The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform

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ABSTRACT: The article conducts a critical analysis of the newly introduced statutory derivative action in China and then makes relevant recommendations for reform. The introduction of derivative actions is a major development in Chinese company legislation. In general, the provisions have established a basic legal framework for the bringing of derivative actions, and it is expected that the regime will have important implications in practice. However, there are some serious problems that need to be properly dealt with in order for the derivative action to function more effectively. The article looks at these problems from a comparative perspective, drawing on overseas experience, and sets out reform proposals, taking into consideration China's particular situation.

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I. INTRODUCTION

After much consideration and public consultation, China introduced the statutory derivative action for the very first time through comprehensive corporate law reform in 2005.\(^1\) It came into effect on January 1, 2006, and is contained in Chapter Six of the Company Law of the People's Republic of China ("Company Law").\(^2\)

The shareholder derivative suit originated in equity to enable a shareholder to enforce a corporate right or claim when the company fails to act. In most common law jurisdictions, this regime has its genesis in the rule in *Foss v. Habottle*\(^3\) and the exceptions to that rule.\(^4\) The basic rule states that if a company suffers a wrong, it is the company that should seek redress for that wrong because it is a separate legal entity from its shareholders. This rule is based on sound corporate law principles and is capable of achieving economically desirable results—for example—by reducing a multiplicity of shareholder legal actions and allowing managers to have the freedom to run the company.\(^5\) However, it can lead to manifest injustices in some circumstances. Problems may arise when a majority of the directors are themselves engaged in conduct detrimental to the company and as such the board refuses to bring suit in the name of the company. As a consequence, a number of exceptions to the rule in *Foss v. Harbottle* were developed to allow a shareholder to sue in order to protect his or her ownership interest in the company.\(^6\)

The common law position has been widely criticized as inadequate in several aspects, including the prohibitive cost of litigation, the restrictive

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4. The derivative actions in the United States are based on the common law principles from a case as early as in 1882: Hawes v. City of Oakland, 104 U.S. 450 (1882).
6. In general, five exceptions were recognized: the illegal or ultra vires act exception, the special majority exception, the personal rights exception, the fraud on the minority exception, and the interests of justice exception. See, e.g., IAN M. RAMSAY & BENJAMIN B. SAUNERS, *LITIGATION BY SHAREHOLDERS AND DIRECTORS: AN EMPIRICAL STUDY OF THE STATUTORY DERIVATIVE ACTION* 9-10 (Center for Corporate Law and Securities Regulation, University of Melbourne, 2006); Lang Thai, *How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand*, 30 AUSTL. BUS. L. REV. 118, 133 (2002).
standing requirements, and the uncertainty of the rule and exceptions.\(^7\) Therefore, a number of common law jurisdictions have either introduced, or are considering the introduction, of the statutory derivative action. The Canadian statutes on derivative actions have been around since the 1970's.\(^8\) In 1993, Singapore and New Zealand introduced statutory derivative action to their corporate law respectively.\(^9\) After nearly a decade of debate and consideration, Australia eventually introduced its statutory derivative action in 2000.\(^10\) Recently, a statutory derivative action has also been proposed and subsequently adopted in the United Kingdom, birthplace of the rule in *Foss v. Harbottle*.\(^11\) The statutory derivative action can also be found in the United States.\(^12\) It is believed that a statutory regime can overcome the common law deficiencies, making a derivative action more feasible and practical.\(^13\)

Although the various jurisdictions differ in the particulars of their statutory derivative actions, there are several distinctive features common to all of them. First, the basis for a derivative suit is harm to the company, not harm to the individual shareholder. Second, because a derivative action asserts a right on behalf of the company rather than a right on behalf of the individual shareholders, any judgment normally goes to the company with the plaintiff shareholder getting a pro rata benefit through his or her shareholding.\(^14\) Moreover, since a derivative suit is based on a corporate claim, it is usually permitted only when the company has chosen not to initiate action itself.

In conferring rights on shareholders to litigate with respect to wrongs to the company, the derivative action needs to strike a balance between giving an effective remedy to shareholders and allowing the company to manage itself.

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8. The Canadian statutory derivative action is currently found in Sections 238-40 and 242 of the Canada Business Corporations Act, R.S.C. 1985.
12. Since there is no federal statute on corporate law, laws relating to derivative action vary from state to state. However, many states have adopted the derivative action principles contained in the Model Business Corporations Act and the American Law Institute's work: PRINCIPLES OF Corporate GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994). In addition, the procedure for bringing a derivative action is set out in Rule 23.1 of the Federal Rules of Civil Procedure.
13. See e.g., CORPORATE LAW ECON. REFORM PROGRAM, AUSTL., PAPER NO. 3, DIRECTORS' DUTIES AND Corporate Governance: Facilitating Innovation and Protecting Investors 34 (Australian Government Publishing Service, 1997). This view is not universally shared however. See, e.g., Brian Cheffins & J. M. Dine, Shareholder Remedies: Lessons from Canada, 12 COMPANY LAW 89 (1992) (stating that statutory derivative actions have failed to make a substantial impact in Canada); Thai, *supra* note 6, at 135, 137 (arguing that the Australian statutory regime is "no more than reformulation of the common law position" and thus "statutory derivative actions in Australia are not likely to be popular").; Ramsay & Sauners, *supra* note 6, at 24 (suggesting that the Australian statutory derivative action has so far failed to substantially increase the number of cases).
14. For a discussion of the circumstances in which a plaintiff shareholder may share in the recovery, see Part IV.D.
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Indeed, while the derivative action serves a number of beneficial functions,\textsuperscript{15} it has also become a vehicle for abuse. In the United States, the common form of abuse is the exposure of the company to strike suits.\textsuperscript{16} In addition, the excessive use of the derivative action may present the danger of shifting corporate governance from the directors of a company to the shareholders. The need for a balanced system of derivative actions has been well-recognized across jurisdictions. As the Australian Companies and Securities Advisory Committee stated,

