INVESTING IN CHINA? BEWARE, IF YOU ARE A MINORITY SHAREHOLDER: HOW EFFECTIVE IS THE DERIVATIVE ACTION AS A PROTECTION DEVICE FOR MINORITY SHAREHOLDERS IN CHINA?

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ABSTRACT

China has developed economically at a rampant pace. However, its corporate governance principles still lag behind the western world. Based upon Hui Huang's impressive empirical study of China's derivative suits from 2006 to 2009, this article analyzes Chinese derivative actions from 2010 to 2013. Disappointingly, it shows that the device introduced by the Chinese 2005 Company Law to protect minority shareholders is actually being used by majority shareholders. A number of reasons are looked at, including the difficulty for an aggrieved shareholder to meet the *locus standi* standard, and the significant expense to bring forward a derivative action. Also, the Chinese Judiciary's mastery of company law is addressed as directly proportional to the accurate adjudication of derivative actions. Though one might think of the Chinese administrative apparatus as the epitome of *big government*, the resources available to China's regulatory commission to hold controlling shareholders accountable for their actions are approached as well. Regretfully, it can be said that, despite the embracing of entrepreneurialism, corporate governance has not developed in China to the same standard of western nations. This is attributed to the Chinese government control of business activity by holding majority positions in state-owned enterprises and listed companies, evidenced by the absence of recorded derivative actions against such listed companies. After looking to common law jurisdictions for a solution to the problem China faces, both foreign and domestic investors are warned about the fact that, unlike the United States, minority investors have very few rights in China.

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I. INTRODUCTION

At the turn of the 21st century many economists made the compelling prediction that this would be the "Asian Century," with China at the helm. China blossomed from an austere country with a closed economy to a nation where investors have flooded to in the last decade. In order to maintain and foster this investor confidence, China decided to import and embrace corporate governance. This has been a reaction to the revival of individualism in China in the last twenty years which has resulted in many investors being conscious of their private rights.[1] Accordingly, China introduced the *2005 Company Law* which was implemented at the start of 2006. Mabel Tsui argues that the legislation followed the OECD's (Organisation for Economic Co-Operation and Development) 'Principles of Corporate Governance' as a general guide.[2] Part of this corporate governance reform, included the development of a statutory based shareholder derivative action. This gave shareholders- particularly minority shareholders, an opportunity

[1] Judith Oliver, Wen Qu & Victoria Wise, *Corporate Governance: A Discussion on Minority Shareholder Protection*, 6 INT'L J. OF ECON. & FIN., no. 3, 2014, at 111, 112.
[2] Mabel Tsui, *Corporate Governance in China*, CORP. GOVERNANCE E-J., Oct. 1, 2010, at 1, epublications.bond.edu.au/cgi/viewcontent.cgi?article=1019&context=cgej.

to hold directors or supervisory board members accountable for any breach of their duties as directors.

However, this article purports that China's statutory derivative action has been an ineffective mechanism for minority shareholder protection in Chinese companies, particularly public companies. This is demonstrated by the fact that from 2006–2013, 89 derivative actions have been initiated and disturbingly only one derivative action has been instigated against a publicly listed Chinese company. Results for 2014–2015 have not been updated on relevant Chinese legal databases, hence the empirical data collected is only up until the end of 2013. Relative to other countries, 89 actions in eight years is not an alarmingly low number, but it will be demonstrated through empirical data,[3] that many of these actions are initiated by shareholders who hold a significant proportion of shares. The focus of this article is concerned with the difficulty of minority shareholders actually being able to initiate proceedings as opposed to the remedy they may acquire.

This article will propose that the difficulties of proving *locus standi* (when minority shareholders can bring forward a suit), the absence of a contingency or litigation fund means that the litigation costs in China are expensive, which perhaps deters minority shareholders from filing suits. Also, the Chinese courts have adopted a literalist approach when interpreting the *2005 Company Law*[4] as opposed to the purposive approach utilised in Australia and New Zealand. Although China permits a mandatory cumulative voting structure, it is an opt-in policy,[5] which means that minority shareholders are not always protected. Finally, enforcement of existing securities law in China has been poor. Arguably, this is because the CSRC's (China's Securities Regulatory Commission) enforcement team is understaffed and under-resourced which means they do not have the ability to hold directors or controlling shareholders, who violate corporate governance laws, accountable for their actions.

It is critical to note that throughout the world, with the exception of the United States and Japan, there are very few derivative actions initiated by minority shareholders in public companies. Nonetheless, this is potentially more of a problem for China, as the country has emerged into a leading global economic power. If it wants to sustain its status as a global economic leader by encouraging foreign investment, China will need to embrace corporate governance, especially the derivative action for minority shareholders.

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[3] The cases which provide the basis of the analysis in this paper have been translated from the original Chinese text by Jie Zhang, at the request of the author.

[4] Zhongguo Renmin Gongheguo Gongsi Fa (中国人民共和国公司法) [Company Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) [hereinafter Company Law].

[5] A policy under which shareholders vote on whether or not to adopt the cumulative voting system on important issues, such as the selection of directors for the company.

A. Importance of Minority Shareholder Protection in China

Protecting minority shareholders is essential to securing stability and long term confidence in a country's stock market. This is because minority shareholders are usually individuals from the general public. As of 2007 small investor accounts (under 1 million RMB) accounted for 99% of all accounts.[6] This has resulted in significantly more investment in Chinese stocks, revealed by the fact that in 1992 there were 8.35 million individual investor accounts, but as of 2012 there were just over 226 million accounts.[7] In 2003, Deng argued that only 172 000 out of the 33.1 million on the Shenzhen Stock Exchange were opened by institutional investors.[8] It suggests that even with the significant influence of state owned enterprises, individual shareholders dominate China's capital markets. If minority shareholders' rights are not protected, it is unlikely that in the long term that members of the public will invest in the stock market. Yong Cheng argues the stable operation of securities markets depends on sustainable investment from minority shareholders.[9] Cheng argues that in listed companies, the stock price is closely related to minority shareholders' confidence in investments.[10] This was corroborated by Meilun Shi, who was the former vice-chairperson of the CSRC.[11] She stated that investor confidence and participation were critical to the stable development of China's capital markets.[12] Protecting minority shareholders could result in a more transparent and stable economy as individual investors with limited financial knowledge will feel more comfortable investing in publicly listed shares.

Even though the state's share in public companies is being slowly diluted, as of 2009, two-thirds of all shares in public companies were non-tradable and state owned[13] and there has been little indication it has changed significantly since 2009. This means that controlling shareholders can act in their own interests as opposed to the company's without fear of being held accountable. Thus, the derivative action is an important mechanism to hold controlling shareholders accountable for violating fundamental corporate governance principles. Another

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[6] Flora Xiao Huang, *Shareholder Revolt?: The Statutory Derivative Action in China* 5 (Comp. Res. in L. & Pol. Econ., Research Paper No. 49, 2009), http://poseidon01.ssrn.com/delivery.php?ID=3951200241
150200120921051250000100110410450650820890580761190220050790271100660660851021031070
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66112024119007120123091015127070088067087112019086007127001031107086003&EXT=pdf .

[7] Oliver, et al., *supra* note 1, at 112.

[8] Jiong Deng, *Building an Investor Friendly Shareholder Derivative Lawsuit System in China*, 46 HARV. INT'L L.J. 347, 348. (2005)

[9] Yong Cheng, *On Protection of Rights and Interests of Minority Shareholders in a Listed Company*, 3 INT'L J. OF BUS. ADMIN. 54, 55 (2012).

[10] *Id.* at 54.

[11] Huang, *supra* note 6, at 5.

