face this question squarely has made it extremely difficult to formulate legal rules on the duties of insiders and controlling shareholders in these newly created, and absolutely dominated, firms.

Second, the prevalence of concentrated ownership in Chinese firms means that the main agency problem in Chinese corporate governance is not vertical, between disaggregated shareholders and managers, but horizontal, between minority shareholders and controlling shareholders. In this respect, China is like most of the world. What is exceptional, however, is the identity of the controlling shareholder. In most cases, it either is or is closely connected to a governmental entity or Party organization. This means that there is a higher likelihood that a shareholder lawsuit or a derivative suit involving a corporatized entity, especially a politically privileged one that has been allowed to access the public capital markets, will, in substance, be directed at a Party group, the state, a state-affiliated agency, or the agent of any of these. The claim will therefore be politically sensitive – something that is likely to affect the willingness and ability of judicial institutions to accept the lawsuit and hear the underlying claim.

The political sensitivity of such lawsuits is even clearer when we note that an important legacy of this reform process is that the administrative channels of control present in the traditional SOE have not disappeared but often continue to function in the shadows, supplanting the formal channels envisaged in the Company Law.[4] For instance, the board of

[4] See N. Howson, 'China's restructured commercial banks: the old nomenklatura system serving new corporate governance structures?', in M. Avery *et al.* (eds.), *China's Emerging Financial Markets: Challenges and Global Impact* (2009), Singapore: John Wiley & Sons

directors may be bypassed entirely in matters such as the appointment of the chief executive officer or other important operational decisions. Instead, the government agency that controlled the firm before its restructuring (or the Party structure behind that state institution) will continue to issue instructions in much the same way after restructuring. Thus, in considering the viability of derivative actions in the PRC, analysts and the corporate law itself must always take account of the pervasive state presence inside large corporations in many sectors – in particular, in publicly listed companies – and be alert to the presence of critically important norms, practices, and lines of authority that simply do not show up in any state laws or regulations, and are typically not mentioned at all in corporate disclosure documents.[5]

Third, the reform-era corporate capital structures outlined above are an invitation to opportunism, abuse and outright fraud by controlling shareholders and insiders – an invitation that has been taken up with gusto at CLSs (publicly listed or not) and closely held firms alike. As our case reports show, closely held firms are a fertile setting for fraud, looting and asset stripping, minority shareholder oppression, and mismanagement. Further, problems in public companies – despite mandatory PRC and foreign disclosure requirements, the power of PRC and foreign securities and stock exchange regulators, and the threat of foreign securities class action suits – are even worse. Public companies have been run as vehicles to attract passive investment capital from the stock markets and serve the needs of the controlling shareholder (and its insiders).[6] 'Tunnelling' by individual insiders and controlling shareholders, both

(Asia): 123–63; and R. McGregor, *The Party: The Secret World of China's Communist Rulers* (2010), New York: HarperCollins, chap. 5.

5 For example, the A-share (Shanghai) and H-share (Hong Kong) prospectuses for the Agricultural Bank of China's 2010 initial public offering are almost completely silent on the role of the Communist Party in the bank. The Party's presence is indicated only obliquely, in the biography of one officer who is also the secretary of the bank's (Party's) discipline inspection committee. Apart from the biographies of key personnel, the word 'Party' (*dang*) does not appear at all. As one of us has noted elsewhere, the same was true for the earlier Bank of China and Industrial and Commercial Bank of China offerings. Howson ('China's restructured commercial banks'), 140–1.

6 S. Green, *China's Stockmarket: A Guide to Its Progress, Players, and Prospects* (2003), London: Profile Books, 118–53; K. Cao, '*Guanyu zhonghua renmin gongheguo gongsifa ('xiugai caoan') de shuoming*' ['Explanation regarding 'Company Law of the PRC (amended draft)'], in M. Gui (ed.), *Zhonghua renmin gongheguo zhengquanfa, zhonghua renmin gongheguo gongsifa xin jiu tiaowen duizhao jianming jiedu* [*Straightforward Reading and New–Old Comparison of the Securities Law and Company Law of the People's Republic of China*] (2005), Beijing: Zhongguo minzhu fazhi chubanshe [China Democracy and Legal System Press]: 525–45, 528–30.

state and non-state, by means of related-party transactions is notorious; in 2002 tunnelling by controlling shareholders was estimated at 96.7 billion yuan, equivalent to the total amount of money raised in stock markets in the same year,[7] and by the following year it had doubled.[8] It is easy to understand, therefore, why policy makers in the early 2000s sought to address this and other governance problems by amending the 1994 Company Law wholesale so as to enhance the judicial remedies available to minority shareholders against insiders, and controlling shareholders.[9] The 2006 Company Law accomplishes this goal in formal terms, with the derivative action in article 152 a key element in making the new substantive causes of action on corporate fiduciary duties, shareholder oppression, and related-party transactions truly justiciable, or at least immune to the blocking power held by controlling shareholders and their designated directors and officers. In 2008 Jin Jianfeng, chief judge of the Supreme People's Court no. 2 Civil Division (the department of the court occupied with corporate law litigation), highlighted this critical aspect of the derivative lawsuit mechanism when he wrote, 'If we don't establish a shareholders' derivative lawsuit system, the articles of the Company Law will be useless and empty provisions.'[10]

3 *The LLC form and other non-Company-Law forms*

The LLC and its informal close company analogues are at the centre of almost all our derivative lawsuit cases. That is true for two reasons: because the courts do not accept cases related to widely held CLSs, and because a significant amount of business undertaken in contemporary

7 S. Li, '*Da gudong qianyi zhankuan qiaoxiang jingzhong, tunshi ju'e lirun ling ren you*' ['Big shareholders misappropriate 100 billion, sounding the tocsin; gobble up huge profits, making people concerned'] (2004), *Shanghai Zhengquan Bao* [*Shanghai Securities News*], 2 April (available at http://finance.sina.com.cn/t/20040402/0615698518.shtml).

8 See Y. Zhang, '*Da gudong zhanyong shangshi gongsi zijin xu biaoben jianzhi*' ['Both the root cause and symptoms of misappropriation of listed company assets by big shareholders must be cured'] (2004), *Zhengquan shibao* [*Securities Times*], 7 December (available at http://business.sohu.com/20041207/n223371872.shtml).

9 This is stated explicitly in the influential *Corporate Governance Report* issued by the Shanghai Stock Exchange in 2003; see Shanghai Stock Exchange Research Center (ed.), *Zhonguo gongsi zhili baogao (2003 nian)* [*China Corporate Governance Report (2003)*] (2003), Shanghai: Fudan daxue chubanshe [Fudan University Press], 20–32.

10 J. Jin, '*Gudong paisheng susong zhidu yanjiu*' ['A study of the shareholders' derivative lawsuit system'], in B. Wang *et al.* (eds.), *Shijianzhong de gongsifa* [*Company Law in Practice*] (2008), Beijing: Shehui kexue wenxian chubanshe [Social Sciences Academic Press], 412–28, 414.

China is not related to the CLS form (whether or not sourced in traditional SOEs).[11]

In fact, a large amount of investment and commercial activity is effected through arrangements that are neither corporate (CLS or LLC) nor have anything much to do with the PRC Company Law, of whatever vintage. Many investment or capital aggregation transactions in China are based in contractual arrangements such as 'agreements' (*xieyi*), 'joint operations' (*lianying*), 'cooperative' (*hezuo*) or non-legal person 'partnership' (*hehuo*) arrangements.[12] Even when something resembling a business organization is established, and even if formal 'enterprise legal person' status is conferred on the entity by registration with the appropriate bureau of the State Administration of Industry and Commerce, the resulting firm very often has no legal basis in the PRC Company Law or the various foreign-invested enterprise statutes and their implementing regulations.[13]

This persistent instability in corporate legal identity and corporate law application leads to difficulties in applying a derivative action meant for the corporate form. For example, the *Chongqing Coal Mine 2006* case[14]

[11] In 2006, for example, there were 7,210 industrial CLSs in China. Their gross value of industrial output was 10.6 per cent of the national total. By contrast, there were 45,738 non-state-owned LLCs; their GVIO was 17.4 per cent of the national total. See National Bureau of Statistics, *Zhongguo gongye jingji tongji nianjian 2007* [*Statistical Yearbook of China's Industrial Economy 2007*] (2007), Beijing: Zhongguo tongji chubanshe [China Statistics Press], 54.

[12] See, for example, the structures featured in *Zhang Junran* v. *Zhang Jianwei and Xie X. re: Shanghai Taiwu Real Estate Consulting Company Limited*, Shanghai Jiading District Basic-Level People's Court (2007), *jia min er (shang) chu zi* no. 944; on appeal Shanghai no. 2 Intermediate People's Court (2008), *er zhong min san (shang) zi* no. 93) (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117612885) [*Shanghai Taiwu Real Estate 2008*]; and *Beijing Longsheng Real Estate Development Company Limited* v. *China National Minorities Periodicals re: Beijing Gelairui National Minorities Culture Media Center Company Limited*, Beijing no. 1 Intermediate People's Court (2008), *yi zhong min chu zi* no. 9701; on appeal Beijing Higher People's Court (2009), *gao min zhong zi* no. 2325 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117615003) [*Beijing Glory Project 2009*].

[13] See, for example, the entity at issue in *Su Zhen and Han Fang* v. *Rong Chunming re: Beijing Tonghua Jinqiu Shangwang Company Limited*, Beijing Municipal Haidian District Basic-Level People's Court (2009), *hai min chu zi* no. 32426 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117654480) [*Beijing Tonghua Online 2009*]; this was established as an 'equity cooperative' (*gufen hezuo*) collectively owned enterprise in 1993, and then transformed into an LLC with deemed investment from the former collective's workers.

[14] *X. Power Enterprise General Company and Y. Enterprise Company Limited* v. *Deng, Cooperative Mine, He and Z. Mining Company Limited*, Chongqing no. 2 Intermediate People's Court (2005), *yu er zhong fa min zhu zi* no. 28; on appeal Chongqing Higher

features an LLC established around a coal mine asset. The investor in the coal mine LLC is listed as a government bureau (*ju*), but another LLC (acting for the bureau) attempts to initiate a derivative action on behalf of the coal mine LLC against a factory (*chang*) possibly without independent legal personality. These transitional identities provide ample defences for the defendants, which are effective in the first-instance hearing but are rejected on appeal.

Another case, *Beijing Golden Century 2009*,[15] seems a relatively straightforward corporate derivative action. Two LLC shareholders sue the company's legal representative, director, and general manager (the same person) to wrest back control of the company after a unanimous shareholders' resolution ousting him from any role in it. Straightforward, that is, until the opinion recites that the LLC exists only in the most formal sense, that the plaintiff shareholders never contributed capital to the enterprise, and that the equity interests in the LLC have already been distributed to forty-three peasants (in exchange for contributions of land use rights) acting through a 'rural cooperative'. The defendant's key defence is that the plaintiffs are not true shareholders of the LLC whose interests they purport to be protecting, and thus their 'shareholders' resolution' ousting the defendant is void. Both the basic-level court and the intermediate court on appeal are forced to rely on pure formalities (the registration of shareholder status and attendant promises to contribute capital) to permit the derivative claim. Likewise, the *Beijing Tonghua Online 2009* opinion allows a derivative action on behalf of an LLC transformed from a collectively owned enterprise, but the court has to use both the 'Township collectively owned enterprise provisions' and the 2006 Company Law to reject the underlying claim of breach of duty of loyalty by an LLC fiduciary, because an 'all-workers' meeting at the collective (doing double duty as an investors' meeting for the LLC) constituted prior approval of the allegedly breaching action.

People's Court (2006) [judgment identifier not provided] (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117561941) [*Chongqing Coal Mine 2006*].

[15] *Beijing Municipal Houlu Agricultural Labor Commercial Company and Beijing Municipal Shunyi Houlu Cement Components* v. *Xu Liansheng re: Beijing Golden Century Agricultural Development Company Limited*, Beijing Municipal Shunyi District Basic-Level People's Court (2009), *shun min chu zi* no. 75; on appeal Beijing no. 2 Intermediate People's Court (2009), *er zhong min zhong zi* no. 08234 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117618214) [*Beijing Golden Century 2009*].

These forms – whether LLCs or informal analogues that have continued or grown organically – are far more like partnerships (with corporate personality) than corporations with a strict separation between ownership and management. The norms governing corporations differ significantly from those governing partnerships, and touch on every major area of enterprise law. Most important, in this chapter, is the lack of any separation of ownership and management in the partnership-like LLC entities. This lack of separation throws into doubt the suitability of corporate derivative actions for entities such as LLCs and contracted partnerships, in which there is no separation between ownership and management, and management cannot therefore absolutely block a lawsuit against itself brought by other investors, whether in their own name or in that of the entity. In partnership-like entities, any partner can act as an agent for the partnership. Not only that, but the vector of duties is different: in corporations, fiduciaries owe duties to the corporation, and in very special situations to the shareholders; in partnerships, however, partners owe duties not only to the partnership but also to the other partners. In many of the cases we now see in the PRC, therefore, courts hearing a derivative lawsuit will reject the claim and instead urge the shareholder partners to lodge a direct claim against their co-investors. We see this in the *Beijing Jindao Hongping Advertising 2008*,[16] *Beijing Glory Project 2009*[17] and *Shanghai Tianguang Medical 2009*[18] cases. In the alternative, courts will allow mixed claims by the company: against both controlling shareholders for oppression and against fiduciaries (often the same parties as the controlling shareholders) for breach of fiduciary duties (typically the duty of loyalty).[19]

If China's corporate landscape is dominated by closely held corporate partnerships then China's judiciary faces a difficult task in wielding the *corporate* derivative action with respect to them. Certainly, the

[16] *Guo Hong* v. *Fu Ping re: Beijing Jindao Hongping Advertising Company Limited*, Beijing Municipal Haidian District Basic-Level People's Court (2008), *hai min chu zi* 7380; on appeal Beijing no. 1 Intermediate People's Court (2008), *yi zhong min zhong zi* no. 14669 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117574153) [*Beijing Jindao Hongping Advertising 2008*].

[17] See *Shanghai Taiwu Real Estate 2008* and *Beijing Glory Project 2009* cases.

[18] *Shanghai Jiaotong University Hospital Associated Ruijin Hospital* v. *Huatong Tianxiang Group Co., Ltd re: Shanghai Tianguang Biology Medical Technology Company Limited*, Shanghai no. 1 Intermediate People's Court (2008), *hui yi zhong min san (shang) chu zi* no. 4; on appeal Shanghai Higher People's Court (2009), *hu gao min er (shang) zhong zi* no. 18 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117644889) [*Shanghai Tianguang Medical 2009*].