[12] *Id.*

[13] *Id.* at 5–6.

minor point is that unlike the United Kingdom and Canada, China does not have a statutory oppression remedy where shareholders can take personal action for relief against the company for their oppression or unfair discrimination.[14] Accordingly, the derivative action is the only protection that minority shareholders have from exploitative and self-interested controlling shareholders.

B. Statutory Derivative Action (SDA) in China

Foss v Harbottle[15] suggested that a derivative action could be brought by the company against directors of the company for a wrong committed against the company.[16] This is often characterised as the *proper plaintiff rule*.[17] It flows from the principle established in the case of *Salomon v A. Salomon & Co. Ltd.*[18] that the 'company' is a separate legal entity to a shareholder or a director. However, a strict application of the principle established in *Foss v Harbottle* would render it illegal for a member of a company to bring forward a derivative action on behalf of the company. The exception to the rule was that a derivative action could be brought against a third party for "fraud on the minority" or for "wrongdoer control."[19] However, since then, many countries such as Australia and New Zealand have employed lenient thresholds for shareholders bringing forward derivative suits. The most significant factor appears to be whether the action brought forward is in the best interests of the company. If so, then it is likely that the action will be permitted to proceed to be heard.[20] In assessing the best interests, a few countries, such as New Zealand, adopted a cost-benefit analysis.[21] However, as will be demonstrated later, Chinese courts have been reluctant to adopt a 'cost-benefit' analysis in assessing whether the action will be against the best interests of the company. As will be explored later, the admissibility of derivative actions in China will generally turn on whether the demand requirements have been satisfied.[22] This is apparent in most civil law jurisdictions.

A shareholder can bring forward a claim on behalf of the company against a third party. In a lot of cases this third party is a director or member of senior management within the company. If a director or any other member of senior management breach a law, provision of the company constitution or an administrative regulation which causes loss to the company whilst exercising their

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[14] Companies Act 2006, c. 46, § 994 (UK); Canada Business Corporations Act, R.S.C. 1985, c. C-44, § 241(2)(c).
[15] Foss v. Harbottle (1843) 67 Eng. Rep. 189; 2 Hare 461.
[16] Pearlie Koh Ming Choo, *The Statutory Derivative Action in Singapore- A Critical and Comparative Examination*, 13 BOND L. REV., no. 1, June 1, 2001, at 64, 64–65.
[17] Edwards v. Halliwell [1950] 2 All ER 104 (Jenkins LJ).
[18] Salomon v. A. Salomon & Co. Ltd. [1897] AC 22 (HL) 42.
[19] *Edwards* [1950] 2 All E.R. at __.
[20] Zhong Zhang, *The Shareholder Derivative Action and Good Corporate Governance in China: Why the Excitement Is Actually for Nothing*, 28 PAC. BASIN L.J. 174, 184 (2011).
[21] Companies Act 1993, §§ 165(2)(a)–165(2)(b) (N.Z.).
[22] Zhang, *supra* note 20, at 188.

power as directors, a derivative action can be brought against them. The derivative action performs a necessary function of holding directors (who are often controlling shareholders in private companies) accountable for their actions in exercising their duty to act in the best interests of the company.

In China, Articles 151 and 152 of the *2005 Company Law* outline that derivative actions can be brought by shareholders in the above circumstances.[23] The specifics of these important provisions will be analysed later in this article.

II. BACKGROUND TO CHINESE COMPANY LAW

In the 1990s, China was a high saving society with the country's saving rate as high as 40% of GDP in the mid-1990s.[24] However, at the turn of the century, China's fiscal policy shifted its focus towards economic growth, introducing the policy of low interest rates to encourage investing and in turn discourage saving.[25] As illustrated above, there was a phenomenal increase in the establishment of individual investor accounts. Since these were individual as opposed to institutional accounts they would have presumably been the accounts of minority shareholders in public or private companies.

Indeed, the Chinese Government as well as Stock Exchange senior management have promoted the need for minority shareholder protection in China. Article 4 of the *2005 Company Law* provides that the legislation "protects the rights and interests of companies, shareholders and creditors."[26] The CSRC's Listing Rules provide that shareholders must be given necessary information by the company to make an informed decision on the issues they are asked to vote on.[27] Nonetheless, the legislation has not resulted in minority shareholders exercising derivative action or being otherwise protected. Arguably, this is because shareholding in major listed companies is still highly concentrated in the hands of the state. The largest, second largest and third largest shareholders in 84%, 49% and 39% of the top 100 Chinese listed companies were state-owned enterprises.[28] There are over 2000 publicly listed companies in China.[29] In 2007, a Stock Exchange official argued that two-thirds of shares in listed companies are non-tradeable.[30]

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[23] MINGKANG GU, UNDERSTANDING CHINESE COMPANY LAW 151–52 (Hong Kong Univ. Press 2d ed. 2010).
[24] Oliver, et al., *supra* note 1, at 111–12.
[25] *Id.* 112.
[26] Company Law, art. 4.
[27] [Rules for the General Meetings of Shareholders of Listed Companies] 2006 (promulgated by the Chinese Sec. Regulation Comm'n) at 1.
[28] PROTIVITI, CORPORATE GOVERNANCE ASSESSMENT 10, http://www.protiviti.com.au/China-en/Documents/CN-en-2012-Corporate-Governance-Survey-Report.pdf.
[29] *Listed Companies in China*, BLOOMBERG, http://www.bloomberg.com/markets/companies/country/ china/.
[30] Roman Tomasic & Neil Andrews, *Minority Shareholder Protection in China's Top 100 Companies*, 9 AUSTL. J. ASIAN L. 21 (2007).

Nonetheless, it is important to note that the Chinese government is attempting to make reforms through an incremental approach. This approach provides less power to state-owned enterprises, by controlling assets and gross output. Admittedly, the government has made progress in these reforms. For instance, in 1998 SOEs controlled 70% of all Chinese assets. However, by 2010 SOEs controlled marginally above 40% of these assets.[31] Similarly SOEs have less gross output than before. In 1998 they controlled 50% of all gross output, in 2010 they controlled 25%.[32] Despite this, many listed companies which may not be state owned enterprises, have controlling shareholders who are linked with the Chinese government. Many of these listed companies were derived from state owned enterprises (SOEs) and the state may remain as the majority shareholder and controlling entity. It controls the funds of the company and can divert capital resources away from business needs. The CSRC has argued that in over 300 listed companies, there is an improper control of funds of USD$7 billion for non-business operating purposes.[33]

China claims to be devoted to creating a market economy but the political influence behind China's securities market has contributed to weak corporate governance principles for listed companies. Retail shareholders, similar to other parts of the world, are presented with limited corporate information, providing an opportunity for corporate assets to be misused. Chinese listed companies are not so well managed that there are no internal issues. This is reflected by the fact that in the United States, 18% of suits were brought against Chinese companies, both private and public.[34]

A. Chinese Law

It is important to outline the relevant provisions for this article. Arguably the most important provision is Article 151 of the *2005 Company Law*. Article 151 states:

Where a director or senior manager is under the circumstance as stated in Article 149 of this Law, the shareholder(s) of the limited liability company or joint stock limited company separately or aggregately holding 1% or more of the total shares of the company may require the board of supervisors or the supervisor of the limited liability company with no board of supervisors in writing to file a lawsuit in the people's court. If the supervisor is under the circumstance as stated in Article 149 of this Law, the aforesaid shareholder(s) may require the board of directors or

[31] Dong Zhang & Owen Freestone, *China's Unfinished State-Owned Enterprise Reforms*, ECON. ROUNDUP, Dec. 6, 2013, at 1, 1, http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Economic-Roundup-Issue-2/Economic-Roundup/Chinas-unfinished-SOE-reforms.
[32] *Id.*
[33] Oliver, et al., *supra* note 1, at 113.
[34] Gu Weixia, *Securities Arbitration: A Better Alternative to Retail Shareholder Protection*, 33 NW. J. INT'L L. & BUS. 286 (2013).

the executive director of the limited liability company with no board of directors to in writing file a lawsuit in the people's court.

If the board of supervisors, or supervisor of a limited liability company with no board of supervisors, or the board of directors or the executive director refuses to file a lawsuit after he receives a written request as mentioned in the preceding paragraph, or if it or he fails to file a lawsuit within 30 days after it receives the request, or if, in an emergency, the failure to file a lawsuit immediately will cause unrecoverable damages to the interests of the company, the shareholder(s) as listed in the preceding paragraph may, on their own behalf, directly file a lawsuit in the people's court.

In case the legitimate rights and interests of a company are impaired and losses are caused to the company, the shareholders as mentioned in the preceding paragraph may initiate a lawsuit in the people's court in light of the provisions of the preceding two paragraphs.[35]

This is complimented by Article 152:

If any director or senior manager damages the shareholders' interests by violating any law, administrative regulation or the articles of association, the shareholders may file a lawsuit in the people's court.[36]

In law, non-controlling shareholders have a codified right to bring forward derivative suits against directors for not exercising their duties properly. Despite this, the empirical evidence highlights that although 89 derivative suits may have been launched since the implementation of the *2005 Company Law,* only one of them involved shareholders in a listed company. Furthermore, these suits have often been brought forward in cases where the applicant is a controlling shareholder.

B. Explanation of Share Structure

Before analysing the problems associated with minority shareholder protection, it is critical to outline what minority shareholders are likely to invest in. Some of these shares include:

A-shares: Only available to Chinese investors; and

B-shares: Only available to foreign investors

A-shares and B-shares are traded on the Chinese Stock exchange. There are also:

[35] Company Law, art. 151
[36] *Id.*, art. 152.

H-shares: Shares listed on the Hong Kong stock exchange; and

N-shares: Shares listed on the New York stock exchange

H-share and N-shares are traded on the foreign exchange. There are other types of shares, which also exist, such as S-shares which are listed on the Singapore stock exchange.

This article is concerned with A-shares which are broken into three further categories: state shares, legal-persons shares and tradeable shares.

State shares are held by local governments or the central government itself. These shares may also be owned by entities that are owned by either the central or local governments.[37] 'Legal-person' shares are held by non-bank financial institutions and security companies. Chinese individuals and companies generally have 'tradable shares.' As outlined above, two thirds of all shares in public companies cannot be traded. This is important when one considers that both state and legal person shares have the same dividend and voting rights as tradable shares.[38] This means that in many public companies the state remains a controlling shareholder. However, recently, there has been a gradual reduction of legal person and state shares so as to give domestic individuals and companies more share value.

III. EMPIRICAL EVIDENCE

A. Methodology

The manner in which the data is presented in this article reflects how Hui Huang presented his empirical evidence on statutory derivative action in China from 2006-2009.[39] Similar to Huang, research was conducted using the database *LawInfo China.* The reason this database was selected was because it is widely accepted as the most comprehensive database for Chinese case law[40] and was easily accessible. The search terms 'statutory derivative action' and 'derivative action' were used to locate cases using article 151 of the *2005 Company Law.* Thus, it is important to note that there may have been cases which did use a derivative action under article 151 which for some reason or another did not appear when the search terms were entered into *LawInfo China.*

It is also imperative to note that the data displayed in this article from 2006-09 was from Hui Huang's research. However, the 2010-13 statistics reflect raw data collated by the author with the aid of translator, Jie Zhang. The reason

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[37] Maggie P. Williams & Denis W. Taylor, *Corporate propping through related party transactions: The effect of China's securities regulations*, 55 J. LAW & MGMT. 28.
[38] *Id.* at 31.
[39] Hui Huang, *Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis*, 27 BANKING & FIN. L. REV. 619 (2012).
[40] *Id.* at 627.

Huang's research was included was because similar to this author he primarily used the database, *LawInfo China*. Thus, there is some consistency to the data being presented. Nonetheless, the precise search terms used by Huang are not known to the author, so this is an important factor which may have led to different search results. Statistics from 2014 were not included because at the time of writing, all the data for that year had not been published. In addition, Huang has noted that *LawInfo China* has at times been slow in updating cases.[41] This means there may be cases from earlier years that have not been uploaded.

LawInfo China does not reflect cases which were resolved outside of court. Huang has outlined that China has a litigation-averse culture.[42] This is reflected in the fact that as many as 32 cases have been submitted for online mediation.[43] It is also important to note that there may be some cases which have not been publicly reported or have not been permitted to proceed to trial. Although the data will show that six cases were defective in their preliminary procedures from 2010-13, it is likely that there are more cases than this where the applicant did not acquire the necessary *locus standi*, but the application may not have proceeded to trial and hence is unrecorded in *LawInfo China*. The presentation of cases that were defective in their preliminary proceedings is a minor extension of Huang's research.

Scholars such as Zhong Zhang have suggested that there was one derivative action commenced by a minority shareholder in a public company.[44] However, it could not be located on *LawInfo China* using the search terms 'statutory derivative action' or 'derivative action.' This highlights that there are gaps in the research and more needs to be done to truly derive how many derivative actions are initiated by shareholders.

I split my empirical evidence into four main categories:

1) Whether the proceeding was at trial or on appeal. I did this to highlight the number of cases that have been appealed, suggesting that Chinese judges at the magistrate level perhaps do not have the requisite knowledge of securities and corporate law or there is a lack of confidence in their expertise.

2) Percentage of Shares held by the applicant: This table was created to illustrate to the reader that although a number of derivative actions have been initiated by shareholders, most of them were done so by shareholders who had a controlling share in the company. A table illustrating the percentage of shares held by applicants in the

[41] *Id.*
[42] *Id.*
[43] CHINESE SEC. REGULATORY COMM'N, CSRC INVESTOR PROTECTION BUREAU RESPONDS TO QUESTIONS FROM INVESTORS (2013), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201303/t20130326_222638.html.
[44] Zhang, *supra* note 20, at 192.

Australian context was created to illustrate that although less derivative actions were initiated in the first few years after the implementation of a statutory based action, a higher number of shareholders who held less than 10% of the shares initiated derivative action.

3) A table displaying the type of plaintiffs was formulated to demonstrate to the reader that even applicants who did not hold a large number of shares in the company were often company directors or officers.

4) Although not the main focus of this article, the function of the remedies table is to display that almost half of the actions that did proceed to court were dismissed by the judge with no remedy awarded.

Essentially, the raw data was split in a manner where it could be demonstrated to the reader that although it may appear that the Chinese derivative action is being well used, its use is by those who are controlling shareholders of directors in a company. As Huang has argued in his empirical research, the objective of the derivative action is to protect minority shareholders.[45] The tables of data created highlight that comparatively, minority shareholders are not initiating enough derivative actions.

B. Raw Data

When were the cases heard?

Year	Cases Heard
2006[46]	12
2007[47]	11
2008[48]	16
2009[49]	11
2010	12
2011	8

[45] Huang, *supra* note 39, at 624.
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *Id.*

2012	10
2013	9
Total	**89**

The evidence suggests that derivative actions have not been increasing, if anything the number of actions being filed has decreased. From 2006-2009, 50 cases were brought forward,[50] but from 2010-2013 only 39 derivative actions have been filed. Article 151 has not been entirely effective in encouraging derivative action. Nonetheless, it is important to note that research conducted by the People's Supreme Court of China revealed that over 50% of civil cases were closed through mediation or withdrawal of proceedings.[51] A reason for this might be that in the case where a claim is resolved through mediation, the parties discuss how to distribute the costs of litigation. Whereas, if the court were forced to pass a judgment, 'the loser pays all' policy would apply. When mediations and settlements are taken into consideration, it means there could easily have been double the number of derivative actions actually recorded in databases such as *LawInfo* China. However, this would still mean that in the space of eight years, under 200 derivative actions would have been brought forward. This is still an incredibly small number, especially considering the great number of derivative actions filed in countries such as Japan.