[19] See, for example, *Shanghai Taiwu Real Estate 2008*.

mechanism will be useful in allowing a close corporation/corporate partnership registered as a company under the Company Law that has been damaged to sue those who have caused the damage (whether traditional fiduciaries or third parties). Equally often, however, individual shareholders *qua* (effective) partners will suffer harm, and should be entitled to sue under a direct claim against co-equal partners (who are characterized as management in the corporate form). Thus, what may appear to be a failure to apply a new *corporate* doctrine (i.e., the non-application of the new derivative lawsuit mechanism) may in fact be a highly competent and principled application of business enterprise law. The *Dongfang Construction Group 2009* case[20] demonstrates this: the 0.68 per cent shareholder in an LLC sues a 10.78 per cent shareholder and company director for the *gratis* transfer of a significant receivable by the company to the defendant shareholder director without shareholder approval. The underlying breach is correctly identified as a breach of the investor director's duty of loyalty; more appropriately, the injury is described as being applicable to 'the company's other shareholders' (*sunhaile gongsi qita gudong de quanyi*) rather than 'the company', and thus the direct claim by the mere 0.68 per cent shareholder against another breaching shareholder is upheld.

4 *The legal representative*

Another somewhat unusual feature animating derivative lawsuits in the PRC is the singular position of the 'legal representative' (*fading daibiaoren*) in Chinese law and practice. Notwithstanding the election of directors and supervisors and appointment of officers, the position familiar from civil law systems is still used uniformly in Chinese corporations (and addressed in the 2006 Company Law). Although the new Company Law allows any duly appointed person to represent that legal person (pursuant to authorization by the shareholders or board of directors), the legal representative is, in the view of most PRC civil and judicial actors, intrinsically authorized to represent the company, and, in the (mistaken) view of many, *exclusively* authorized to act for the company. Moreover, for many corporate actors, only the specific person who is the legal

[20] *Chen Ju* v. *Dongfang Construction Group Company Limited*, Zhejiang Province Zhuji City District Basic-Level People's Court (2009), *shao zhu shang chu zi* no. 4058 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117678194) [*Dongfang Construction Group 2009*].

representative can affix the all-important corporate seals (or 'chops') necessary to confirm corporate action, such as the execution of contracts or the commencement of a lawsuit. Accordingly, many of the derivative lawsuits analysed in this chapter – especially in the LLC context – arise when the legal representative refuses to act for the company in enforcing an obligation or suing breaching fiduciaries, or refuses to give over the corporate chops necessary for corporate action. This situation may seem strange to lawyers used to the Western or Anglo-American system, but obstacles erected by an inactive or opposing legal representative who will not allow use of the corporate seals can be near-absolute, and in many cases trump the power of a unanimous shareholders' or board resolution (at least in the short term).

5 *The Chinese judiciary: local protectionism, Party control and the avoidance of 'mass' litigant cases*

As noted earlier, the more important the political-economic actor involved in a lawsuit, the more likely the lawsuit is to be politically sensitive and subject to various kinds of obstacles and interference. The management and controlling shareholders of significant companies are likely to be influential – certainly in the area in which the company is headquartered, employs workers, and pays taxes, and often nationally as well. Indeed, the controlling shareholders may even be governmental or quasi-governmental bodies of some kind, or tied to Party organizational structures. Therefore, pressure may be brought to bear on courts to protect such actors from claims against them. Local political power – formally, the local People's Congresses, and, in reality, the local Communist Party organization – controls courts both informally and formally through the power of appointment and power over budgets. This means that local Party and state officials – and those who have influence over them – have considerable power over courts. An extensive study of local protectionism in the courts found that, 'when confronted with interference, disturbance and influence exerted by various external forces, the judiciary has to surrender itself to the external pressure and cater for the needs of local interests'.[21] Indeed, Communist Party

[21] Z. Liu, '*Zhongguo sifa difang baohu zhuyi zhi pipan – jianlun "sifaquan guojiahua" de sifa gaige silu*' ['Critique of judicial local protectionism in China: reflections on "nationalization of judicial power" as the guideline for judicial reform'] (2003), *Faxue Yanjiu* [*Legal Studies*] 2003, 1: 83–98, 90.

committees can and do issue instructions to courts telling them how to handle particular cases. Some areas have a specific rule providing that, when a party from outside the jurisdiction sues a local enterprise, the court must get permission from the local Party leadership to hear the case, or the court is ordered to judge the case in accordance with the instructions of the Party committee.[22]

Courts are particularly reluctant to get involved in lawsuits involving multiple plaintiffs or the interests of multiple parties, and various rules and practices reflecting the state's own distaste for such suits reinforce this reluctance. Sometimes courts directly instruct lower courts not to take multiple-plaintiff lawsuits at all.[23] In securities litigation, which by its nature tends to involve many shareholder parties, the Supreme People's Court has issued instructions to lower courts that strictly limit the claims that litigants may make under the Securities Law, as well as the procedures for bringing them.[24] The political sensitivity of group

[22] See D. Guo, '*Shixing sifa duli yu ezhi sifa fubai*' ['Implementing judicial independence and preventing judicial corruption'] (1999), *Falü Kexue* [*Law Science*] 1999, 1: 5–15, 8; and Y. Wu, '*Sifa duli yu difang baohu zhuyi*' ['Judicial independence and local protectionism'] (2004), *Hunan Gongan Gaodeng Zhuanke Xuexiao Xuebao* [*Journal of the Hunan Higher and Specialized Institutes of Public Security*], 16, 2: 18–22, 19.

[23] One of us was informed by a Chinese law professor in 2006 that the Shanghai Higher-Level People's Court had instructed all the lower courts in Shanghai not to accept suits with ten or more plaintiffs. The other of us found this kind of instruction, both explicit and 'internal' only, in an extensive review of corporate law and securities litigation in the Shanghai courts from 1992 to 2008; see N. Howson, 'Corporate law in the Shanghai People's Courts, 1992–2008: judicial autonomy in the contemporary authoritarian state' (2010), *East Asia Law Review* 5, 2: 303–440.

[24] See Supreme People's Court, *Zuigao renmin fayuan guanyu she zhengquan minshi peichang anjian zan bu yu shouli de tongzhi*' ['Notice on temporarily not accepting securities cases involving civil suits for damages'], issued 21 September 2001 (available at www.law-lib.com/law/law_view.asp?id=16373); Supreme People's Court, '*Zuigao renmin fayuan guanyu shouli zhengquan shichang yin xujia chenshu yinfa de minshi jiufen anjian youguan wenti de tongzhi*' ['Notice on issues relating to the acceptance of civil cases arising out of false representations in securities markets'], issued 15 January 2002 (available at www.law-lib.com/law/law_view.asp?id=16956); and Supreme People's Court, '*Zuigao renmin fayuan guanyu shenli zhengquan shichang yin xujia chenshu yinfa de minshi peichang anjian de ruogan guiding*' ['Several provisions on the adjudication of civil suits for damages arising out of false representations in securities markets'], issued 9 January 2003 (available at www.law-lib.com/law/law_view.asp?id=42438). A judicial document issued to courts internally some time after a nationwide meeting on civil adjudication in May 2007 has apparently now broadened the scope of permissible claims to include market manipulation and insider trading, but other procedural hurdles established by the aforementioned documents still apply. See P. Luo, '*Qianzhi chengxu quliu kunjing*' ['Difficulties over whether to eliminate or keep the precondition procedure'] (2007), *Caijing* [*Finance*] 2007, 19: 28 (available at

litigation is further shown in the Supreme People's Court's efforts to push multi-plaintiff litigation down to the lowest level possible within the court system, so that plaintiff groups will not physically take their case to provincial capitals (if appeal lies with a higher-level people's court) or to Beijing (if appeal lies with the Supreme People's Court).[25] Courts have also sometimes required plaintiffs wishing to litigate together to separate their claims into smaller groups. In the first permitted shareholder litigation on false or misleading disclosure, for example, the Harbin Intermediate Court required the original 381 plaintiffs to split up into smaller groups of ten to twenty persons.[26]

Restrictions have also been placed on group litigation even before the plaintiffs get to court. In March 2006, for example, the All-China Lawyers Association – a government-controlled body that, together with the national Ministry of Justice and its local government counterpart judicial bureaus, is in charge of lawyers in China – issued a regulation entitled 'Guidance opinion on the handling by lawyers of mass cases', applying to all suits with ten or more plaintiffs.[27] This regulation requires lawyers taking such cases to report to government bodies and 'accept supervision and guidance' from them.

Derivative suits are not, of course, class actions, and could in theory have a single initiating shareholder plaintiff. PRC judges will be aware, however, that derivative suits involving widely held or listed companies will necessarily implicate the interests, on one side, of large numbers of shareholders even if they are not formally plaintiffs and, on the other, of influential and politically backed corporate managers and controlling

www.p5w.net/news/xwpl/200709/t1222550.htm); and X. Wu, '*Neimu jiaoyi, caozong shichang minshi peichang anjian hu zhi yu chu*' ['Civil compensation cases for insider trading and market manipulation about to appear'] (2007), National People's Congress, 18 November (available at http://npc.people.com.cn/GB/6543957.html).

25 See Supreme People's Court, '*Zuigao renmin fayuan guanyu renmin fayuan shouli gongtong susong anjian wenti de tongzhi*' ['Notice on the question of the acceptance by people's courts of joint litigation cases'], adopted 30 December 2005 (available at www.law-lib.com/law/law_view.asp?id=149701), para. 1.

26 See '*Daqing lianyi an jiannan tuijin*' ['The Daqing Lianyi case is pushed ahead with difficulty'], *Nanfang zhoumo* [*Southern Weekend*] (2003), 14 August (available at http://finance.sina.com.cn/roll/20030814/1108406286.shtml).

27 All-China Lawyers Association, '*Guanyu lüshi banli quntixing anjian zhidao yijian*' ['Guiding opinion on the handling by lawyers of mass cases'] (2006), 20 March, www.acla.org.cn/pages/2006-5-15/s34852.html). For an English-language news report, see *South China Morning Post*, 'Warning to lawyers handling protest suits: new rules from government-controlled All-China Lawyers Association demand lawyers to be wary of foreign media contact' (2006), *South China Morning Post*, 19 May (available at www.asiamedia.ucla.edu/article.asp?parentid=45908).

shareholders. It is therefore reasonable to think that much of the reluctance to take multi-party suits with some political sensitivity will spill over into derivative suits in which widely held or listed companies are involved.[28]

6 *Derivative versus representative*

The derivative action is the subject of considerable doctrinal confusion in China, affecting both the surrounding discourse and judgments in actual cases. Because the classic derivative action outside China often involves a large number of shareholders, for many years PRC analysts pointed to the 'group action' (*gongtong susong*) provided for in China's Law on Civil Procedure as somehow related to the shareholders' derivative action. This is plainly wrong: the group action in Chinese civil procedure merely allows for the aggregation of a number of litigants with the same or similar claims against one or a group of defendants. Similarly, many PRC experts and most opinion-writing judges refer to the derivative action as a 'representative action' (*daibiao susong*), instead of the correct, directly translated term of art: *paisheng* [or *yansheng*] *susong*.[29] Indeed, nowhere in the 2006 Company Law are any of these characters used for a derivative lawsuit; instead, article 152 speaks of shareholders bringing an action against defendants 'in their own names . . . in the interest of the company' ('*weile gongsi de liyi yi ziji de mingyi*'). Just as with the 'group action' noted above, the 'representative action' applies only to a situation in which one party among a group of named litigants 'represents' the interests of the group in the judicial proceeding. This problem becomes substantively important, certainly

28 As Professor Tang Xin of the Tsinghua University Law School states, '[T]he court system is not active in hearing corporate and securities cases. Listed companies and their officers still have a certain political backing, and Chinese courts are neither experienced nor politically powerful and are hence reluctant to take cases involving complicated reasoning and powerful defendants.' X. Tang, 'Protecting minority shareholders in China: a task for both legislation and enforcement', in H. Kanda *et al.* (eds.), *Transforming Corporate Governance in East Asia* (2008), London: Routledge: 141–67, 147; see also Howson ('Corporate law'), 400–13.

29 Professor Liu Junhai makes it clear that the use of the misleading character set '*daibiao susong*' ('representative lawsuit') arose because these are the same Chinese characters used in Japan's and Taiwan's corporate law. See J. Liu, *Gufen youxian gongsi gudongquan de baohu* [*Protection of Shareholders' Rights in Companies Limited by Shares*], rev. edn. (2004), Beijing: Falü chubanshe [Law Press], 314–15. The great majority of the legal opinions we analyse in this chapter use the term '*daibiao susong*' instead of the term of art that accurately conveys the derivative nature of the claim.

in the pre-2006 environment, when some litigants fight over the availability of a legal basis for 'derivative' versus 'representative' lawsuits.[30] It also infects the ongoing conversation in the PRC regarding perfection of the derivative lawsuit, as, for example, when the Supreme People's Court justifies the 1 per cent shareholding threshold for CLS derivative actions because it ensures that the plaintiffs are in some sense 'representative' of all the shareholders' interest.

7 *Costs, cost allocation and cost–benefit analysis for shareholder plaintiffs*

If a lawsuit cannot be financed, it cannot occur. Typical financing mechanisms include various combinations of contingency fees, a 'loser pays' rule, an order whereby the company whose interest is being protected bears the burden if the derivative suit is accepted (i.e., regardless of the success of the underlying claim), and a 'common fund' rule, in which the plaintiff's attorney's fees come from the corporate recovery, not the plaintiff. In addition, other jurisdictions, such as Taiwan, have experimented with a quasi-public foundation whose mission is to bring such lawsuits.[31]

Chinese civil procedure is not now well suited to supporting these financing mechanisms.[32] The basic rule of Chinese civil procedure is that the loser pays various costs of litigation and court fees, but attorney's fees are not included in costs of litigation and so are borne directly by the parties.[33] Filing fees in the PRC are calculated as a fraction of the amount in controversy, with plaintiffs usually required to pay such fees upfront before acceptance of the action.[34] Moreover, law firms usually require a

30 See, for example, *Zhejiang Golden Bridge CLS 2003* (in which the court distinguishes between a 'representative' lawsuit brought by four plaintiffs on behalf of 165 other shareholders (for which there is a legal basis) and a 'derivative' lawsuit seeking remedy for harm to the company (for which there is, at the time, no explicit legal basis)).

31 See C. Milhaupt, 'Nonprofit organizations as investor protection: economic theory and evidence from east Asia' (2004), *Yale Journal of International Law* 29, 1: 169–207; Tang ('Protecting minority shareholders'), 153–4; and Wallace Wen Yeu Wang and Wang Ruu Tseng's chapter on Taiwan in this volume.

32 On issues of funding for derivative suits in China, see generally Z. Zhang, 'Making shareholder derivative actions happen in China: how should lawsuits be funded?' (2008), *Hong Kong Law Journal* 38, 2: 523–62.

33 See State Council, '*Susong feiyong jiaona banfa*' ['Measures for the payment of litigation costs'], effective 1 April 2007 (available at www.law-lib.com/law/law_view.asp?id=184005), arts. 6, 29.