Cases brought forward at First Instance or on Appeal?

Nature of Proceeding	Number of Cases	Percentage
First Instance (Trial)	29	33%
Appellate Court	60	67%
Total	89	100%

A case which has gone through to the appeal stage is not counted as a 'first instance' case for the purposes of the above table. Interestingly, from 2010-2013 there have been considerably more cases that have been appealed as opposed to from 2006-09. Huang's research revealed that 55% of cases were appealed from 2006-09. This has increased significantly as of the end of 2013. Huang suggested in his empirical study in 2011 that the Chinese judges did not have the necessary technical knowledge to preside over derivative suits- this will be explored later in this thesis.

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[50] *Id.* at 627.

[51] Xiao Jianguo & Tang Xin, *Cost and Fee Allocation in Civil Procedure*, 4 TSINGHUA CHINA L. REV. 49 (2012).

What percentage of shares do applicants hold?

Applicant's Corporate Ownership at the Time of Derivative Actions	Number of Cases	Total Percentage
<10%	8	9%
11-29%	12	13%
30-49%	21	24%
>50%	22	25%
Not provided	26	29%
Total	89	100%

The 2005 Company Law appears to be inadequate in defending shareholders who have a small interest in a company. The table above elucidates that generally shareholders with a significant share of a company bring forward derivative actions. In almost 50% of cases, a shareholder holds at least 30% of the total share value of a given company. Arguably, article 151 was introduced to protect minority shareholders, who did not have a substantial share of a company. Since 2010, there have been only two cases where a shareholder who holds less than 1% of the total share value of a company has filed a derivative action.

1. Corporate Ownership of Shareholders in Australia Bringing Forward Derivative Actions

The results below reflect the empirical research conducted by Ian Ramsay and Benjamin Saunders as of 2006.[52] Unfortunately, since then an empirical project has not been carried out by corporate law scholars on the frequency and nature of statutory derivative actions in the Australian context. Accordingly, the table below only highlights the nature of applicant from 2000-2006.

Corporate Ownership of Applicants Who Brought Forward Each Derivative Action	Number of Cases	Total Percentage
0-30%	12	38.7%
30-49%	2	6.8%

[52] IAN M. RAMSAY & BENJAMIN B. SAUNDERS, CTR. CORP. L. & SEC. REGULATION, LITIGATION BY SHAREHOLDER & DIRECTORS: AN EMPIRICAL STUDY OF THE DERIVATIVE ACTION 25 (2006).

>50%	7	22.5%
Unknown	10	32%
Total	31	100%

Even though Australia also has a low number of derivative actions brought forward, almost 40% of cases were brought forward by shareholders who had a non-controlling share of the company. Whereas in China, only just over 20% of cases were brought forward by those who did not control equal to or more than 30% of the company they had invested in.

All of China's derivative suits bar one have been initiated by shareholders of limited liability companies.[53] Nonetheless, in Australia over 10% of derivative actions from 2000-2006 were initiated by shareholders in public companies.[54] It illustrates that even though Australia may have a disappointing record for protecting minority shareholders in public companies, it is still marginally better than China's record. This is slightly disturbing, considering that China, unlike Australia is a global economic leader. As Hui Huang has demonstrated through his research, there were derivative actions filed against listed companies on three occasions prior to the implementation of the *2005 Company Law*.[55] However, this article specifically analyses the impact of the 2005 legislation on enabling minority shareholders to initiate derivative actions.

2. *Remedies Granted to the Injured Party*

Remedy Granted	Number of Cases	Percentage
Compensatory Damages	39	44%
Injunction & Compensatory Damages	2	2%
Injunction	1	1%
Rescission of Contract	1	1%
Contract/Transaction deemed void	1	1%

[53] 2009 Nian Zhenquan Shichang Shida Dianxing Anli Pandian (Stocktaking of Ten Major and Typical Cases Concerning the Securities Market in 2009) (15 March 2010) *Zhongguo Zhengquan Bao (China Securities Journal)*.
[54] *Id.* at 25.
[55] Huang, *supra* note 39, at 631.

Other non-monetary relief	7	8%
Derivative Action dismissed with no remedy granted	38 (6 of these cases were dismissed for being defective in preliminary procedures (*locus standi* requirements))	43%
Total	89	100%

Evidently, in most cases where a derivative action is not dismissed, the aggrieved shareholder acquires compensatory damages on behalf of the company. However, the evidence also reveals that a considerable number of cases are dismissed with no relief. Perhaps this is one of many reasons why minority shareholders in listed companies are reluctant to bring forward derivative actions.

3. Types of Plaintiffs: 2010–2013

Plaintiff Type	**Company Position**	**Number**	**Percentage**
Non- Controlling Shareholders	Company Position Unknown	8	21%
	General Manager	1	2%
Controlling Shareholders (>30%)	Company Positions Unknown	19	49%
	Supervisor	1	2%
	CEO	2	5%
Unknown	N/A	8	21%
Total		39	100%

Article 151 was introduced to give minority shareholders a legal basis to bring forward derivative actions. However, evidence from 2010-13 highlights that controlling shareholders have brought forward derivative actions in private companies. Minority shareholders make up less than a quarter of applicants who filed for derivative action. Furthermore, there are only two cases where a shareholder who held less than one per cent of the total share value of the company filed a derivative suit. In considering this, it does not appear unusual that there have been no derivative suits filed against listed companies.

IV. LEGAL & PRACTICAL ASSERTIONS TO EXPLAIN THE EMPIRICAL EVIDENCE

A. Substantive Requirements Not Required for the Initiation of Derivative Action Proceedings

Chinese courts do not adhere to common law substantive requirements (such as in Commonwealth jurisdictions) for the admissibility of a derivate action. Unlike the common law in Commonwealth jurisdictions such as Canada, New Zealand and Australia, judges do not have a wide discretion in Chinese courts. The legislation in common law countries requires the court to look at the *interests of the company*[56] when determining whether a derivative action should proceed to litigation. Although, article 151 does outline that if the company's interests are being impaired, then the shareholders may initiate a lawsuit in the People's Court,[57] the admissibility of derivative actions rarely turns on this point. This reflects Zhang's argument that in civil law jurisdictions the admissibility of derivative actions generally turns on whether the minimum shareholder requirements have been satisfied.[58] Common law jurisdictions such as New Zealand adopt a *cost-benefit* analysis when determining whether an applicant's actions are in the best interests of the company. Whilst in England, the *best interests* test is considered of paramount importance.[59] In the English case of *Franbar Holdings v Patel*[60] the court outlined that many factors are taken into consideration when determining whether the application is important for the company. One of them is whether the company has the necessary assets to satisfy the court order.[61] However, the Chinese legislation does not specifically refer to the action having to be brought forward in the best interests of the company.

Traditionally, common law jurisdictions required a derivative action to be brought forward in good faith. Despite this, in Australia, the New South Wales case of *Lewis v Nortex*[62] established that even if the good faith criterion is not satisfied but the *best interests* element is, then the derivative action will be allowed to be heard. Although the case is not binding on states outside of New South Wales it reflects that contemporary judges are taking less notice of the 'good faith' requirement as opposed to the *best interests* of the company. In China, there appears to be no mention in the legislation about a good faith criterion being satisfied.

Nonetheless, similar to common law jurisdictions, there must be a prima facie case of success. This is corroborated by Flora Xiao Huang, who argues that a

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[56] Canada Business Corporations Act 1985 C-44, s 239(2)(c); Companies Act 1993 s 165(2)(d) (NZ); Corporations Act 2001 s 237(2)(c) (Cth)(Australia).
[57] Company Law, art. 151.
[58] Zhang, *supra* note 20, at 188.
[59] *Id.* at 184.
[60] Franbar Holdings Ltd v. Patel [2008] EWHC (Ch) 1534.
[61] *Id.* at [36].
[62] Lewis v. Nortex Pty Ltd [2006] NSWSC 768, at [5].

prima facie case must exist for an application to be brought forward successfully under article 151.[63] In the cases this article has analysed, there have been instances where the court has outlined that because the case is unlikely to succeed, the derivative action has not been permitted to proceed.[64]

Although Chinese derivative actions are not subject to the above substantive measures, it may be beneficial that they are only constrained by procedural requirements. This is because it prevents judges or magistrates from pre-judging or presuming the issues of the case. This was illustrated in the 1980s English case of *Prudential Assurance*[65] where at first instance the court strictly adhered to the substantive requirements, determining that the derivative action should be dismissed. This was because the *wrongdoers* were controlling shareholders in the company and had passed a resolution preventing the company from initiating litigation because they believed litigation would do more harm than good to the company. The court was forced to prejudge whether it was in the corporate interest of the company to proceed with litigation. China do not have to contend with this problem as Article 152 allows shareholders to bring forward action against directors or supervisors of the company if their actions have violated the shareholders' personal rights.

B. Locus Standi

Although China may not follow the *locus standi* requirements of common law jurisdictions, similar to Germany, the most significant reason why shareholder derivative action is so uncommon in Chinese public companies is because of the restriction placed upon minority shareholders in joint stock limited companies (JSLC). These companies are essentially the equivalent to public companies in common law jurisdictions. The first issue is that a shareholder must hold 1% of the total share value of the company in order to have standing to bring forward a derivative action.[66] Second the shareholder must have held these shares for 180 days.[67] In 2006, the Chinese Supreme Court issued *Rules on Various Issues of Implementing the Company Law* that these two criteria must be achieved at the time the action is initiated.[68] Nonetheless, it is unclear whether the alleged wrongdoing must fall within the 180-day period and whether the holding period must be strictly continuous without any interruption. However, Huang suggests

[63] Huang, *supra* note 6, at 15.
[64] Zhao Ji v. Hangzhou Yuhang Government, Zhang Siming (2010) (citation unknown).
[65] Prudential Assurance Co. Ltd. V. Newman Industries Ltd. (No 2) [1982] Ch 204.
[66] Company Law, art. 151.
[67] *Id.*
[68] Zuigao Renmin Fayuan Guanyu Shiyong Zhonghua Renmin Gongheguo Gongsifa Ruogan Wenti de Guiding (1) (关于贯彻落实公司法的各种问题的规定)[Rules on Various Issues of Implementing the Company Law (1)] 4 (Sup. People's Ct. 2006) (China).

that the shares must be held for 180 days continuously.[69] Another ambiguity of the legislation is whether the applicant must be a shareholder at the time the action is filed, or could they have been a former shareholder who has been wronged. DC Clarke argues that the fundamental rule of Chinese Civil Procedure is that the plaintiff must have a direct interest in the matter being litigated.[70] On this basis, it appears that the applicant would had to have been a shareholder at the time they filed their derivative action. The requirement of 1% holding for 180 consecutive days is clearly a strict barrier on minority shareholders in JSLCs. No other jurisdiction in the world, with the exception of Singapore makes a distinction between its private and public companies, when outlining the procedure that has to be followed to initiate a derivative action.[71]

The difficulty of overcoming the fact that a shareholder must hold 1% of the company's shares is best illustrated by Huang's empirical research which revealed that as of 2010 the largest shareholder of the listed company, Sinopec[72]had greater than 75% of the company's shares. Meanwhile, the second largest shareholder had a mere 0.29% of shares.[73] In this case, it would be impossible for minority shareholders to ever file a suit against directors for not exercising their duties with care or in the interests of the company. Whereas in private companies, minority shareholders who hold less than 1% of the total share value have successfully filed derivative action against controlling shareholders. In the case of *Dongfang Construction Group*[74] a shareholder who held 0.68% of shares sued a director who held almost 11% of the total share value of the company.[75] He was sued for committing an action that needed shareholder approval which he did not acquire.[76] If similar circumstances faced a minority shareholder in a public company they would be powerless to file action. This restriction on a minority shareholder acquiring the necessary *locus standi* is a critical reason why derivative actions amongst public companies are non-existent. Admittedly, civil law countries, such as Germany and France, have minimum shareholder thresholds: in Germany a shareholder must hold 10%, whilst in France 5% holding is required for a shareholder to file derivative action.[77]

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[69] Hui Huang, *The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform*, 4 BERKELEY BUS. L.J. 227, 236 (2007).
[70] DONALD C. CLARKE & NICHOLAS C. HOWSON, *Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China*, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 243, 261 (D. Puchniak, H. Baum, & M. Ewing-Chow eds., 2012).
[71] Huang, *supra* note 63, at 236.
[72] SINOPEC, 2010 HALF-YEARLY REPORT: SHANGHAI STOCK EXCHANGE 1, http://www.static.sse.com.cn/sseportal/ps/zhs/home.html.
[73] *Id.* at 1.
[74] Chen Ju v. Dongfang Construction Group Company Limited (Zhejiang Province Zhuji City District People's Court (2009) *shao zhu shang chu zi* No. 4058).
[75] Clarke & Howson, *supra* note 70, at 250.
[76] *Id.* at 7.
[77] Clarke & Howson, *supra* note 70, at 261.

In the circumstances where a minority shareholder of a JSLC owns 1% of the company's total shares, they face further barriers. Similar to the United States, the *demand* requirement places more obstacles in front of minority shareholders. It is important to note that this requirement is the same for minority shareholders in both private and public companies in China. Shareholders are required to make a request in writing to the *supervisory board* if they intend the action to be brought against a manager or directors of the company. However, if the minority shareholders feel aggrieved by the supervisory board, they make their written request to the managerial board. Only if the company refuses to litigate within 30 days of receiving the written request can the shareholders bring forward an action in court.[78] Despite this, the legislation does not clearly provide for who the shareholder should write to if the offending party is not part of the board of supervisors or directors. Lu holds the belief that in the case where the defendant is not a supervisor or director, written demand must be made to the company's legal representative.[79] If the demand is rejected, then the aggrieved shareholder can write to the board of directors, and if that fails then to the board of supervisors. They would have to wait 30 days for each party to respond.[80] The number of obstacles that face all shareholders but especially minority shareholders of public companies illustrates that they are not adequately protected. Arguably, the obstacles hamper the assertiveness of minority shareholders.