34 See Civil Procedure Law, art. 107; and Supreme People's Court, '*Renmin fayuan susong shoufei banfa*' ['Provisions regarding collection of litigation fees by the people's courts'],

retainer to the value of over half of the total predicted fees.[35] Although these upfront payments may pose few difficulties for a corporate plaintiff of reasonable size, individual shareholder plaintiffs may find them difficult to make.[36]

Another way of funding derivative litigation is through contingency fees. In the post-Mao era of legal system construction, contingency fees in the PRC have been frowned upon. Over the past several years, however, they have come to be accepted in practice. In 2006 the central government issued a regulation specifically allowing contingency fees of up to 30 per cent, but not in a specified class of cases, including unpaid wages, spousal support, inheritance, marriage, and – most pertinently for our purposes – multi-plaintiff lawsuits, underlining once again the state's particular concern with, and desire to discourage, this type of litigation.[37] As noted above, derivative suits need not in form be multi-plaintiff lawsuits; a single initiating shareholder will suffice. Assuming the state's concern is with the substantive spectacle of numerous interested parties and not with the mere form, however, it is reasonable to suppose that the policy might be applied to derivative suits involving widely held companies as well.

It should be noted that to state the formal rule is not necessarily to describe actual practice, and therefore the system has more flexibility than might at first appear to be the case. Contingency fees have been allowed at a time when they were formally prohibited, and we show in this chapter that derivative suits themselves were allowed in practice before they were formally sanctioned in the 2006 Company Law. By the same token, even in the absence of specific statutory authorization, courts have on occasion shown hospitality to fee shifting in favour of winning plaintiffs, at least in consumer cases.[38] In preliminary research

issued 12 July 1989 (available at www.law-lib.com/law/law_view.asp?id=5802); see also Zhang ('Making shareholder derivative actions'), 559–61; and X. Hong and S. Goo, 'Derivative actions in China: problems and prospects' (2009), *Journal of Business Law* 2009, 4: 376–95, 392–3.

35 See J. Xiao and X. Tang, 'Cost and fee allocation in civil procedure (China)', www.personal.umich.edu/~purzel/national_reports/China%20(PRC).pdf (last accessed 15 December 2011).

36 Xiao and Tang ('Cost and fee allocation'), 10–11.

37 See State Development and Reform Commission and Ministry of Justice, '*Lüshi fuwu shoulifei guanli banfa*' ['Measures on fees for lawyers' services'], adopted 13 April 2006 (available at www.law-lib.com/law/law_view.asp?id=156310), art. 11.

38 See the discussion in D. Clarke, 'The private attorney-general in China: potential and pitfalls' (2009), *Washington University Global Studies Law Review* 8, 2: 241–55, 253–5; see also J. Tu, '*Lüshifei you baisufang chengdan, you li yu minzhong xuanze falü shouduan baohu hefa quanyi*' ['For the loser to pay attorneys' fees is advantageous to

on this issue, one of us found that, in more than half the cases in which plaintiffs asked for attorneys' fees and won their case, the courts were willing as a matter of law to award attorneys' fees. It appears, therefore, that in practice the rule against awards of attorneys' fees is not an insuperable obstacle. The real question is whether courts will be willing as a practical matter to do so.[39]

III Derivative actions before 2006

Despite the absence of a firm statutory basis in law, derivative actions were accepted and heard in Chinese courts before 2006 and the entry into force of the 2006 Company Law. The history of derivative actions before their formal recognition in law shows that, *when they desire to do so*, Chinese courts in both their rule-making and adjudicatory capacities can readily create and apply rules on their own, even when they run counter to formally superior rules.

In this section, we find a pattern that is quite common in other fields of Chinese law: a central-level policy disfavouring a practice, limited experimentation with the practice at sub-central levels (often through the courts), and eventual formal incorporation into central-level norms. We further find lower-court practice occasionally overstepping the bounds laid out by apparently 'superior' statute, higher courts, and regulatory authorities.

1 *Non-statutory rule making: CSRC principles, SPC utterances, local 'opinions', and the (draft) 'Omnibus' regulation on the 1994 Company Law*

Prior to 2006, in spite of the absence of enabling legislation from the centre, local governments and non-legislative bodies were not idle. In January 2002 the China Securities Regulatory Commission issued its 'Principles of corporate governance for listed companies',[40] which states in article 4 (emphasis added):

the people's choosing legal methods to protect their lawful rights and interests'] (2009), 5 January, www.lawyn.com (available at http://tinyurl.com/r5mxdt).

39 In the cases reviewed here, we find evidence only of a court-mandated sharing of litigation filing fees, etc., and no recitation of how attorneys' fees were allocated. See footnotes 106 and 107 and accompanying text.

40 China Securities Regulatory Commission, '*Shangshi gongsi zhili zhunze*' ['Principles of corporate governance for listed companies'], issued 7 January 2002 (available at www.law-lib.com/law/law_view.asp?id=16889).

> The directors, supervisory board members, and managers of the company shall bear liability for compensation in cases where they violate law, administrative regulation, or the articles of association and cause damage to the company during the performance of their duties. Shareholders shall have the right to request *the company* to sue for such compensation in accordance with law.

As authorization for a derivative lawsuit in China, the 'Principles' have several defects. First, and most obviously, they are not legislation. They are, in effect, suggestions from the CSRC as to how companies should organize their internal governance. They provide no legal basis for shareholders to bring, or courts to accept, derivative pleadings. Second, they merely authorize the shareholders to request that the company sue. Shareholders did not need the 'Principles' to authorize them to communicate with directors and officers about desired corporate action, however. What is special about demand in derivative actions is that typically it is a *required* step, and a condition precedent, not simply an authorized one. Indeed, shareholders wishing to sue on behalf of the company might be happier without it.

Less than a year later, in December 2002, a senior Supreme People's Court judge stated publicly that courts should accept derivative suits.[41] A lower court subsequently found these remarks inadequate as a basis for accepting a derivative suit, calling them 'for reference only'.[42] Nevertheless, there is good reason to believe that the remarks were a sign of internal conversations taking place within the court system.

For example, from late 2002 to 2004 the higher-level people's courts (one level below the Supreme People's Court and responsible for courts at the provincial level) of Jiangsu, Shanghai and Beijing all issued 'Opinions'[43] permitting the use of the derivative suit mechanism in courts under their

41 See *Beijing yule xinbao* [*Beijing Recreation News*], '*Gao fayuan fuyuanzhang Li Guoguang biaoshi: xiao gudong gao da gudong fayuan ying shouli*' ['Supreme People's Court vice-president Li Guoguang indicates that courts should accept suits by small shareholders against large shareholders'] (2002), *Beijing yule xinbao*, 12 December (available at http://news.sohu.com/58/64/news204906458.shtml).

42 See *Shanghai zhengquan bao* [*Shanghai Securities News*], '*Shouli gudong daibiao susong wei bei shouli*' ['First shareholder representative suit is not accepted'] (2003), *Shanghai zhengquan bao*, 22 April (available at http://101.stock888.net/030422/100,101,78015,00.shtml); see also W. Qian, '*Gongsi susong: gongsi sifa jiuji fangshi xin lun (6)*' ['Corporate litigation: a new discussion of methods of judicial remedies for companies (6)'] (2003), chinalawinfo.com, 23 May, http://article.chinalawinfo.com/article/user/article_display.asp?ArticleID=25304.

43 Chinese courts below the Supreme People's Court level and governmental bodies often issue documents labelled 'Opinions' (*yijian*) setting forth proposed rules on various issues. Opinions can be binding in varying degrees. They should not be confused with

jurisdiction, and describing their implementation in great detail.[44] For example, the 'Shanghai Opinion' affirms the inclusion of controlling shareholders and third parties as potential defendants; identifies the participation of the company as a 'third party'; authorizes judicial determination of whether the company has been harmed, the causal connection between the defendants' actions and the harm, any good-faith defences available to the defendants, and the degree of control exercised by the controlling shareholder defendant over the corporate entity inhibiting the underlying action; forbids settlement that will disadvantage the real parties in interest (minority shareholders in the company);[45] empowers the court to annul offending transactions; and allows for damage awards against not just the defendants but also the company. This level of detail is strong evidence that local-level courts were in fact accepting and adjudicating derivative lawsuits well before 2006. In fact, one pre-2006 case report in our sample[46] actually cites the 'Beijing Opinion' (article 8) as the basis for a derivative claim, which fails because of no demand.

the term 'opinion', as used to indicate a court decision in a particular case, or 'explanations' (*jieshi*) or 'regulations' (*guiding*) issued by the Supreme People's Court.

44 See Jiangsu Higher-Level People's Court, '*Guanyu shenli shiyong gongsifa anjian ruogan wenti de yijian (shixing) (2003 nian 6 yue)*' ['Opinions on several issues on adjudicating cases applying company law (trial implementation) (June 2003)'], in Shanghai Higher People's Court (ed.), *Gongsifa yinan wenti jiexi (di san ban)* [*Company Law Issues: Problems and Analysis*] 3rd edn. (2006), Beijing: Falü chubanshe, 240–8 ['Jiangsu Opinion']; Shanghai Higher-Level People's Court, no. 2 Civil Division, '*Guanyu shenli sheji gongsi susong anjian ruogan wenti de chuli yijian (yi)*' ['Opinions on adjudicating cases regarding corporate litigation (no. 1)'], in Shanghai Higher People's Court (ed.), *Company Law Issues*, 231–6 ['Shanghai opinion']; and Beijing Higher-Level People's Court, '*Guanyu shenli gongsi jiufen anjian ruogan wenti de zhidao yijian (shixing) (2004 nian 2 yue)*' ['Guiding opinions on several issues on adjudicating corporate dispute cases (trial implementation) (February 2004)'], in Shanghai Higher People's Court (ed.), *Company Law Issues*, 236–40 ['Beijing Opinion'].

45 For the concern in one of our reported cases, which apparently made it to the Supreme People's Court before being settled, see *Zhejiang Hexin Electric Power Development Company Limited & Jinhua City Daxing Materials Company Limited* v. *Tonghe Zhiye Investment Company Limited re: Tonghe Investment Holding Company Limited*, Zhejiang Higher People's Court and Supreme People's Court (2009), reported at http://www.legaldaily.com.cn/ajzj/content/2009-07/22/content_1126739.htm and http://www.legaldaily.com.cn/zmbm/content/2009-08/27/content_1144482.htm [*Tonghe Investment 2009*].

46 *Hantang Jicheng Co., Ltd (Taiwan)* v. *Chen Shihu, Lin Cangmin and Gan Wenqi re: Beijing Taiqun Technology Company Limited*, unidentified Beijing Basic-Level People's Court (after 2003); on appeal Beijing no. 2 Intermediate People's Court (after 2005), reported at http://www.tpan.cn/html/4769.htm [*Beijing Taiqun Technology 2006*].

The Supreme People's Court also demonstrated its approval in a more formal way than through casual remarks by senior judges. As early as 1994, in connection with the *Zhangjiagang Fiber Company 1994* case noted immediately below, it had issued a document approving a derivative-type action by the Jiangsu courts (the 'Approving Response'). Then in 2003, with significant PRC academic input, it distributed for comment a draft regulation (the 'Omnibus Regulation') for lower courts that substantially rewrote the Company Law and, inter alia, provided for a derivative suit mechanism.[47] Finally, in 2005 – and on the eve of the coming into effect of the 2006 Company Law with the new article 152 in it – the Supreme People's Court approved a decision of the Beijing Higher-Level People's Court recognizing a derivative action.[48]

2 *Pre-2006 cases*

Several cases arising before 2006 show how the derivative suit mechanism was implemented in practice, sometimes in accordance with the documents and regulations described above, sometimes by the PRC courts acting entirely autonomously.

a Genesis of the 1994 SPC Approving Response and other LLC cases

Case collections and opinions show that, well before 1 January 2006, PRC plaintiffs brought derivative pleadings to court, and Chinese courts accepted derivative pleadings or affirmatively restructured claims to allow pleadings on behalf of corporate entities. There are, of course, limits to the conclusions we can draw from these opinions; we do not

47 See Supreme People's Court, '*Guanyu shenli gongsi jiufen anjian ruogan wenti de guiding (yi) (zhengqiu yijian gao)*' ['Regulation regarding several problems on hearing company dispute cases (first) (comment draft)'], issued 4 November 2003 (available at http://www.chinacourt.org/public/detail.php?id=88551) [Omnibus Regulation]. The draft regulation never made it to the stage of formal issuance, and was made moot by the 2006 Company Law.

48 *Suzhou New Development Investment Company Limited & Yankuang Group Company* v. *Qingdao Qianxi Hongda Sports Recreation Company Limited, Sichuan Hongda (Group) Company Limited, Sichuan Hongda Ltd, Co. re: China Zhongqi Futures Broker Company Limited*, Beijing Higher People's Court (2004), *gao min chu zi* no. 1287; affirmed on appeal (after withdrawal of original defendants' appeal) Supreme People's Court (2006), *min er zhongzi* no. 56 [*China Zhongqi Futures 2004–6*]; reproduced in J. Zhao and G. Wu (eds.), *Ban an quancheng shilu – gudong daibiao susong* [*True Records of Complete Course of Case Handling: The Shareholders' Representative Lawsuit*] (2007), Beijing: Falü chubanshe, 263–74, 306–7.

know, for example, whether such accepted cases, or the cases that actually went to trial and produced an opinion, represent a large or a small proportion of attempts to file such suits.

The first acknowledgement of the derivative mechanism after the promulgation of the 1994 Company Law came in the *Zhangjiagang Fiber Company 1994* case,[49] which gave rise to the Supreme People's Court Approving Response noted above. This case was in the limited area of foreign-invested enterprises, and, initially at least, apparently relevant only to Chinese–foreign equity or cooperative joint ventures in which the foreign investor was also the technology licensor/transferor to the same joint venture. As we show immediately below, however, the same case, the permitted derivative action, and the Approving Response were all used to support a post-2006 judgment (on pre-2006 facts) concerning an entirely domestically invested venture.

In the *Zhangjiagang Fiber Company 1994* case, the Jiangsu Higher People's Court asked the Supreme People's Court for guidance on the question of whether a factory, the Chinese investor in a Chinese–foreign equity joint venture, could represent the JV in suing a vendor to the JV (and a related party to the foreign investor in the JV). The SPC responded that the Chinese factory could indeed exercise the litigation rights of the JV, but in this particular case would not be able to do so because of a pre-existing arbitration agreement in the contract between the JV and the vendor.

This was a first specific acknowledgement by the apex of the PRC judiciary of the legitimacy of a derivative action, although it was hedged with so many conditions that it made it appear of limited broader applicability. The Approving Response quickly proved useful in non-FIE-related cases, however. For instance, it was cited as a legal basis in the pre-2006 CLS-related *Zhejiang Wu Fang Zhai 2001* case.[50] Then, in a second important case – the largest derivative-action-related award to date in the PRC – the Guangdong Higher-Level People's Court used the 1994 Supreme People's Court Approving Response as the basis for ordering damages of 400 million yuan to an entirely domestic enterprise.[51] This *Guangzhou Tianhe Scitech 2003* decision is noteworthy not only for its use of the 1994 SPC Approving Response when FIEs were not involved, but also because the Guangdong court issued its judgment after 1 January 2006. This means that it could have applied the newly effective article 152 of the 2006 Company Law to the facts of the case (as our later discussion of 'straddling'[52] will make clear), but chose not to do so. The 1994 SPC Approving Response also proved immensely useful to the plaintiff shareholder in the Guangzhou case, as it allowed the court to reject the defendant's sensible assertion that the derivative pleadings should be thrown out because the plaintiff shareholder had not complied with the pre-suit demand requirements of article 152.[53]

49 Described in Supreme People's Court, '*Guanghu zhongwai hezi jingying qiye duiwai fasheng jingji hetong jiufen, kongzhi heying qiye de waifang yu maifang you lihai guanxi, heying qiye de zhongfang ying yi shei de mingyi xiang renmin fauan qisu wenti de fuhan*' ['Reply letter on the issue of in whose name the Chinese party to a Chinese–foreign equity joint venture should bring suit when the joint venture has an economic dispute with an external party and the foreign party controlling the joint venture has a relationship of interest with the seller'], issued 4 November 1994 (available at http://www.people.com.cn/zixun/flfgk/item/dwjif/falv/9/9-1-4-01.html).

50 Described in P. Luo, *Gongsifa de hetong jieshi* [*A Contractual Interpretation of Company Law*] (2004), Beijing: Beijing daxue chubanshe [Beijing University Press], 335–6; X. Lu, '*Dongshizhang zi tao yaobao pei 250 wan; zhiyi wu fang zhai shijian*' ['Chairman of the board compensates 2.5 million from his own wallet; questions about the Wu Fang Zhai case'] (2001), *Caijing Shibao* [*Finance and Economic Times*], 27 July (available at http://www.finance.sina.com.cn/g/20010727/88091.html); and '*Dou shi danbao re de huo; dongshizhang bei gudong gaodao*' ['A disaster all caused by a guarantee; chairman of the board brought down by shareholder suit'] (2001), *Jiancha ribao* [*Procuratorial Daily*], 27 July (available at http://chinalawlib.com/358543998.html) [*Zhejiang Wu Fang Zhai 2001*].

51 *Guangzhou Municipal Tianhe Science and Technology Park Construction Company Limited* v. *Guangdong Zhujiang Investment Company Limited, Liao Ruoqing, Nambour Properties Limited re: Guangzhou Tianhe Science and Technology Park Enterprise Management Company Limited*, Guangdong Province Higher People's Court (2003), *yue gao fa min chuzi* no. 5 (available at www.union-lawyer.org.cn/news_130) [*Guangzhou Tianhe Scitech 2003*].

52 As described below, straddling actions are those that use the 2006 Company Law after 1 January 2006 to adjudicate facts arising before 1 January 2006.

53 This is a defence that works very well in a number of the post-2006 cases noted here, such as *Wang Bin* v. *Wang Yuanquan and Beijing Peieryou Technology Company Limited re: Shanghai Peieryou Technology Company Limited*, unidentified Shanghai Basic-Level People's Court; on appeal Shanghai no. 1 Intermediate People's Court (after 2006) (available at www.qzfz.qz.gov.cn/about.asp?ID=2621) [*Shanghai Peieryou 2006*]; *Zhao Yu* v. *Zhou Yuchao re: Shunde Municipal Zhaoyu Electronic Hardware Company Limited*, Guangdong Province Foshan Municipal Shunde District Basic-Level People's Court (2006), *shun fa miner chuzi* no. 02196; on appeal Guangdong Province Foshan Intermediate People's Court (2007), *fo zhong fa miner zhongzi* no. 348 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117521884) [*Shunde Zhaoyu Electronic Hardware 2007*]; *Zhang Ke* v. *Zhang Chen re: Beijing Dingyu Special Type Electric Cable Company Limited*, Beijing Municipal Haidian District Basic-Level People's Court (2008), *hai min chuzi* no. 23873 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117618469) [*Beijing Dingyu Cable 2008*]; and *Qian Qingwen and Chen Xiaobing* v. *Gao Weiyong re: Kunming Kangpaili Technology Company Limited*, Kunming Municipal Wuhua District Basic-Level People's Court (2008), *wu fa min san chu zi* no. 253; on appeal Kunming Intermediate People's Court (2009), *kun min wu zhong zi* no. 49 (available at http://vip.chinalawinfo.com/

After the 1994 Supreme People's Court Approving Response there is evidence of other derivative pleadings in the Chinese courts in a number of cases from 1996 to 2005.[54] Most interesting for this chapter is the fact that, in these cases, Chinese courts on their own reasoned their way to the derivative action in order to provide plaintiffs with a remedy. As the report of the *Xiamen Xinda 1997* case stated,

> If the infringement suffered by the shareholder is to the rights of the company, then the shareholder should first present a written application to the organ of power of the company requesting that the company take action or bring litigation against the party inflicting the harm and pursue its legal liability. Where the company does not take any action, the shareholder may in its stead bring a lawsuit.[55]

Alternatively, as the opinion in the *Unknown Beijing Parties 2001* case reasoned,

Case/displaycontent.asp?Gid=117674614) [*Kunming Kangpaili Technology 2009*]; but see, *contra*, *Beijing Golden Century 2009*; and *Shi Jianjun* v. *Qian Guoli, Qian Guojun, Zhou Guojin, Xu Xuejun, Zheng Dongsheng, and Shi Huifang re: Huangshan Municipal Fenghua Real Estate Development Company Limited*, Huangshan Municipal Intermediate People's Court (2004), *huang zhong fa min er chu zi* no. 21; and, after remand (2005), *huang zhong fa min er chu zi* no. 24; on appeal Anhui Provincial Higher People's Court (2009), *wan min er zhong zi* no. 0163 (available at http://www.vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117684487) [*Huangshan Fenghua Real Estate 2009*].

54 See the *Shanghai Yanzhong Water Company 1996–7* case, as described by J. Deng, 'Building an investor-friendly shareholder derivative lawsuit system in China' (2005), *Harvard International Law Journal* 46, 2: 347–85, 366–7 [*Shanghai Yanzhong Water Company 1996–7*]; the *Xiamen Xinda* 1997 case, as described by Z. Xie and M. Chen, '*Gudong paisheng susong zai sikao*' ['Rethinking shareholder derivative suits'] (2001), *Fujian zhengfa guanli ganbu xueyuan xuebao* [*Journal of the Fujian Political-Legal Administrative Cadre Institute*] 2001, 4: 24–7, 24 [*Xiamen Xinda 1997*]; the *Beijing Taishan* 2000 case, as described by R. Zhang and L. Wang, '*Ben an gudong shifou you quan chongdang yuangao daibiao gongsi tiqi susong*' ['Does the shareholder in this case have the right to take the role of plaintiff and bring suit on behalf of the company?'] (2004), *Renmin fayuan wang* [People's Court Net], 31 May www.chinacourt.org/public/detail.php?id=117915 [*Beijing Taishan 2000*]; a case reproduced by Beijing no. 1 Intermediate People's Court (no. 4 Civil Division) (ed.), *Gongsifa shenpan shiwu dianxing anli pingxi* [*Company Law Hearing Guide: Critique and Analysis of Representative Cases*] (2005), Beijing: Zhongguo jianchayuan chubanshe [China Procuratorate Press]: 359–70 [*Unknown Beijing Parties 2001*], trans. N. Howson, 'The doctrine that dared not speak its name: Anglo-American fiduciary duties in China's 2005 Company Law and case law intimations of prior convergence', in H. Kanda *et al.* (eds.), *Transforming Corporate Governance in East Asia* (2008), London: Routledge: 193–254; *Huangshan Fenghua Real Estate 2009*; and *Beijing Taiqun Technology 2006*.

55 See Xie and Chen ('Rethinking'), 24.

> In the present case, because [defendant A] is the chairman of the board of directors of the company and because by law and under the company's articles of association he convenes the board meeting and presides over it, he should be responsible for calling a board meeting so that the board can make resolutions regarding major issues that arise in the course of company operations. [Plaintiff] believes that board chairman [defendant A] and general manager [defendant B] have taken actions which injure the interests of the company. In this situation, there is no way that [defendant A], as a conflicted party, will convene a board meeting to address his own actions, just as there is no way he can represent the company in bringing litigation [against himself]. Thus, [the plaintiff], as a shareholder of the company, has the ability to represent the company in appropriate litigation, with the goal behind the litigation being to protect the lawful rights and interests of the company and its [other] shareholders.[56]

Perhaps most importantly, the Supreme People's Court itself implicitly affirmed a derivative action before 2006 – and in an actual case decision,[57] not in an 'approving response' like the 1994 instruction engendered by the *Zhangjiagang Fiber Company 1994* case. In affirming a lower-court judgment allowing a derivative-type action, on 18 December 2005 the SPC also implicitly affirmed the viability of derivative pleadings in the Chinese courts.[58]

b Widely held companies

Almost all the successful cases involving derivative pleadings from before 2006 involve close corporations – usually LLCs. There is evidence,

56 See *Unknown Beijing Parties 2001*, 362–3. The (unidentified) second-instance court hearing the appeal, and even the Beijing intermediate court judge commenting on the case, do not take issue with this derivative claim apparently constructed out of whole cloth.

57 See *China Zhongqi Futures 2004–6*.

58 This was only after the promulgation of the new (2006) Company Law form, however, including article 152, which would become effective just thirteen days later. The lawyers representing the plaintiffs note wryly that the Beijing Higher People's Court rendered its judgment without once invoking the idea of, or legal basis for, 'derivative' or 'shareholders' representative' actions, and seemed to accept without comment the idea that these shareholders are allowed to plead a cause of action on behalf of the corporation they are invested in. See J. Zhao and G. Wu, *Zhongguo lüshi ban'an quancheng shilu: gudong daibiao susong* [*Complete Record of Case Handling for Chinese Lawyers: Shareholder Representative Suits*] (2007), Beijing: Falü chubanshe, 274.

however, that Chinese courts accepted at least a few derivative cases involving CLSs, and even publicly listed companies.[59]

A remarkable pre-2006 case involving a CLS[60] indicates some of the stakes involved in CLS-related cases, publicly listed or not. The case arose from the promotion of a CLS just as China's 1994 Company Law went into effect, and the receipt – on trust – by a company run by the Shaoxing County government of 35 million yuan from more than 160 public investors for the capitalization of a future CLS, in which the trustee was to also be a 30 per cent shareholder. The trustee company never forwarded the funds to the CLS after it had been established, and so upon liquidation the public shareholders sued the trustee company on behalf of the CLS. The case and the resulting opinion are remarkable because of the politically powerful parties involved as defendants, the pleading of the Shaoxing County government as a named defendant on what resembles a piercing theory to be jointly and severally liable with its alter ego, the acceptance of a case involving a widely held CLS (and almost 170 irate investors), and the sophisticated reasoning that permits a shareholder derivative action despite the lack of statutory basis for it at the time. As the judges in the case state:

> [A]lthough the party directly harmed by inappropriate action by the controlling shareholder is the company, it is extremely difficult for the company to defend its rights in its own name when it is under the control of the party acting inappropriately. [...] We do not agree with [the defendants'] responsive assertion that the plaintiff has no power to represent the company to bring the litigation. [...] To protect the rights and interest of the company, the listing of the [company] as a third party in this case is not in violation of Article 56 of the PRC Civil Procedure Law.[61]

This kind of case, involving a widely held CLS with a large number of shareholders as plaintiffs and with government-controlled corporate entities and government departments as defendants, will remain very

[59] See *Zhejiang Wu Fang Zhai 2001*; *Li Kai* v. *Henan Lianhua MSG Co., Ltd and Lianhua Group Company*, Daqing Municipal Ranghu Road Basic People's Court (2004), reported in *Shanghai Zhengquanbao* [*Shanghai Securities Daily*] (2004), 7 July [*Henan Lianhua MSG 2004*]; and *Shanghai Yaoguo Energy Science and Technology Company Limited* v. *Gao Baoquan re: Shanghai Lujiazui United Real Estate Company Limited*, Shanghai no. 1 Intermediate People's Court (2005), *hu yi zhong min san (shang) chuzi* no. 26; on appeal Shanghai Higher People's Court (2005), *hu gao min er (shang) zhongzi* no. 188 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117518355) [*Shanghai Lujiazui 2005*].

[60] See *Zhejiang Golden Bridge CLS 2003*.

[61] *Zhejiang Golden Bridge CLS 2003*.

rare even after an unambiguous statutory basis is provided in the 2006 Company Law.

IV The 2006 Company Law and statutory authorization for derivative actions

The derivative lawsuit mechanism authorized in article 152 of the 2006 Company Law is distinct from the derivative action received from the Anglo-American or Continental traditions, including the systems in place for the Republic of China (Taiwan) and Japan.

Article 152's rule cannot be stated simply, because it makes several distinctions not found in the systems of other countries. First, the procedural rules distinguish between LLCs and CLSs. Second, the substantive claims that may be brought on behalf of the company allow claims against both (1) traditional corporate fiduciaries (directors, officers and supervisors) and (2) what are called 'others', which includes controlling shareholders and third parties (with the basis of the underlying claims against each also differing slightly).

The rule may be summarized as follows.

(1) *Defendants and associated causes of actions*. Initiating shareholders may bring a derivative lawsuit against (i) directors, supervisory board members or senior management who have violated law (*falü*), administrative regulations (*xingzheng fagui*)[62] or company articles of association in the course of performing company duties, thereby causing damage to the company (*gei gongsi zaocheng sunshi*), and (ii) 'others' who violate the company's lawful rights and interests, thereby causing damage to the company.

(2) *Standing*. In CLSs, initiating plaintiffs must collectively satisfy a 1 per cent shareholding requirement and must have held their shares for 180 days. There are no comparable requirements for plaintiffs in LLCs.

(3) *Demand requirements*. Before bringing an action against directors or senior management, shareholders must first make a written demand

[62] In this context, 'law' and 'administrative regulations' are terms of art, referring respectively to norms promulgated by (1) the National People's Congress or its Standing Committee, and (2) the State Council. Regulations issued by central government ministries, for example, would not count as 'administrative regulations' (*xingzheng fagui*). See P. Keller, 'Sources of order in Chinese law' (1994), *American Journal of Comparative Law* 42, 4: 711–59.

on the board of supervisors (or individual supervisors in case there is no supervisory board). Before bringing an action against supervisors, shareholders must first make a demand on the board of directors (or the executive director where there is no board of directors). The plaintiff may proceed with the suit if (i) the demand is rejected, (ii) the demand is not acted upon within thirty days or (iii) the company would suffer irreparable damage if the suit could not proceed immediately.