Perhaps the greatest evidence of the legal restraints on minority shareholders of JSLCs, is the fact that from 2006 to 2013, no action has been brought forward on behalf of a listed company. This clearly highlights that minority shareholders do not have the means to hold controlling shareholders or managers accountable for their violations of the law. However, it is critical to note that minority shareholder disputes that were originally litigated but then resolved outside of court would not be available in Chinese database records. There have been a number a number of cases resolved outside of court, with 32 cases submitted online for mediation, 21 being accepted and 10 having been resolved.[81] This is still a remarkably small number, considering that there are over 2000 listed companies in China.[82] There was a case filed in 2009 by the name of *Sanlian Shangshe*,[83] however this author has been unable to locate the results of the case.[84] Perhaps the case was later settled outside of court. A survey held in 2008–2009 revealed that

[78] Company Law, art. 151.
[79] X. Lu, Mantan woguao xin, *'Gongsi Fa' gudong daibiao susong qianzhi chengxu* (Discussion of the Precondition Procedure for Shareholders' Representative Lawsuit in China's New 'Company Law'], Caijingjie [Financial World] 232 (2007).
[80] Clarke & Howson, *supra* note 70, at 261.
[81] 'Chinese Securities Regulatory Commission' ‹http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201303/t20130326_222638.htm›, p.
[82] Bloomberg, http://www.bloomberg.com/markets/companies/country/china/.
[83] The specific citation is unknown but the case is discussed in depth in Anon., *ST Sanlian Shangshe minority shareholder suit against Sanlian group for infringement is formally docketed*, THOUSAND DRAGONS NET 1 (2009), http://qy.qianlong.com/7440/2009/12/16/4722@5353758.htm.
[84] Clarke & Howson, *supra* note 70, at 264.

over 88% of individual investors in China have less than 300 000 RMB invested in the stock market (Shenzhen or Shanghai Stock Markets).[85] This means that even if an individual investor were to invest all of his or her 300 000 RMB into a listed company with the smallest amount of share capital it would only be 0.15% of the total share value of a company.[86] This illustrates how the 1% threshold requirement is too high. It renders the possibility of derivative actions by minority shareholders in JSLCs almost impossible. Recently, the China Securities Investors Development Center Co. Ltd has been established to buy shares and act as a body that protects shareholders' rights.[87] However, the effectiveness of this body in creating an atmosphere where derivative actions can be brought forward is yet to be seen.

Also, judges in China appear to be more concerned with the procedure the applicants have to follow as opposed to assessing whether another party's actions are in substance an unfair detriment to minority shareholders. In *Long Jinwen v Zhonghua Accountant Firm* an applicant shareholder's attempt to see the audited company books was rejected despite adhering to the necessary request requirements.[88] The company rejected their request on the grounds that the applicant shareholders had no accounting background.[89] This argument was accepted by the judge when the matter was litigated. In addition, in *Yu Huihui v Yu Zhenxian* the applicant brought forward a derivative action without following the necessary procedures.[90] Article 151 provides that the applicant must have made a written request to the board of directors or supervisors (depending on who the potential defendant could be) to file a lawsuit in the People's Court.[91] Only if the request is rejected, can the shareholders file a derivative action.[92] In *Yu Huihui* the applicant did not submit a written request, as he considered it to be a special 'emergency' case which does not warrant this written request.[93] The court only dismissed the case on the grounds that the application was defective in its preliminary procedure because they considered it not to be an emergency case, thus a written request was required.[94] They did not consider that the actions of the CEO (Yu Zhenxian) were potentially detrimental to the company and its shareholders. The two cases analysed in this paragraph relate to minority shareholders in private companies. Considering that the courts strictly adhere to

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[85] Zhang, *supra* note 20, at 194.
[86] *Id.* at 194.
[87] Lan Xinzhen, *Protecting Small Investors*, BEIJING REV. (Jan. 13, 2014), http://www.bjreview.com.cn/ business/txt/2014-01/13/content_590522.htm.
[88] Shaowei Lin & David Cabrelli, *Legal Protection for Minority Shareholders in China*, FRONTIERS OF L. IN CHINA 8(2) (2013), http://blog.chinadaily.com.cn/blog-1158878-11211.html
[89] *Id.*
[90] Yu Huihui v. Yu Zhenxian (2011) (People's Sup. Ct.), http://vip.chinalawinfo.com/Case/display content.asp?Gid=117753360&Keyword=.
[91] Company Law, art. 151.
[92] *Id.*
[93] *Yu Huihui v. Yu Zhenxian* (2011).
[94] *Id.*

the procedures that shareholders of private companies have to follow to file derivative suits, minority shareholders of public companies would almost certainly have to follow the strict procedures required of them in Article 151. As demonstrated above, to achieve *locus standi* is difficult.

C. Judges in China: Are They in a Suitable Position to Assess Derivative Actions?

Minority shareholders may be reluctant to bring forward derivative actions in court because of their lack of faith in China's judiciary. China's constitution may have created a completely independent judiciary from the executive, but in reality this is not the case. Unlike in Australia, local governments fund the local courts in China. Furthermore, the local government has power to remove, appoint, demote and promote judges. Accordingly, judges may be pressured by government forces to make a decision in the controlling shareholder's interests or not allow the case to be heard at all. The judicial committee (*shenpan weiyuanhui)* assesses how politically sensitive cases should be decided, and judges rarely go against the committee's recommendation.[95] It illustrates that the judiciary is not a strong independent authority that is willing to hold powerful controlling shareholders accountable for their actions. Also, many listed companies are affiliated with the government.[96] Zhang argues that this means that the government perceives these companies as a major source of employment and tax revenue,[97] which means they would be hesitant to support an action against the management or controlling shareholders (often state-owned). Controlling shareholders could easily influence the judiciary to dismiss the action brought against them, particularly if they have time to assess the intended action. This is substantiated by Benjamin Liebman, whose research has outlined that although theoretically the executive and judiciary are independent, in reality this is not the case. This was corroborated in 2007, when former Chief Justice of China, Xie Chunjiao argued that there is a lack of judicial independence.[98]

Another important point, is that precedents in Chinese law are not given the same weight as in many common law jurisdictions. Judges generally do not defer to these precedents when they make their judgment, so even if a minority shareholder has been successful on a point of law, another judge is not required to follow the *ratio decidendi* in that case. This is because Chinese law has very strong civilian (mainly German) influence from the 19th century. In fact the German Civil Code was introduced to China in the latter years of the Qing dynasty.[99] Civil law systems do not recognise precedents the same way as common law systems.

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95 Nicholas C. Howson, *Corporate Law in the Shanghai People's Courts, 1992-2008: Judicial Autonomy in the Contemporary Authoritarian State*, 5 E. ASIA L. REV. 405 (2010).
96 Zhang, *supra* note 20, at 207.
97 *Id.* at 174.
98 *Id.*
99 Udo C. Braendle, *Shareholder Protection in the USA and Germany: Law and Finance, Revisited*, 7 GERMAN L.J. 258 (2006).

In *Shunde Zhaoyu Electronic Hardware*[100] the derivative action was quashed by the court because the applicant did not satisfy the 'demand' requirement in Article 151.[101] Alternatively, in 2006, the court decided to accept the derivative action in the *Beijing Aeronautical*[102] case even though no demand had been made to a corporate body.[103] Despite this purposive approach, in 2008, the Chinese courts did not follow the precedent set in 2006. In the *Beijing Dingyu Cable*[104] case, the derivative action was deemed defective in its preliminary proceedings. This is because the aggrieved shareholders were unable to actually send a written complaint to this corporate body, which resulted in them still notifying the company but not the managerial or supervisory board, simply because neither existed in this company.[105] This strict judicial interpretation of Article 151 demonstrates the inconsistent judgments passed by Chinese courts and perhaps this deters minority shareholders from filing action.

Nonetheless, judicial independence alone is not the reason why investors may not trust the judiciary. Donald Clarke's research has revealed that unlike in the United States and Australia, where experienced lawyers who are highly skilled are appointed as judges, in China, many law graduates with very little professional experience are often appointed judges.[106] Clarke even argues that some judges have not even acquired a proper legal education, *i.e.*, a recognised degree or diploma in law. In addition, empirical research conducted by Hualing Fu demonstrates that there is a particular concern for judges presiding over *economic cases*.[107] This is because of their lack of specialised knowledge of the subject matter.

D. Funding of Derivative Actions

Another critical reason why there may be so few shareholder derivative actions filed in China is because of the significant expense an individual

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[100] Zhao Yu v. Zhou Yuchao re: Shunde Mun. Zhaoyu Elect. Hardware Co. Ltd. (Guangdong Province Foshan Municipal Shunde District 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).

[101] Zhao Yu v. Zhou Yuchao re: Shunde Mun. Zhaoyu Elect. Hardware Co. Ltd. (Guangdong Province Foshan Intermediate People's Court (2007) *fo zhong fa miner zhongzi* No. 348).