We discuss each element of the rule in more detail below, but first note the following two contextual points about other new parts of the Company Law introduced in 2006. First, this new action in law must be distinguished from a separate cause of action – similar in philosophy to direct actions under the 1994 Company Law and the 1999 Securities Law – accruing directly to shareholders for unlawful acts by directors or senior management (but not supervisory board members) that 'damage the interests of shareholders' (*sunhai gudong liyi*).[63] Second, aside from the innovative derivative action embodied in article 152, the 2006 Company Law is noteworthy for its expanded list of permitted claims against directors, senior management and supervisory board members, as well as compensation obligations directed to the company as a potential beneficiary, including: a breach of the duty of care and duty of loyalty;[64] compensation for corporate losses arising from board action that is in violation of law, administrative regulation, the company articles of association, or shareholders' resolutions (except when a director has affirmatively dissented);[65] the restitution of ill-gotten gains arising from specific duty of loyalty breaches;[66] and compensation for losses arising from related-party transactions (apparently whether or not disclosed and approved).[67] The derivative action added in 2006 is thus, at least potentially, the procedural vehicle for a much-expanded roster of substantive claims.

1 *Standing*

As noted above, there are special standing requirements for shareholders of CLSs. First, they must have held their shares for at least 180

[63] 2006 Company Law, *Zhonghua renmin gongheguo gongsi fa* [Company Law of the People's Republic of China], effective 1 January 2006 (available at www.law-lib.com/law/law_view1.asp?id=102906), art. 153.
[64] 2006 Company Law, art. 148. [65] 2006 Company Law, art. 113.
[66] 2006 Company Law, art. 149 (final para.). [67] 2006 Company Law, art. 21.

consecutive days. The statute does not stipulate that the shareholders bringing the demand must have been shareholders at the time the cause of action arose and thus rejects the first prong of the US-origin 'contemporary ownership rule'.[68] It seems unlikely that the failure to specify the first prong of the COR is an oversight; the 2003 Omnibus Regulation made this rule explicit, showing that experts were aware of the issue.[69] An alternative rule proposed in the 2003 Omnibus Regulation – that the six-month holding period be satisfied before the cause of action arises – was also rejected, making the promulgated article 152's rule the least burdensome on plaintiffs of those that were apparently under serious consideration.

Interestingly, article 152 does not explicitly state that those initiating the suit must be shareholders at the time of making the demand, although it would strain the statutory language to read it any other way: after all, it states that 'shareholders' must make the demand. It seems fairly clear, then, that those initiating the suit have to be shareholders when they bring the suit to court; it is a basic rule of Chinese civil procedure that plaintiffs must have a direct interest in the matter to be litigated, and it is hard to see what the interest of non-shareholders (other than corporate creditors, of course) could be in a corporate recovery. The first regulations issued by the Supreme People's Court on the 2006 Company Law also suggests (albeit with less than perfect clarity) that the holding period (discussed below) needs to extend to the date that the lawsuit is brought.[70] In no case that we have reviewed for this chapter is the initiating plaintiff *not* a shareholder at the time of the lawsuit.

Other civil law systems tend to require that a shareholder seeking to initiate a derivative lawsuit (1) be a shareholder at the time of demand, and (2) have been a shareholder for a set period of time previously, ignoring the question of whether the demanding party was a shareholder at the time the cause of action arose. For example, the Japanese Company Law requires only that the demanding party have been a shareholder for

[68] See Delaware General Corporation Law, sect. 327.
[69] See Omnibus Regulation, art. 44.
[70] See Supreme People's Court, *Zuigao renmin fayuan guanyu shiyong 'Zhonghua Renmin Gongheguo Gongsi Fa' ruogan wenti de guiding (1)'* ['Provisions of the Supreme People's Court about several issues concerning the application of the Company Law of the People's Republic of China (1)], effective 9 May 2006 (available at www.law-lib.com/law/law_view.asp?id=158579) [First Company Law Regulations].

six months prior to the demand; in Germany the period is three months, and in Taiwan it is one year.

The second standing requirement for shareholders in CLSs is that they must collectively own at least 1 per cent of the CLS's outstanding shares. There is no ownership threshold for LLC shareholders. As with the holding period requirement, article 152's approach is more plaintiff-friendly than the 2003 Omnibus Regulation, which duplicated the requirement for CLS shareholders but imposed a 10 per cent requirement for LLC shareholders. By comparison, US state and Japanese corporate law systems do not stipulate a minimum percentage of holdings before a demand may be made, although some US states allow courts to order the posting of a bond before the demand is made if the shareholding percentage (or value) is deemed too low. Civil law systems do generally stipulate minimum shareholder percentages – for example, 10 per cent in Germany and 5 per cent in France. Influential adjacent systems, such as Taiwan and South Korea, also provide for minimums: 1 per cent and 5 per cent, respectively. As we note in this chapter, the minimum shareholding requirement for CLSs threatened to defeat at least one high-profile derivative action attempted after the coming into force of the 2006 Company Law.[71]

2 *Demand*

The 2006 Company Law explicitly requires that a demand be made in writing to the appropriate body. This requirement is a nod to the principle of the exhaustion of intra-corporate remedies – a concept we see raised frequently in Chinese pleadings and opinions. In reality, however, intra-corporate remedies seem irrelevant; the only thing that can stop the plaintiff from bringing suit is the corporation's bringing suit itself. Unlike many other derivative lawsuit mechanisms internationally, there is no room for the corporation to argue that a lawsuit would not be in the corporation's interests, or that it has obtained adequate non-litigious remedies for the wrongdoing.

71 This is the *Sanlian Shangshe 2009* case, which was finally accepted by the Shandong Higher People's Court in December 2009. The case is described in '*ST Sanlian shangshe xiao gudong susong sanlian jituan qinquan zhengshi lian*' ['ST Sanlian Shangshe minority shareholder suit against Sanlian Group for infringement is formally docketed'] (2009), Qianlongwang [Thousand Dragons Net], 16 December, http://qy.qianlong.com/7440/2009/12/16/4722@5353758.htm.

Although article 152 improves on the 2003 Omnibus Regulation formulation by generally specifying on whom demand has to be made,[72] it does not specify on whom demand should be made when seeking corporate action not against traditional fiduciaries but against non-insider 'others'. One PRC writer opines that, in such cases, demand should be made first on the legal representative, then on the board of directors and finally on the board of supervisors, in each case waiting thirty days for a response.[73] We see this view vindicated in one case.[74] In general practice, however, it seems that courts have not been so demanding when faced with cases involving derivative claims against 'others'.[75]

Finally, we note that, read closely, the part of article 152 that declares the 'plaintiff may proceed with the suit if . . . the company would suffer irreparable damage if the suit could not proceed immediately' does not appear to mean that demand may be excused (although that may have been intended). As worded, the statute requires demand to be made even in such urgent situations; what it allows to be waived is the waiting period. This strict interpretation does not seem to be how the Chinese courts normally understand the provision, however, as they regularly permit demand waiver in 'urgent' or 'emergency' circumstances.

3 *Defendants and associated causes of action*

One of the very important – and relatively unusual – aspects of the Chinese derivative action is that article 152 divides potential defendants into two classes: insiders (directors, senior managers, and supervisors) and 'others' (*taren*), with the cause of action stated differently for each class. This additional prong (corporate action against 'others') is aimed at two situations: (1) when a third party (but very often a related party) has injured the corporation and conflicted corporate directors or the legal representative will not pursue remedies against the third party; and (2) when controlling shareholders abuse the corporate form to disadvantage or oppress minority shareholders in the company as understood under article 20(2) of the 2006

72 See Omnibus Regulation, art. 45.

73 See X. Lu, '*Mantan woguo xin "Gongfsi Fa" gudong daibiao susong qianzhi chengxu*' ['Discussion of the precondition procedure for the shareholders' representative lawsuit in China's new "Company Law"'] (2007), *Caijingjie* [*Financial World*] July: 231–2, 232.

74 See *Tonghe Investment 2009* (demand on the board of directors is adequate).

75 See *Huangshan Fenghua Real Estate 2009* (demand is excused because the company is already in liquidation) and *Beijing Golden Century 2009* (article 152 is invoked with no mention whatsoever of the demand requirement).

Company Law.[76] Thus, as of 2006, China permits derivative actions in the limited 'vertical' sense (company versus corporate fiduciaries) and the 'horizontal' sense (company versus controlling shareholders for oppression or breach of controlling shareholders' fiduciary duties). As noted in the introduction to this chapter, given the capital structures and dysfunctions resulting from China's corporatization programme, this ability to use the derivative lawsuit against controlling shareholders for a remedy against oppression makes very good sense. This inclusion of third parties is a significant expansion of the scope of possible defendants when compared with Taiwan's Company Law[77] and the Japanese Company Law.[78] It remains unclear, however, why the 2006 Company Law drafters did not choose a unified cause of action for traditional insiders and for 'others'. Pursuant to article 152, insiders may be sued when they have damaged the company through breaches of law, administrative regulations, or the company's articles of association in the course of performing company duties ('cause 1'); others may be sued when they have damaged the company by violating its lawful rights and interests ('cause 2'). If cause 2 reaches acts not covered by cause 1, why should insiders be exempt from it? The structure of article 152 suggests, however, that they are not intended to be co-extensive.

There is ample evidence in our sample of the derivative lawsuit being used to go against 'others' – both contracting parties with the injured company[79]

[76] 'Where a company shareholder abuses its shareholder rights and causes losses to the company or the other shareholders, it shall be liable for compensation according to law.' This is the equivalent of the Anglo-American common law actions for breach of (shareholders') fiduciary duties and 'oppression'. Articles 20(1) & (3) of the 2006 Company Law also provide the basis for a traditional veil-piercing claim in which the claimants are third-party creditors of the corporation.

[77] Taiwan Company Law, art. 214; defendants are limited to 'directors' only.

[78] The scope of defendants is limited to promoters, directors, supervisors, senior management, and liquidation committee members; Japanese Company Law, art. 847(1).

[79] See *China Zhongqi Futures 2004–6*; *Chongqing Coal Mine 2006*; *Pinghai Development Company Limited* v. *Shanghai Zhongxing Group Zhencheng Real Estate Company Limited re: Shanghai Decheng Real Estate Company Limited*, Shanghai no.1 Intermediate People's Court (2005), *hu yi zhong min wu (shang) chu zi* no. 127; on appeal Shanghai Higher People's Court (2006), *hu gao min si zi* no. 55 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117578353) [*Shanghai Decheng Real Estate One 2006*]; *Pinghai Development Company Limited* v. *Shanghai Municipal Pan-Asia Law Firm and Zhongxing Group Zhencheng Real Estate Company Limited re: Shanghai Decheng Real Estate Company Limited*, Shanghai no.1 Intermediate People's Court (2005), *hu yi zhong min wu (shang) chu zi* no. 122; on appeal Shanghai Higher People's Court (2006), *hu gao min si zi* no. 58 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117541209) [*Shanghai Decheng Real Estate Three 2006*]; *(U.S.A.) Enbi Group Yuanji Yanghang* v. *Shanghai Cooperative Investment Company Limited and Zhou Zuyuan re: Shanghai Yuanji International Trade Company Limited*, Shanghai no. 2 Intermediate People's Court (2006), *hu er zhong min wu (shang) chu zi* no. 2 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117613479) [*Shanghai Yuanji International 2006*]; *Wu Yongjian* v. *Xu Wenxing and Zhu Yuxiang re: Beijing Puren Hospital Administration Company Limited*, Beijing Municipal Shunyi District Basic-Level People's Court (2009), *shun min chu zi* no. 1065; on appeal Beijing no. 2 Intermediate People's Court (2009), *er zhong min zhong zi* no. 11811 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117625069) [*Beijing Puren Hospital 2009*]; and *Tonghe Investment 2009*.

and controlling shareholders.[80] Some cases – such as *Shanghai Yuanji International 2006*, *Shanghai Taiwu Real Estate 2008* and *Beijing Puren Hospital 2009* – contain mixed claims, with third-party (but often related-party) or controlling shareholder defendants as well as defendants who are traditional fiduciaries. In these cases, Chinese courts seem less sensitive to the differences in the required breaches and damages.

V The reality of derivative actions in the PRC from 1 January 2006 to date

Since 1 January 2006, and with the new derivative action mechanism in place, Chinese courts at all levels have accepted derivative pleadings and rendered judgments on them.

1 *Absence of CLS or publicly listed CLS-related cases*

Derivative suits involving CLSs, listed or unlisted, are striking by their virtually complete absence.[81] This is a tragedy of sorts, as the derivative

[80] See *Zhejiang Golden Bridge CLS 2003* (public shareholder suit against a controlling 30 percent government-backed shareholder); *Henan Lianhua MSG 2004* (minority shareholder suit against controlling shareholder of a publicly listed company); *Pinghai Development Company Limited* v. *Shanghai Zhongxing Group Zhencheng Real Estate Company Limited re: Shanghai Decheng Real Estate Company Limited*, Shanghai Higher People's Court (2005), *hu gao min si (shang) chu zi* no. 1 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117578346) [*Shanghai Decheng Real Estate Two 2005*] (suit against a 50 per cent Chinese–foreign joint venture partner to make it comply with its capitalization obligations); *Shanghai Peieryou 2006* (suit by a 49 per cent shareholder against a 51 per cent corporate shareholder that has deprived the company of a corporate opportunity); *Shanghai Taiwu Real Estate 2008* (20 per cent shareholder-cum-supervisor sues two other shareholders holding 54 per cent of the equity in a three-person LLC); and *Beijing Puren Hospital 2009* (defendant is a 90 per cent shareholder).

[81] For the period prior to 1 January 2006 we found only a few cases; see notes 59–61 above and accompanying text. After 2006 we found only a few cases involving an *unlisted* CLS or large numbers of shareholders in an LLC; see, for example, *Li Xiaozhong and 28 other shareholders* v. *Xiao Wuyong & Zhang Dingzhong re: Nanchuan Municipal Hardware*

action was written into the 2006 Company Law precisely to give minority shareholders in widely held CLSs a way to bring claims against corporate fiduciaries, controlling shareholders, and third party obligors seemingly immune from performance or enforcement by related-party-dominated companies.