[102] Lin Yu v. Aeronautical New Concept Science & Tech. re: Beijing Aeronautical City Tongzhi Nengka Engineering Co. Ltd. (Beijing Municipal Haidian District People's Court (2006) *hai min chuzi* No. 08927).

[103] Clarke & Howson, *supra* note 70, at 266.

[104] Zhang Ke v. Zhang Chen re: Beijing Dingyu Special Type Elect. Cable Co. Ltd. (Beijing Municipal Haidian District People's Court (2008) *hai min chuzi* No. 23873).

[105] Clarke & Howson, *supra* note 70, at 266.

[106] Donald C. Clarke, *Empirical Research in Chinese Law*, *in* BEYOND COMMON KNOWLEDGE: EMPIRICAL APPROACHES TO THE RULE OF LAW 175–77 (Erik Jensen & Thomas Heller eds., 2003).

[107] Hualing Fu, *Putting China's Judiciary into Perspective: Is it Independent, Competent and Fair?*, *in* BEYOND COMMON KNOWLEDGE: EMPIRICAL APPROACHES TO THE RULE OF LAW 210 (Erik Jensen & Thomas Heller eds., 2003).

shareholder would have to bear to bring forward an action. However, as argued above, individual shareholders in JSLCs do not even have the necessary *locus standi* to bring forth an action. In LLCs (Limited Liability Companies), many individual shareholders may not have the necessary liquid cash to pay for the high filing costs, court costs and their attorneys.

Contrary to this, in the United States, it was established in the case, *Interlake Porsche & Audi Inc v Bucholz*[108] that if a plaintiff was successful in bringing forward a derivative action and the company acquired some material benefit from it, the company's common fund would compensate the plaintiff's court and attorney costs. Evidently, a minority shareholder in the US context bears less financial risk than a minority shareholder in China. This too, may explain the relatively low number of derivative actions filed in China in the last eight years. This theory is corroborated by the Australian context, where in the pre-statutory derivative action period, payment for these actions were usually compensated by the company on order of the court. Despite this, since the introduction of the statutory based action in 2000, the courts have not always ordered the companies to bear the costs of the shareholder applicants. Arguably, this contributes to the fact that the statutory derivative action in Australia has not flourished. Nonetheless, litigation funding is available in Australia. However, the plaintiff(s) would have to find a funder(s) who would be willing to enter into a litigation funding agreement.[109] The funder would generally absorb a proportion of the damages awarded to the applicant shareholder(s) if they are successful. However, Lang Thai argues that often the funders conduct their own investigation in determining the prima facie merits of the case initiated by the aggrieved shareholders.[110] The selectivity is based on whether the funders believe the case will be successful in giving them substantial compensation.[111]

Although Japan does not have an American-style contingency funding or the litigation funding of Australia, they have had more derivative suits filed than China. This is because the stamp fee to file cases for derivative suits was reduced significantly following the *Nikko Securities* case in 1993.[112] Tomotaka Fujita, a leading Japanese company law professor, argues that almost immediately following this case there was a considerable increase in Japanese shareholder derivative litigation. It made pursuing such litigation favourable from a 'cost-benefit' analysis. Whereas in China, the high costs of filing cases means that shareholders are dissuaded from filing a derivative suit because if the suit is dismissed, they can lose a great amount of money. This is because under standard Chinese civil law, all court costs are borne by the losing party. This was

[108] 45 Wash. App. 502 (1986).
[109] Lang Thai, *Commercial Litigation Funding: The Need to Impose Regulations to Improve to Outcome of the Shareholder Class Actions*, 4 J. AUSTRALASIAN L. TEACHERS' ASS'N 2 (2011).
[110] *Id.*
[111] *Id.*
[112] DAN W. PUNCHIAK, THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 43(Cambridge University Press, New York, 2012).

corroborated by a statement made by the Chinse State Council in April 2007. The council stated that when allocating litigation costs the 'loser pays all.'[113] Nonetheless, it is important to note that as of 2007, over 50% of civil cases heard in front of Chinese local courts end in mediation with the case being withdrawn by the plaintiff.[114] Accordingly, most losing parties do not pay the entire litigation costs of the opposing party. The parties generally determine how the costs should be apportioned, if a decision cannot be made, the court allocates the cost- but the 'loser pays all' concept does not apply.[115]

Although both sides are generally responsible for their own lawyers' fees, even if an action is successful it may not outweigh the huge cost of the lawyers. Furthermore, China has 'filing fees.' The fee is determined on a 'sliding-scale' basis with 2.5% as a maximum rate for cases RMB 10 000 or less, and 0.5% as a minimum rate for cases RMB 20 million or more.[116] Although the losing party generally must pay for the winning side's filing fee, the plaintiff is required to provide it upfront.[117] This is very uneconomical, especially when class actions are generally restricted. For example, in ST Dongfang, there were 61 plaintiffs and instead of pursuing a class action, they were split into six groups, each not allowed to have more than 10 plaintiffs.[118] It is unclear whether every group was subject to pay the full filing fee.

Furthermore, Chinese minority shareholders do not have the protection of a contingency fund. A contingency fund, used in countries such as the United States is a fund for unexpected outflows and expenses. Kranenburg outlined that the fund specifically addresses class actions and ensures that the plaintiff are not 'out of pocket' whether their claim is successful or not.[119] Interestingly, attorney's fees are considered separate to litigation costs which means the losing party is not liable to pay the other side's lawyers' fees.[120] Despite this, Xiao and Tang have argued that law firms generally require a retainer for over half of the predicted law fees.[121] Theoretically, lawyers' fees are determined by the *Administration Measures on Lawyers' Service Fees.* Article 26 specifies that all lawyers must abide by these measures. Despite these supposedly strict guidelines, Xiao and Tang have argued that the government rarely intervenes in how much law firms charge their clients, which suggests that in practice lawyers can charge clients more than what the *Administration Measures* recommend.

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[113] Xiao Jianguo & Tang Xin, *Cost and Fee Allocation in Civil Procedure*, 4 TSINGHUA CHINA L. REV. 45 (2012).
[114] *Id.* at 49.
[115] *Id.*
[116] BO GONG, UNDERSTANDING INSTITUTIONAL SHAREHOLDER ACTIVISM: A COMPARATIVE STUDY OF THE UK AND CHINA 295 (2013).
[117] Chinese Civ. P. L., art. 107.
[118] Gong, *supra* note 112, at 295–96.
[119] Werner R Kranenburg, Address at the New York State Bar Association: Transatlantic Litigation 3 (2011).
[120] *Id.* at 45–46.
[121] *Id.* at 67.

E. Inadequate Resources for the Chinese Securities Regulatory Commission (CSRC)

A minor point as to why minority shareholders are unlikely to file derivative suits is because of a lack of transparency in public companies. This lack of transparency is reflected through the ineffectiveness of the CSRC—China's main securities regulatory body. The CSRC has only established thirty-six regulatory bureaus in the whole of China, despite being having been established in 1992. Although there was a special Enforcement Team created in 2007 (*jicha zongdui*), there are a mere 600 staff members on the Enforcement Bureau who are responsible for monitoring 2000 listed companies.[122] Although in Australia, the Australian Securities Exchange (ASX) only has 530 skilled members for monitoring listed companies,[123] the Australian Securities and Investments Commission (ASIC)—with over 12,000 staff members—provides critical enforcement on public companies.[124] Admittedly, not all of these 12,000 staff members are responsible for monitoring the actions of public or listed companies. Hongming Cheng argues that some of this staff do not have the requisite securities knowledge, which means they are unable to detect securities related crimes so as to protect minority shareholders.[125] This is illustrated by the fact that in 2011 only 198 individuals were sanctioned along with 13 companies,[126] even though there are well over 2,000 listed companies in China.[127]

When one considers the compelling evidence that is available on related party transactions and tunnelling activities,[128] it sheds light upon the ineffectiveness of the CSRC. These tunnelling activities and related party transactions reallocate funds and resources to other companies that the majority shareholders or directors may be a part of.[129] This reallocation could be detrimental to the company itself and its minority shareholders, but the CSRC have been incredibly ineffective in quashing this activity. If the CSRC cannot deter the malpractice of directors or third parties, then it is even more difficult to expect minority shareholders to check this malpractice. The CSRC have been given no power to curb the misappropriation of a company's assets by controlling persons (within the company). Perhaps the CSRC need to be given formal powers to punish violators of company law. Accordingly, controlling shareholders would be

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122 *Listed Domestic Companies*, THE WORLD BANK (2014), http://data.worldbank.org/indicator/CM. MKT.LDOM.NO.