The only example we have found in the post-2006 period of a case involving a listed CLS is one that is still sub judice.[82] Plaintiffs are attempting to sue derivatively on behalf of Sanlian Shangshe Company, Ltd, against the former controlling shareholder of that listed company, Sanlian Group. We feel relatively certain that this is the only listed CLS-related case in the PRC courts as of January 2010, because it is noted as such in the 21 January 2010 brief/request (filed by the defendant) for transfer of the case away from the Shandong Higher People's Court to the Supreme People's Court in Beijing. The request states, '[T]his case is the first shareholders' representative suit [regarding] a listed company in China's capital markets[.]'[83]

Infrastructure Electric Chemical Industry Company Limited, Chongqing Nanchuan City Basic-Level People's Court (2006), *nanchuan fa min chuzi* no. 538 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117484117 and www.siaaa.com/falvanliku/gongsixiangguan/200910/386516_2.html) [*Nanchuan Chemical Industry 2006*] (twenty-eight shareholders); *Dong Fengchang* v. *Fang Yishu re: Shanghai Zhongjian Enterprise Company Limited*, Shanghai Hongkou District Basic-Level People's Court, no. 2 Civil Division, case filed 26 September 2008, case opinion not reviewed, but report by Judge Luo Jianhao of the Hongkou District Basic-Level People's Court, 26 February 2009 (available at http://www.legaldaily.com.cn/zmbm/content/2009-02/26/content_1043325.htm) [*Shanghai Zhongjian Enterprise 2008*] (forty shareholders); and *Zhu Yongjun and 20 other shareholder plaintiffs* v. *Liu Huanren, Zhu Yongjun and Ma Zhonghua re: Shizuishan Municipal Hengyuan Metals Collection Company Limited*, Shizuishan Municipal Wukou District Basic-Level People's Court (2008), *shi da min zhu zi* no. 1008; on appeal Ningxia Hui Minority Autonomous Region Shizuishan Municipal Intermediate People's Court (2009), *shi min zhong zi* no. 25 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117633588) [*Shizuishan Hengyuan 2009*] (twenty-one shareholders). Of course, these latter cases do not rise to the level of truly public companies owned by thousands of shareholders.

82 See *Sanlian Shangshe 2009*. This case was accepted by the Shandong Higher People's Court on 11 December 2009 (after a large minority shareholder and one independent director were able to persuade 1.56 per cent of the listed company's shareholders to join the action).

83 See Zhongguo zhengquan wang [China Securities Net], '*Daiwei susong: xiao gudong zhi sanlian jituan an muqian reng zai jinxingzhong*' ['Substitute lawsuit: minority shareholder's case against Sanlian Group presently still proceeding'] (2010), Zhongguo zhengquan wang, 15 March (available at www.p5w.net/stock/news/gsxw/201003/t2866796.htm).

There are several possible reasons of varying plausibility for this absence of CLS-related cases. First, it is possible that CLSs are on the whole better managed and do not see the same kind of abuses that give rise to the LLC cases. We find this explanation implausible, and not even remotely supported by the data issuing forth from the CSRC and its enforcement division. Even if it were largely true, it could not account for the almost complete absence of CLS-related cases. Second, it is possible that the various obstacles to litigation and transaction costs that we have described above weigh especially heavily on prospective plaintiffs in CLS-related derivative suits. This explanation has much more plausibility. The formal law is tougher on plaintiffs in CLS-related suits, and the practical barriers are also higher, in the sense that the cost–benefit analysis for a small shareholder in a CLS is much less likely to be favourable than for a large minority shareholder in an LLC or a closely held CLS. Nevertheless, this reasoning is also wanting as an explanation for the near-total absence of CLS-related suits. Occasionally, surely, there could have been holders of large minority stakes in a CLS who wished to bring a derivative suit (as there is in the *Sanlian Shangshe 2009* case). A third possible explanation is that for some reason CLS-related derivative suits are being settled invisibly to us, in the shadow of the law, as it were, either after filing (case filings are not reported nearly so well as case judgments) or even without any filing at all. As with the second explanation, however, this one does not help us understand why CLS-related suits should be so utterly absent from our sample. We cannot think of any reasons why CLS-related suits should settle disproportionately early, relative to LLC-related suits, unless perhaps the courts have a different attitude to them. Moreover, we surmise that settlement is probably easier in the close corporation context, in which all the litigants have better information, as contrasted with the information deficit traditionally experienced by small shareholders in widely held companies.

We are thus led to a fourth explanation: that courts do not accept CLS-related shareholder litigation, whether on their own initiative or by instruction from superior levels of the judicial bureaucracy. One of us has noted how the Chinese courts, on their own, will essentially stop accepting politically or technically complex cases.[84] We have set forth above certain well-known instructions from the Chinese court

84 See Howson ('Corporate law'), 332–3, 404 (regarding the nationwide refusal to accept or adjudicate cases seeking the enforcement of bank non-performing loans transferred to asset management companies and then sold (at a discount) to commercial buyers).

bureaucracy inhibiting or forbidding the acceptance or adjudication of cases involving large numbers of plaintiffs. One of us has described elsewhere specific *public* instructions delivered to local-level courts commanding them not to accept certain kinds of public company corporate law cases (in one case, shareholder actions to invalidate shareholder meeting resolutions at publicly listed companies),[85] and an *internal* instruction forbidding the acceptance of all listed CLS-related cases.[86] We have both speculated elsewhere as to the reasons for this rejectionist stance or these prohibitions from on high, and noted above the keen hostility to judicial proceedings involving many parties. Suffice it to say here that the lack of derivative lawsuits involving CLSs is a starkly evident fact.

2 *'Straddling' actions: 2006 Company Law application to pre-2006 transactions*

As noted above, the First Company Law Regulations issued by the Supreme People's Court allowed judges to apply new rights from the 2006 Company Law in cases involving transactions that had occurred before it came into effect. In our sample, when the facts occur before 2006, there is not one court that rejects the subsequent derivative pleadings simply on those grounds. Indeed, most such cases permit the derivative suit explicitly 'with reference to' the 2006 statute.[87]

85 Howson ('Corporate law'), 406 (allegedly to deter 'vexatious shareholder litigation').

86 Howson ('Corporate law'), 405 (disclosed to one of the authors by the president of one of Shanghai's busiest and most expert basic-level people's courts).

87 See the following cases: *Jiangyin Municipal Shunxing Chemical Industry Machinery Company Limited* v. *Lin Zhen [Lim Chin]and Lin Jingzhi re: Jiangyin Xingyi Particle Chemical Industry Company Limited*, Jiangsu Province Wuxi Muncipality Intermediate People's Court (2005), *xi min san chu zi* no. 0016–2 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117531198) [*Jiangyin Xinghua 2005*]; *Zhang Xinlong* v. *Lu Yiming re: Shanghai Shixing Real Estate Development Operations Company Limited*, Shanghai no. 2 Intermediate People's Court (2005), *hu er zhong minsan (shang) chuzi* no. 403 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117613635) [*Shanghai Shixing Real Estate 2005*]; *Lin Yu* v. *Aeronautical New Concept Science and Technology re: Beijing Aeronautical Chengshitong Smart Card Engineering Company Limited*, Beijing Municipal Haidian District Basic-Level People's Court (2006), *hai min chuzi* no. 08927 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117529283) [*Beijing Aeronautical 2006*]; *Beijing Taiqun Technology 2006*; *Chongqing Coal Mine 2006*; *Lin Xiangyang, Lin Luqiang & Lin Xiongjie* v. *Lin Yijun, Guangzhou Municipal Lan An Glass Company Limited & Jia Baozhen re: Guangzhou Lan An Glass Company Limited*, Guangzhou Municipal Tianhe District Basic-Level People's Court (2005), *tian fa min er zi* no. 2493; on appeal Guangdong Province Guangzhou Intermediate People's Court (2006), *sui zhong fa min san zhongzi* no. 1 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117524964) [*Guangzhou Glass 2006*]; *Fujian Yatong New Materials Science and Technology Co., Ltd* v. *Liu Daomin, Huang Shanshan & Shenyang Fugu New Materials Pipes Company Limited re: Liaoning Baotong New Materials Science and Technology Company Limited*, Liaoning Provincial Shenyang Municipal Intermediate People's Court (2006), *shen zhong min si quan chu zi* no. 1 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117541366) [*Liaoning Baotong Materials 2006*]; *Nanchuan Chemical Industry 2006*; *Shanghai Decheng Real Estate One 2006*; *Shanghai Decheng Real Estate Two 2005*; *Shanghai Decheng Real Estate Three 2006*; *Shanghai Peieryou 2006*; *Shanghai Yuanji International 2006*; *Shanghai Taiwu Real Estate 2008*; *Shunde Zhaoyu Electronic Hardware 2007*; *Jinja Investments Pte. Ltd* v. *Zong Qinghou re: Hangzhou Wahaha Beverages Company Limited*, Xinjiang Production and Construction Corps, no. 8 Agricultural Division Intermediate People's Court (2007), *bing ba min yi chu zi* no. 17 [*Hangzhou Wahaha 2007*]; *Jiang Zhiling and Jiang Zhijun* v. *Shen Lusui re: Beijing Weishite Development Consulting Company Limited*, Beijing no. 2 Intermediate People's Court (2009), *er zhong min chu zi* no. 09350 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117625007) [*Beijing Weishite 2009*]; and *Huangshan Fenghua Real Estate 2009*. There are only two slight deviations from this pattern: see *China Zhongqi Futures 2004–6* (May 2006 affirmation of pre-2006 lower-court judgment, but not referencing 2006 Company Law) and *Guangzhou Tianhe Scitech 2003* (November 2006 judgment in case brought in 2003, but not referencing 2006 Company Law).

3 *Avoidance of derivative pleadings*

Several cases in our sample show judicial competence, but also an excessively technical reading of article 152 that allows the courts involved to avoid the bother of implementing the derivative action. Judicial practice is certainly not uniform in this regard, as shown by the sometimes equally aggressive acceptance of derivative pleadings described in the next section.

For instance, the *Shunde Zhaoyu Electronic Hardware 2007* case saw a derivative action on a 'straddling' claim permitted by a basic-level court overturned by the intermediate-level court on appeal and re-hearing, because the initiating shareholder did not make a demand strictly in accordance with article 152. The court may have noticed that the complaining shareholder was also the legal representative, and thus had the power to act *for the company* in bringing suit. Nonetheless, we see the same denials of derivative lawsuits, even with apparently strong underlying claims, because of the failure to 'undertake legally stipulated procedures' (conforming demand) from courts around the country.[88]

88 See *Shizuishan Hengyuan 2009*; *Kunming Kangpaili Technology 2009*; *Beijing Glory Project 2009*; *Beijing Weishite 2009*; *Beijing Dingyu Cable 2008*; *Shanghai Peieryou 2006*; and *Shanghai Tianguang Medical 2009*.

Beijing Dingyu Cable 2008 demonstrates a very unforgiving reading of the demand requirement, rejecting a derivative lawsuit for a failure to make a proper demand even though there was no corporate organ or actor in existence that could have received the demand.

We distinguish these highly technical and prohibitive adjudications of derivative claims from other cases that deny the derivative lawsuit on better grounds. In the *Kunming Kangpaili 2009* case, for example, both the Kunming Wuhua District Basic-Level People's Court and the Kunming Intermediate People's Court block derivative pleadings with strong underlying substantive claims against a shareholder/legal representative of an LLC because the initiating parties are so-called 'hidden shareholders' (*yinming gudong*): contributors of capital to the LLC, but not registered as such in public documents. Both Kunming courts decline to rule that a private document reciting true shareholding interests should trump the publicly registered shareholding interests, and find that, even if the initiating plaintiffs are deemed 'shareholders' in law, they have not met the demand requirements of article 152. This outcome seems reasonable, if only to make commercial actors in China take public documents more seriously and to assert the primacy of filing and procedural requirements under law.

In the *Shanghai Tianguang 2009* case, the Shanghai Higher People's Court properly upholds a lower court dismissal of derivative pleadings for demand failure (called a 'procedural defect' and a 'failure to exhaust internal remedies') but still allows plaintiffs a direct action against co-shareholders (in substance, partners). This also seems a justified redirection of derivative pleadings on behalf of the company to a more doctrinally appropriate arena.

4 *Autonomy and acceptance*

Although some courts have used technical readings of the law to avoid taking derivative suits, others have gone out of their way to welcome them.

The 'straddling' *Beijing Aeronautical 2006* case – responding to a shareholder's suit regarding a 35 per cent shareholder-controlled LLC that had already entered liquidation – shows a remarkably aggressive use of the derivative lawsuit. Unlike *Beijing Dingyu Cable 2008*, this case allows the suit even though there exists no corporate body that can receive the demand.[89] Moreover, the court allows the derivative action to defeat a statute of limitations defence: the alleged defaults occurred between 1999 and 2002 and the case was initially accepted in 2004. The court held boldly that, because the derivative claim was not even available until 1 January 2006, the two-year limitation period did not lapse until 1 January 2008.

In *Tonghe Investment 2009*, the Zhejiang Higher People's Court permitted the derivative lawsuit to go forward notwithstanding a possible technical defect in the related demand and refusal: when the defendant was an 'other' (i.e., not an insider) demand was made on, and refusal issued in writing by, the board of directors, not the supervisory board. As we note above, the 2006 Company Law is unclear in such cases as to where demand is to be made. A more cautious court might have used the failure to make demand on the supervisory board specifically as grounds for rejecting the suit. The same tolerant approach to the precise addressee of the demand may be seen in *Beijing Puren Hospital 2009*, a complex related-party 'borrowings' case, in which demand served on the legal representative of the looted company was deemed sufficient to let the action proceed.

In *Henan Golden Mango Property 2009*,[90] the first- and second-instance courts allowed a derivative action to proceed even though the complaining shareholder had not formally served demand on the company that it sue a construction contractor. Both courts noted that originally the company *had* sued on the contract, but had later withdrawn its action. This, said the second-instance court, 'may be seen as a refusal to bring the action' (*ke shiwei jujue tiqi susong*).

Courts have also liberally used the notion of urgent circumstances (article 152 collapses the thirty-day waiting period when 'the company would suffer irreparable damage if the suit could not proceed immediately') effectively to excuse the demand requirement and to bring otherwise non-conforming actions into court.[91]

89 Courts allowed derivative suits in similar circumstances in *Kokō Shōkai Kabushiki Gaisha* v. *Yao Renjun, Shanghai Municipal Fengxian Laofang Products Factory, and Shanghai Fengxian District Nanqiao Township Agricultural Commercial Cooperative*, Shanghai no. 1 Intermediate People's Court (2008), *hu yi zhong min wu (shang) chu zi* no. 181 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117632788) [*Shanghai Ninghui 2008*]; *Liaoning Baotong Materials 2006*; and *Huangshan Fenghua Real Estate 2009*.

90 *Lu Tong* v. *Henan Longxiang Construction Engineering Company Limited re: Henan Golden Mango Property Company*, Zhengzhou Municipal Guancheng Hui Minority District Basic-Level People's Court (2007), *guan min er chu zi* no. 257; on appeal Henan Provincial Zhengzhou Municipal Intermediate People's Court (2009), *zheng min er zhong zi* no. 718 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117611759) [*Henan Golden Mango Property 2009*].

91 See *Qingdao Municipal Chemical Petroleum Supply Company Limited* v. *Zhang Chun re: Weihai Yinghai Zhiye Development Company Limited*, Weihai Municipal Intermediate

Indeed, in some cases the Chinese courts appear almost excessively lax in accepting derivative pleadings with no real requirements or analysis at all. In the only domestic corporate litigation arising from the highly contentious Danone-Wahaha dispute[92] that went to judgment, the *Hangzhou Wahaha 2007* opinion rendered on 11 December 2007, the court did not even comment on the derivative nature of the pleadings, and yet allowed the case to proceed and made its own determination on the merits.

5 *Technical competence*

PRC judicial officials have shown an impressive level of competence in understanding and implementing the derivative mechanism.[93]

A small number of 'straddling' cases show lower-level courts refusing derivative pleadings before 2006 because there was no legal basis; these denials were then overturned on appeal. The 'straddling' *Chongqing Coal Mine 2006* case exemplifies this. Although the first-instance court denied the derivative suit for its lack of a legal basis, the second-instance court

People's Court (2007), *wei min er wai chu zi* no. 27; on appeal Shandong Provincial Higher People's Court (2008), *lu min si zhong zi* no. 103 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117677965) [*Weihai Yinghai 2008*] (emergency situation); *Beijing Dingyu Cable 2008* (no emergency situation); *Huangshan Fenghua Real Estate 2009* (company is in liquidation, so lack of demand not an issue); *Beijing Golden Century 2009* (company is not able to operate when ousted director, legal representative and general manager will not give up corporate chops and licences, in defiance of unanimous shareholders' resolution); and *Beijing Puren Hospital 2009* (plaintiff shareholder is notified that dominating shareholder and allegedly breaching fiduciary will apply for bankruptcy of the company as a strategic response to the fiduciary lawsuit). See also the published views of a Sichuan Province county-level judge confirming the availability of a direct action without demand in 'emergency circumstances', with H. Peng, '*Konggu gudong sunhai gongsi ji gudong liyi de falü jiuji yu sikao: cong yi gudong daibiao susong kan gongsi ji xiao gudong de falü baohu* ['Legal analysis and remedies regarding controlling shareholder injury to the company and minority shareholders: looking at legal protections for company and minority shareholder rights from a shareholder representative suit'] (2009), China Court, 9 March, www.chinacourt.org/public/detail.php?id=347591.

92 The dispute is described by J. Perkowski, 'Danone/Wahaha: the final chapter' (undated), Managing the Dragon, http://managingthedragon.com/?p=598; and *Forbes*, 'Danone quits Wahaha venture' (2009), *Forbes*, 30 September (available at www.forbes.com/feeds/afx/2009/09/30/afx6949755.html).

93 We do not discuss here the many cases in which the derivative action is implemented without issue, such as the *Shanghai Zhongjian Enterprise 2008* case, in which a mere 2.86 per cent shareholder brings a suit on behalf of the company against a negligent or disloyal legal representative on a loan, and the legal representative is ordered to compensate the company for the loan.

reversed the decision because the 2006 Company Law had since come into effect.

The *Shanghai Kouweier 2008* case[94] sticks closely to the derivative action offered in the 2006 Company Law, rejecting a 'double derivative' lawsuit. The plaintiff was a shareholder in a company that was the sole shareholder of the allegedly damaged entity; the court ruled that he could not bring an action on behalf of a remote subsidiary. Regardless of policy, this is the technically correct solution under article 152, which does not seem to allow for the 'double derivative'/'multiple derivative' action.[95]

There are also several cases applying the derivative lawsuit mechanism of article 152 to foreign-invested enterprise legal persons established under and governed by the separate system of FIE laws and regulations.[96] In no case do we find a Chinese court refusing a derivative lawsuit on the grounds that the relevant entity is an FIE and therefore not governed by the Company Law.

A number of opinions show real technical competence in denying derivative pleadings because the underlying injury is in reality suffered by one partner/shareholder, and not the jointly invested LLC. We see this in *Beijing Jindao Hongping Advertising 2008*, in which the first-instance court (affirmed on appeal) dismisses somewhat spurious derivative pleadings in what is really a dispute between fifty-fifty LLC shareholders, and the company has already entered into liquidation and there is no injury *to the corporation*. The *Beijing Glory Project 2009* case takes much the same line in denying derivative pleadings – formally for a lack of conforming demand on the company, but in our view really because the dispute is between two parties to a real estate development contract in which the money-investing partner sues the party holding the development licence for defection. In each of these cases, and several

94 *Jiang Wenhong* v. *Wu Jinhui and Suzhou Jiaci Clothing and Accessories Company Limited re: Shanghai Kouweier Clothing and Accessories Company Limited*, Shanghai no. 2 Intermediate People's Court (2008), *hu er zhong min wu (shang) chu zi* no. 21 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117622632) [*Shanghai Kouweier 2008*].

95 Other jurisdictions allow for such actions: Australia, New Zealand, Canada and Singapore all allow them by statute, and Hong Kong allows them as a matter of a common law extension of existing derivative suit doctrine.

96 See *Beijing Taiqun Technology 2006*; *Beijing Weishite 2009*; *Liaoning Baotong Materials 2006*; *Shanghai Decheng Real Estate One 2006*; *Shanghai Decheng Real Estate Two 2005*; *Shanghai Decheng Real Estate Three 2006*; *Shanghai Yuanji International 2006*; *Hangzhou Wahaha 2007*; *Shanghai Kouweier 2008*; *Shanghai Ninghui 2008*; and *Weihai Yinghai 2008*.

others in our sample,[97] the Chinese courts effectively channel what are pleaded as *corporate* and thus derivative lawsuits into the more appropriate arena of direct claims *between partners*.

6. *Difficulties regarding underlying substantive claims*

Our research shows that while Chinese courts may increasingly accept derivative pleadings, they can encounter difficulties in adjudicating the underlying substantive claims. Indeed, only rarely do we see really robust application of the underlying substantive claim against a traditional corporate fiduciary. One rare example is the *Beijing Xiangkouxiao Food and Beverage 2009* case,[98] in which a legal representative who had misappropriated corporate revenues was found to have violated the 'duty to properly use company assets' (*zhengdang shiyong gongsi caichan de yiwu*), which was in turn explicitly deemed a part of the 2006 Company Law Article 150 duties.[99]

Far more common are case opinions where Chinese judges fumble or avoid adjudication of the underlying substantive claims. For example, in *Nanchuan Chemical Industry 2006*, the court allowed a derivative lawsuit even though the acts complained of occurred before 2006. But it rejected the underlying substantive claim against some of the defendant directors and officers of the company, reasoning (bizarrely, in our view) that '... even though the other defendants may have been in breach of their duty of care,[100] the breach of that duty and resulting liability to the company [for damages] is a separate legal relationship (*lingwai de falü guanxi*).'

We see a similar misstep on the substantive claim in the *Weihai Yinghai 2008* case, at least at the first level of adjudication. There, the court accepts derivative pleadings, but then finds the defendant's alleged misdeeds not actionable either because they are authorized by a corporate resolution (use of the company chop) or because they 'pertain to

[97] See, for example, *Shanghai Tianguang Medical 2009* (Shanghai Higher People's Court overturns first-level denial of derivative lawsuit but then directs re-pleading based on plaintiff's (not company's) injury).

[98] *Wen Jianguo* v. *Zhao Limei re: Beijing Xiangkouxiao Jingnan Jinjia Food and Beverage Company Limited*, Beijing Xuanwu District Basic-Level People's Court (2009), *xuan min chu zi* no. 2625 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117617288) [*Beijing Xiangkouxiao Food and Beverage 2009*].

[99] See also *Shanghai Kouweier 2008*, in which the court dismisses the 'double derivative' action but then nonetheless addresses the underlying breach of duty of care.

[100] The opinion uses both '*qinmian yiwu*' from the 2006 Company Law and '*zhuyi yiwu*' – a form used in Chinese-language academic writing and Taiwanese corporate law.

issues of the company's internal administration' (*shuyu gongsi neibu guanli shiyi*) (disclosure to company shareholders of financial records).

The same problem is apparent again in *Huangshan Fenghua Real Estate 2009*. In that case, the Anhui provincial-level court affirms the lower court's allowance of the derivative action, but also upholds its dismissal of the underlying cause of action because it relates – in the words of the defendant's brief – 'merely to internal shareholder disputes' (*jinjin shi gudong neibu jiufen*), and because the underlying contracts challenged as harmful to the company are subject only to the principles of contract formation described in the PRC Contract Law. The opinion goes so far as to say that the derivative action is applicable *only* to asserted breaches of Article 150 of the Company Law by corporate directors and senior management. Thus, when faced with nine land sales contracts at below-market value entered into by the company already in liquidation as represented by the defendant, the court refuses to look at potential breaches by the defendant and instead affirms the validity of the contracts under the PRC Contract Law.

We find a number of cases where courts accept the derivative action but seem reluctant to find fiduciary duty violations.[101] *Shanghai XXX Electric 2009*[102] shows an inability to apply fiduciary duty law coloured by misunderstanding of the logic behind the derivative action. The court rejects the underlying cause of action on grounds which include the failure of the plaintiff to show losses by the company, and then proceeds to subvert the rationale behind the already-accepted derivative pleadings, noting that 'the lent funds can be recovered via a lawsuit by the company and other methods against director Zhang [the defendant].' The court fails to understand that the defendant director, as executive

[101] See, among others, the following cases with alleged duty of loyalty breaches: *Shanghai Decheng Real Estate One 2006*; *Zhang Wei* v. *Wang Long re: Beijing Yuannian Culture Development Company Limited*, Beijing Municipal Fengtai District Basic-Level People's Court (2009), *feng min chu zi* no. 02775 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117616166) [*Beijing Yuannian Culture 2009*]; *Liu Bin* v. *Li Zhanjun re: Beijing Wanpeng Property Management Company Limited*, Beijing Municipal Haidian District Basic-Level People's Court (2009), *hai min chu zi* no. 13158; on appeal Beijing no. 1 Intermediate People's Court (2010), *yi zhong min zhong zi* no. 1099 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117661861) [*Beijing Wanpeng Management 2010*]; *Shanghai Ninghui 2008*; and *Shanghai Yuanji International 2006*.

[102] *Lin X* v. *Zhang Y re: Shanghai XXX Electric Company Limited*, Shanghai Minhang District Basic-Level People's Court (2009) (available at www.personal.umich.edu/~purzel/national_reports/china/% 20(PRC).pdf)[*Shanghai XXX Electric 2009*].

director and legal representative of the LLC, can block the company entirely from seeking this remedy.

7 *Confusion between derivative and representative lawsuits*

In some cases we see excessively aggressive and technically flawed application of the derivative lawsuit, or the use of article 152 in situations that do not warrant it. One good example of this phenomenon is the *Beijing Huayuya Real Estate 2009* case,[103] in which the court invokes article 152 to force a dissident shareholder to fulfil the terms of a shareholders' resolution. In this case, a father shareholder in a three-shareholder LLC dies, whereupon his 72 per cent interest in the LLC passes to his wife and three of his children, and all the shareholders resolve to appoint the surviving wife as legal representative and executive director of the LLC. The two pre-existing shareholders (the deceased father's child and someone who is probably his or her spouse) do not implement the shareholders' resolution, and take no action to register the surviving wife's appointment as the new legal representative and executive director. The new shareholders sue, *in their own names and to remedy injury to themselves*, to cause performance of the shareholders' resolution. In allowing the suit to proceed under article 152, the court states, 'Shareholders who suffer injury to their rights can bring a shareholders' representative suit' (*quanli shou sun de gudong keyi tiqi gudong daibiao susong*). This is incorrect as applied to this case. If the court really means 'representative suit' then it is wrong, because the plaintiff shareholders do not seek to represent any other shareholders. If it means 'derivative suit' under article 152, it is equally wrong, because the shareholders are not suing over an injury to the company.[104]

8 *Judge-made direct litigation right for supervisors*

Our review of cases shows an interesting example of judicial initiative: the judge-made creation of a legal right for supervisors to sue on behalf of the injured company without any prodding from a shareholder

[103] *Chen X, Zhu X, Zhu 1 and Zhu 2* v. *Beijing Municipal Huayuya Real Estate Development Company Limited, Zhu 3 and Li X*, Beijing Municipal Dongcheng District Basic-Level People's Court (2009), *dong min chu zi* no. 4349 (available at http://vip.chinalawinfo.com/case/displaycontent.asp?Gid=117616117) [*Beijing Huayuya Real Estate 2009*].

[104] See the same misconception in *Dongfang Construction Group 2009*.

demand.[105] We speculate that PRC courts have created this direct litigation right in order to avoid technical obstacles to implementation of the derivative lawsuit mechanism, while allowing themselves to invoke its terms and spirit. Importantly, this direct right of action seems effective only with respect to closely held LLCs and when the office of supervisor is coupled with a shareholder interest.

9 *Allocation of court fees and 'loser pays all'*

Court fees in our sample of cases are generally allocated to the loser both before and after 1 January 2006. Unfortunately, the case reports we have reviewed do not generally reveal how attorneys' fees are allocated between the parties, although one imagines that the case opinions would describe any variance from the alleged norm in Chinese litigation – that each party pays its own attorneys' fees. In the derivative action context, this would mean that initiating shareholders would have to pay their own attorneys' fees.

In the forty-four cases analysed for this chapter, eighteen adhere to the 'loser pays all' principle, nineteen are silent on the court fee allocation question, and seven show a variation from the alleged 'loser pays' norm. Only one case in our sample appears to internalize the logic of the derivative action: *Beijing Tonghua Online 2009*. In this case, shareholder plaintiffs bringing suit on behalf of the company are successful in derivative pleadings, but unsuccessful on the underlying claim of a breach of duty of loyalty, and so the 'third party' (the company that has allegedly been injured) is assessed 8,109 yuan in court fees.[106] Although the loser still pays, the 'loser' is deemed to be the company,

[105] See *Shanghai Shixing Real Estate 2005* (failing to set forth any legal or statutory basis for this power, other than to say that the supervisor plaintiff 'has the power according to Company Law stipulations' and that such a lawsuit 'conforms to stipulations of law'); *Hao Ling* v. *Wang Qiyan re: Beijing Kejiemei Window Company Limited*, Beijing Municipal Haidian District Basic-Level People's Court (2007), *hai min chuzi* no. 11373; on appeal Beijing no. 1 Intermediate People's Court (2009), *yi zhong zhongzi* no. 5142 (available at http://vip.chinalawinfo.com/Case/displaycontent.asp?Gid=117619255) [*Beijing Kejiemei Window 2009*] (stating that the plaintiff need not specifically use article 152's derivative action mechanism, because he or she is both a shareholder and a supervisory board member); *Shanghai Taiwu Real Estate 2008* (permitting a 24 per cent shareholder in an LLC to sue two co-shareholders holding in the aggregate 54 per cent 'as a supervisor acting for the company'); and *Beijing Xiangkouxiao Food and Beverage 2009* (seeming to hold that supervisors have not only the right but the duty to sue when management is conflicted).

[106] The same logic is vindicated, but in a case that does not adhere to the 'loser pays all' principle; see *Chongqing Coal Mine 2006*, in which the plaintiff shareholders are

not the shareholders who initiated the derivative claim on behalf of the company.