123 *Careers at ASX*, ASX (2014), http://www.asx.com.au/about/careers-at-asx.htm.

124 *Careers at ASIC*, ASIC (2014), https://careers.asic.gov.au/jobtools/JnCustomLogin.Login?in_organid=16529.

125 Weixia 'Securities Arbitration: A Better Alternative to Retail Shareholder Protection', p 290.

126 *Id.* at 291.

127 THE WORLD BANK, *supra* note 22.

128 *See* Maggie P Williams & Denis W Taylor, *Corporate propping through related party transactions: The effect of China's securities regulations*, 55 J. L. & MGMT. 1 (2013).

129 *Id.* at 30.

forced to make decisions in the interests of the company and minority shareholders. The lack of transparency may be a critical reason why minority shareholders in public companies do not file derivative actions as information may not be made available to them because of the ineffectiveness of the CRSC to hold public companies accountable for their breaches of the company law.

Although it is critical to note that in the United States private litigation by investors as opposed to public enforcement drives derivative suits. However, in other jurisdictions such as Australia, a strong regulatory body such as ASIC provides an avenue for disgruntled investors to bring forward derivative suits.

F. Mandatory Cumulative Voting

Although this final point does not directly address the dearth in minority shareholder derivative actions, it is still a relevant to the larger question of effective protections that exist. Article 106 allows listed companies to choose whether they want to implement a *cumulative voting* method in electing directors and supervisors or opt for the standard *straight voting* system. The former Chinese company law made it compulsory for all listed companies with a controlling shareholder that holds greater than 30% of the total share value of the company to have a method of *cumulative voting*. Now, this is not the case, but Bo Gong attests that most listed companies with a lone controlling shareholder who has greater than 30% of the corporation's share value are subject to a *cumulative voting* method.[130]

A *cumulative voting* system is where minority shareholders are given the right to vote for some of the directors in their company.[131] The number of directors they are permitted to elect is proportionate with the value of shares they hold in the company.[132] This is in contrast to *straight voting* where each shareholder votes the number of shares he or she owns for as many candidates as can be elected.[133] In many cases, majority shareholders would prefer this because then they can elect all of the board of directors. However, cumulative voting allows minority shareholders to elect some directors, albeit a minority. In China, the cumulative voting system is not mandatory in all public corporations in China. Rather, it allows companies to *opt-in* to use *cumulative voting* as a method to elect its board of directors. The *opt-in* cumulate voting policy has enabled companies to abuse minority shareholders. The findings of Jun Qian and Shan Zhao highlight that those firms that have adopted *cumulative voting* have experienced less *tunnelling* activities than those companies that have maintained a *straight voting* system.[134]

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[130] Gong, *supra* note 112, at 210.
[131] Richard S Dalebout, *Cumulative Voting for Corporation Directors: Majority Shareholders in the Role of a Fox Guarding a Hen House*, 2 BYU L. REV. 1199 (1989).
[132] *Id.* at 1199.
[133] *Id.* at 1200.
[134] Jun Qian and Shan Zhao (2013) 'Tunnelling activities of Listed Companies,' p 10.

Although Qian and Zhao have provided a link between *cumulative voting* and a reduction in tunnelling activity, only about 20% of listed companies with tradable shares to the public have adopted *cumulative voting*.

Nonetheless, corporate governance expert, Richard Dalebout argues that *cumulative voting* is illusory in protecting minority shareholders.[135] This is because the company's shareholders generally vote on whether *cumulative* or *straight* voting is to be used. Accordingly, the majority shareholders maintain control over whether a cumulative voting method should be utilised. Even if the majority shareholders opted in to use *cumulative voting*, they would still determine the majority of the board of directors, which allows them to manipulate decisions made by the company through the directors they have voted for. This goes against a key principle of corporate governance: that the director owes a duty of care to the company above all else (as opposed to majority shareholders). The company's articles of association outlines whether a *cumulative voting* system will be used.[136] Of course, the articles of association can be amended, however, this would need shareholder approval. Perhaps the great paradox is that the minority shareholders would not have enough votes to implement the *cumulative voting* method, which is supposed to curtail the power of controlling shareholders. Practically, minority shareholders rarely create a block together nor share the same interests. So, even if cumulative voting was adopted, there is no assurance that all minority shareholders would have their interests represented on the board of directors.

V. CONCLUSION

In the final analysis, the *2005 Company Law* is not a legislative instrument that has created a favourable corporate governance framework for minority shareholders. Article 151 may give shareholders an opportunity to file derivate actions against directors, supervisory board members or other third parties but in reality this action is rarely used. Although 89 cases have been filed since the inception of the reformed company law, this is a remarkably small number, especially when compared to Japan where there have been on average over 70 derivative suits filed per year for the past decade. In public companies, there is only one reported derivative action by minority shareholders since 2006. Evidently, minority shareholders are afforded less protection in public companies. This is reflected in the strict *locus standi* requirements they have to meet before they can even file a derivative suit. At times, the courts have dismissed applications because they did not conform to non-essential procedural requirements, despite the fact that there may be merit behind the claim. Furthermore, the *loser-pays-all* system in Chinese litigation arguably deters potential actions from being filed. Although

[135] Dalebout, 'Cumulative Voting for Corporation Directors', p 1200.

[136] Shaowei Lin and David Cabrelli (2013) 'Legal Protection for Minority Shareholders in China' 8(2) *Frontiers of Law in China* ‹http://blog.chinadaily.com.cn/blog-1158878-11211.html›, p 1 (Last Accessed: 09/05/2014).

the *loser-pays-all* system may exist in other countries, Chinese companies do not have contingency funds which are a common source of derivate action funding in the United States. This means that minority shareholders would have to compensate their own litigation, even though they are presumably filing the claim on behalf of the company.

Also, the Chinese judiciary is often controlled by the government which plays a critical role in State Owned Enterprises (SOEs). Thus, the government can influence the decisions made in derivate suits. Although article 106 affords companies the opportunity to implement a *cumulative voting* method which is theoretically supposed to give minority shareholders more influence in electing directors, in reality this is still controlled by the majority shareholders. They have the power to elect most of the board and can even elect to have a *straight voting* system instead of a cumulative method. Finally, the CSRC, the key regulatory body for corporate governance is largely ineffective. It is under-funded and does not possess the means to protect minority shareholders in private companies, let alone public companies. If China is to create a corporate governance framework that inspires long term investment for generations to come, they need to implement more effective mechanisms to protect minority shareholders. Arguably, the changes that need to be made, stretch beyond company law, such as the need to separate the function of the judiciary and the government. In addition, contingency funds need to be promoted in China so as to encourage minority shareholders to hold their directors accountable. Also, judges should be influenced to interpret law with a *purposive approach* and more resources need to be allocated to the CSRC. For China to realise its full potential, it needs to protect and make its minority shareholders more assertive.