There are some cases going the other way.[107] Unfortunately, the case reports and opinions do not provide sufficient data for us to know why these occasional departures from the 'loser pays all' principle occur. We can speculate that departures are more likely to occur when a plaintiff has won a significant damage award from defendant(s), as we see in the *Shanghai Shixing Real Estate 2005* case, in which the defendant was ordered to pay 272,000 yuan back to the company.

VI Critique of article 152 and reform suggestions

The preceding sections have noted various problems with the article 152 mechanism. In this section, we summarize our critiques and suggestions for reform.

First, the Company Law should state clearly that the initiating shareholder of a derivative action must be a shareholder of the affected company at the time the suit is brought.

Second, the Company Law currently lacks any standards for, or even a concept of, justified refusal by the board or supervisory board to satisfy the demand. Read literally, the statute makes the demand requirement virtually meaningless, because if the company does not bring suit upon demand the shareholder may always do so. No doubt the drafters were concerned about structural bias and demand futility when boards are conflicted. Making demand irrelevant, or not allowing a board of supervisors or directors to make a justified, good-faith, refusal, is no solution, however, and may result in abuse of the derivative lawsuit. In addition,

successful in the derivative action, but the LLC whose interest is being protected is assigned almost one-third of the court costs.

107 These include (in chronological order): *Shanghai Shixing Real Estate 2005* (supervisor successfully sues on behalf of company but is assessed 96 per cent of court fees); *Chongqing Coal Mine 2006* (plaintiff shareholders successful in derivative action, but the LLC whose interest is being protected is assessed one-third of court fees); *Shanghai Decheng Real Estate Three 2006* (partially successful plaintiff/appellant and the company itself pays part of court fees); *Beijing Dingyu Cable 2008* (derivative action denied, yet court orders return of the plaintiff's litigation fee deposit); *Weihai Yinghai 2008* (successful plaintiff assessed 348,000 yuan in court costs; losing defendant assessed only 200 yuan); *Beijing Kejiemei Window 2009* (initiating supervisor/shareholder permitted to sue on behalf of company, but ordered to pay 0.75 per cent of the first-instance court's fees and 33.7 per cent of the second-instance court's fees); and *Beijing Xiangkouxiao Food and Beverage 2009* (initiating supervisor-cum-shareholder pays 2,389 yuan in court costs; losing defendant assessed only 171 yuan).

the badly drafted mechanism does not acknowledge the supervisors' and directors' duties under article 148 to act in the best interests of the corporation, much less any judicial role in evaluating whether their refusal of the demand conforms to that duty. The options for statutory remediation here are many, including a mandated 'independent committee' or an affirmative basis for the judicial evaluation of a board refusal (or shareholder allegation of demand futility) and recognition of something akin to the directors' 'business judgement'. One Supreme People's Court judge has made just this suggestion: '[W]e must stipulate effective conditions for any resolution [by the board refusing demand]: first, that the resolution is conditioned on prior appropriate investigation [of the claim] by the supervisory board or the independent directors; second, that the directors who vote on the resolution do not include defendants in the derivative action; and third, that the resolution be made in the best interests of the corporation' (*weile gongsi de zuidade liyi*).[108] The third prong suggested for justified refusal implies significant participation by the judiciary in evaluating whether the refusal is in conformity with the directors' fiduciary duties, raising the question of whether Chinese judges, who are unlikely to have any significant business experience, are up to the task.

Third, the Company Law should stipulate upon whom demand must be made when the action demanded is against a non-insider 'other'. Failure to do so risks allowing conservative judicial institutions to stymie meritorious derivative lawsuits on a technicality.

Fourth, the Company Law should clarify the exact effect of 'urgent' or 'emergency' circumstances upon demand and the stipulated thirty-day waiting period. Is, as most PRC courts rule, demand itself excused, or is it just the thirty-day period that is eliminated?

Last in the line of specific critiques, article 152 makes a distinction in terms of the wrong on the company that triggers the derivative action: insiders may be sued when they have damaged the company through breaches of law, administrative regulations or the company's articles of association in the course of performing company duties, while 'others' may be sued when they have damaged the company by violating its lawful rights and interests. We can think of no good reason for this difference.

More generally, we question the idea of minimum shareholding requirement for CLSs. This makes little sense in the PRC, where there

108 Jin ('A study'), 423.

remains such concentrated ownership in publicly listed CLSs, and there are so many temptations for controlling shareholder malfeasance or minority shareholder oppression. It makes even less sense when there are so many other mechanisms working against minority shareholders bringing what, after all, is a *corporate* claim (and must be recognized as such during adjudication). There is a persistent (and, we believe, mistaken) sense in the Chinese discourse that the required minimum is tied to the notion that a derivative lawsuit is in fact a 'representative' lawsuit, and therefore requires a minimum number of shareholders to 'represent' the interests of all or most of the other shareholders.[109] This is a radical misunderstanding of the derivative action: a derivative lawsuit is a *corporate* claim, merely initiated by one or more shareholders to get around the structural block presented by those who control the corporation and are unwilling to bring suit. In addition, even if there is to be a minimum threshold, the 1 per cent level may well be so high as to discourage otherwise meritorious actions by minority shareholders in widely held companies.[110]

PRC jurisdictional rules generally require derivative lawsuits to be heard where the company has its headquarters (*zhuyao banshichu jigou*).[111] This hurts derivative actions, because the insiders of the corporatized state-owned enterprises being sued – or the controlling shareholders of such entities – are often locally powerful government and Party figures who have significant political, administrative and fiscal control over the local court system.

With respect to the role of the judiciary in evaluating fact and law questions, the language in the statute about 'irreparable damage to the interests of the company' (i.e., an emergency) strongly implies some kind of real evaluation role for the PRC judiciary, unless shareholders are simply to plead these conclusions and have them accepted in all cases. We note travesties such as the *Beijing Dingyu Cable 2008* case, in which derivative pleadings are denied on the theory that there is no

[109] For example, PRC Supreme People's Court Justice Jin Jianfeng justifies minimum shareholder percentages because they 'ensure that the plaintiff is sufficiently representative'; see Jin ('A study'), 418. Of course, in a true derivative action, the plaintiff is the company and is not 'represented' by anyone, and certainly not by shareholders (who have their own 'direct' claims to pursue).

[110] See Tang ('Protecting minority shareholders'), 145. The fear of abusive strike suits brought just for their settlement value may well be overblown; see Zhang ('Making shareholder derivative actions'), 549–50.

[111] See Jin ('A study'), 423.

emergency situation because the company has already been fully looted. At the same time, though, we also see a good number of other opinions in which an emergency is found and demand is effectively waived.

In addition, the system does not currently take account of demands by shareholders who have previously ratified the allegedly offending actions under conditions of full disclosure, and who then opportunistically turn around and initiate derivative lawsuits protesting those actions. In each of these examples, the only body that can properly evaluate the fact and law questions is the judiciary. It remains to be seen, however, if Chinese courts have the requisite competence and autonomy to make the required evaluations in such complex situations. Here they might benefit from stronger, more bright-line rules.

The 2006 Company Law and the current Civil Procedure Law remain unclear on the legal position of the company in the newly authorized derivative lawsuit. The classic Anglo-American derivative action is in fact two suits at equity, one of which is a claim by the company as the 'real party plaintiff' against those alleged to have injured it. This structure is important, because it directs any compensation or damages to the company and not to individual shareholders who may have distinct interests in the litigation. Civil law systems handle this somewhat differently, and, again, in a way that may be tied closely to the understanding that derivative lawsuits are really 'representative' lawsuits. The Japanese system, for instance, holds that the corporation is not a necessary formal party to a derivative lawsuit, and that the court may at its own discretion reject the company's application to join or include the corporation in the action when the company is unwilling to be joined. The 2006 Company Law makes no explicit provision for the formal role of the corporation, and thus judges are left to wonder if the company in a well-pleaded derivative action is: (1) not a party; (2) the plaintiff (with, or alone and to the exclusion of, the shareholders taking the initiative); or (3) some kind of involuntary 'third party' (*di san ren*) – a role permitted under the PRC's Law on Civil Procedure but only on *voluntary* application.[112] One influential SPC judge asserted in 2008, for example, that the company should be either the 'name plaintiff' or the 'third party' (*di san ren*).[113] Efforts should therefore be made in statute (either the Company Law or the Civil Procedure Law) to clarify the position of the company as the

[112] Civil Procedure Law, art. 56(1). Supreme People's Court judge Jin Jianfeng acknowledges this technical problem; see Jin ('A study'), 421.

[113] See Jin ('A study'), 415.

formal plaintiff. This would help derivative lawsuits on a number of fronts, from cost allocation (including upfront payment of attorneys' fees and court costs by the usually richer company) and financial incentives to the adjudication of harm and causality, and it would go a long way to clearing up the evident confusion rooted in the term 'representative lawsuit', with its implication that the company is being 'represented' by the shareholders. The company should be the direct, named, plaintiff, and thus the lawsuit should be pursued in the company's interests.

We are also concerned about the position of shareholders who are not part of the demand on the company. If it is a true derivative claim then they are affected equally by the success or failure of the company's claim. How are such other shareholders to be protected against colluding shareholders who get control of the article 152 lawsuit (i.e., those who are first to make a demand), however? One idea is to give other non-demanding shareholders the right to join in control of the suit if it proceeds.[114] Another idea is to provide a statutory basis for courts to prohibit settlements between defendants and the shareholders running the derivative lawsuit.[115] Rules on derivative actions in foreign jurisdictions often restrict such settlements without court approval.[116] China's current civil procedure norms stipulate no such restriction. That is why the pre-2006 sub-national 'opinions' permitting derivative lawsuits stipulated precisely such a constraint[117] and why one authoritative Supreme People's Court justice has urged that settlements in derivative actions be permitted only with court approval.[118]

Finally, given the existing obstacles to the financing of derivative actions in China, we believe it would be unwise for China to impose

[114] This has been suggested by Supreme People's Court judge Jin Jianfeng, although his rationales – first, that this will enable better investigation of defendant malfeasance, and, second, that the lawsuit be more 'representative' – miss the key concern, which is the prevention of collusion. See Jin ('A study'), 420.

[115] In the one case in our sample that is settled (while on appeal before the Supreme People's Court), the case reports also focus on the caution that must be exercised with respect to any settlement reached in a derivative action, given the risk that the controlled company will agree to terms that are disadvantageous to it. See *Tonghe Investment 2009*.

[116] See, for example, FRCP, 23.1. The Chinese Law on Civil Procedure provides only affirmation of the ability to settle suits, at article 51.

[117] See, for example, 'Shanghai Opinion': '[W]hen the parties raise a settlement proposal in the course of the litigation, and the People's Court determines that the proposed settlement will harm the interests of other shareholders of the company, then the settlement should not be approved and the litigation should continue.'

[118] See Jin ('A study'), 425.

further obstacles, such as requiring that demanding shareholders post a bond as a precondition to bringing a derivative suit.[119] Indeed, article 47 of the 2003 Omnibus Regulation reproduced one mechanism familiar from article 847(7) of the Japanese Company Law designed to inhibit nuisance suits: providing that, if derivative lawsuit defendants can offer evidence that plaintiffs were suing in 'bad faith', the court could, upon application of the defendants, require plaintiffs to post security for the defendants' reasonable litigation expenses. This would be counterproductive in the PRC, even if included in some misguided attempt to create an 'international (best) standard' derivative lawsuit.

VII Conclusion

In today's China, the derivative lawsuit is suddenly viable and is increasingly being brought to the courts throughout the country. It is unquestionably a step forward in the development of China's corporate governance that courts are actually hearing derivative suits despite the technical, institutional, economic, and political obstacles we have identified in this chapter. Given the courts' preference for specific instructions over general statutory authorizations, this is all the more remarkable, because the Supreme People's Court has not yet promulgated implementing rules specifically governing the derivative lawsuit.

Our study of cases shows that the courts will permit derivative pleadings to overcome structural obstacles inherent in the corporate form, and sometimes quite aggressively, as seen in the derivative actions permitted without any statutory basis, the use of the 1994 Supreme People's Court Approving Response facially limited to foreign-party-controlled joint ventures as a legal basis for other derivative suits, the many straddling actions applying the post-2006 derivative action to pre-2006 transactions, the abundant use of the derivative lawsuit 'horizontally' against 'others' that include controlling shareholders, and the post-2006 allowance for a supervisor's direct right of action to sue on behalf of the company (at least when the supervisor is also a shareholder). These judgments are strong evidence that the technical defects we have highlighted have not seriously constrained the development or implementation of the derivative action in China, at least with respect to LLCs. In

[119] See the suggestion of Supreme People's Court judge Jin Jianfeng (Jin ('A study'), 423–4) and Tsinghua University law professor Tang Xin's pre-emptive worry on the same score (Tang ('Protecting minority shareholders'), 146).

addition, the developments and specific jurisprudence discussed in this chapter also show the courts' increasing cognizance of, and comfort wielding, the complex substantive corporate law doctrines that underpin the derivative lawsuit vehicle (including fiduciary duties, at least as far as the duty of loyalty is concerned). These observations bode well for the elaboration and strengthening of China's corporate governance regime and the role of the courts in applying corporate law.

On the other hand, some of the defects and obstacles we discuss in this chapter will provide an easy excuse for courts to avoid hearing derivative suits, thereby leaving certain corporate actors and contract parties unaccountable. Most importantly, we have found almost no cases involving listed, or even unlisted, CLSs. We have speculated above on the reasons for this absence. Whatever the reasons, it remains true that the virtual absence of CLS-related cases is a misfortune for corporate law and corporate governance in the PRC. For the rapidly expanding number of CLSs and their minority shareholder investors, the derivative suit mechanism of article 152 is simply not working, or not being permitted to work.

A further problem we observe is that, even when the derivative action is successfully implemented, some courts remain wary or uncomprehending of the underlying corporate law doctrines, especially the duty of care. We found virtually no cases involving the duty of care, and other research we have done in non-derivative suit cases yields similar results. Indeed, we found one shocking case, noted above, that liberally permitted a derivative action but then abandoned application of the substantive fiduciary claim because the latter was deemed part of a 'separate legal relationship'. If courts are unwilling or unable to enforce a duty of care, an important element of the rationale behind allowing derivative suits will remain unrealized.

In sum, China's mechanism for derivative lawsuits remains insufficient to support good corporate governance and accountability for managers and controlling shareholders in widely held CLSs. It is not wholly insufficient, or so weak, that we would advise abandoning the effort to improve the associated substantive law and to develop the institutions needed to apply it. Indeed, the mechanism's mere existence is in some sense helping judicial institutions act more autonomously and with greater power in Chinese society. On the corporate governance side, and particularly in the absence of other remedies for shareholder oppression, it is a vital tool for shareholders in CLSs and LLCs alike. We believe that the derivative lawsuit has a future in China. We also believe,

however, that at present it can only supplement, and not replace, state regulatory institutions in the policing of corporate governance and insider action. In China today it remains state regulatory institutions, and not courts, that are likely to have the necessary independence from local political and economic interests, as well as the technical expertise, to enforce accountability and expanded legal rights.