A key objective of shareholder litigation is that of achieving managerial accountability. . . Consequently, shareholder litigation can be seen as a mechanism for maintaining investor confidence. . . At the same time however it is clear that management needs to be protected against vexatious and hostile minority shareholders who, when commencing litigation, are not acting in the interests of the company. Therefore, any proposal for law reform in this area must contain mechanisms which operate to prevent needless and harmful shareholder litigation.\textsuperscript{17}

Indeed, this balance requirement should be a key element of the derivative action in any jurisdiction. However, what is regarded as appropriate balance varies from jurisdiction to jurisdiction, depending amongst other things on the corporate governance requirements and the underlying market. The purpose of this article is therefore to evaluate the extent to which the newly established Chinese derivative action has achieved the right balance in its context and then make relevant reform proposals.

The remainder of the article proceeds as follows: Part II discusses the importance of the derivative action to China. Next, Part III describes the legal framework of the Chinese derivative action and points out its distinctive features. Part IV then critically examines the Chinese provisions, taking a comparative perspective to explore ways of improving the potential utility of the action. Finally, Part V contains some concluding remarks.

II. THE BACKGROUND OF CHINESE DERIVATIVE ACTION REGULATION

A. The Need for Derivative Actions

It is generally accepted that the derivative action has a number of significant functions, particularly the provision of a shareholder remedy and the improvement of corporate governance.\textsuperscript{18} According to this school of thought,

\textsuperscript{15} See infra Part II.

\textsuperscript{16} A strike suit is defined as a "[s]hareholder derivative action begun with hope of winning large attorney fees or private settlements and no intention of benefiting corporation on behalf of which suit is theoretically brought." BLACK'S LAW DICTIONARY 127 (5th ed. 1979).

\textsuperscript{17} COMPANIES AND SECURITIES ADVISORY COMMITTEE (AUSTRALIA), REPORT ON A STATUTORY DERIVATIVE ACTION 4 (July 1993).

the derivative action plays an important role in deterring managerial misconduct, thereby reducing the agency costs inherent in corporate management. Nevertheless, some commentators have been opposed to the idea of improving corporate governance by way of shareholder litigation. These critics argue that the premise that managerial liability in shareholder litigation will reduce agency costs is “far from obvious” because other measures of corporate governance have already encouraged managers to act in shareholders’ best interests and because liability rules “play little or no role in creating incentives for beneficial conduct.” In addition, some have claimed that in practice derivative actions almost never produce real recovery for shareholders and that the lawyers representing investors make out much better than the investors themselves.

Since the theoretical debate remains largely inconclusive, many empirical studies have been carried out with the hope of providing some decisive data, but the mission has not yet been accomplished. First, depending on the assumptions made and the methods used, different studies have arrived at different conclusions. A recent empirical study in the United States finds that in all derivative suits against public companies filed in the Delaware Chancery Court in 1999 and 2000, around 28 percent produced affirmative relief for shareholders, showing that derivative actions have provided an effective means of shareholder remedy. Secondly, and perhaps more importantly, it is virtually impossible to empirically assess the benefits of deterrence of corporate wrongdoing because it does not result in positive actions for examination. However, the deterrent effect of the action is commonly regarded as its primary purpose. The difficulty of precisely measuring the benefits of deterrence has,
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to a large extent, impeded the empirical efforts in this area.

The debate over the economic value of derivative actions will probably persist in the foreseeable future, as will the relevant empirical studies. As with most legal debates, the issue of derivative actions cannot be sensibly examined without taking into account the specific context in which they operate. It can be said that the derivative action has a particularly strong appeal to China, because in the current context of rapid economic transition, there has been a high incidence of directors and the majority members harming the interests of the company or minority members.26

At present, the problem of corporate governance is acutely serious in China. There are, in theory, a number of corporate governance measures, but they are not as effective as expected in practice. First, in the Chinese securities market, non-tradable, state-owned shares have traditionally represented more than 60% of all the outstanding shares in most listed companies.27 This has provided ample opportunities for the majority shareholder to abuse his or her power by voting at the general meeting or by controlling the board of directors. Second, although China has been making efforts to encourage the practice of independent directors on the board, their independence and effectiveness have been subject to criticism. Third, while takeovers, especially hostile takeovers, have long been an effective mechanism of monitoring the management of corporations in the developed economies, this is not yet the case in China because of the over-concentration of share ownership in most listed companies. Indeed, it is virtually impossible to acquire a company without the cooperation of the over 50% majority shareholder.28

Another important reason why the derivative action may have a promising future in China lies in the shareholder remedy regime itself. In many common law jurisdictions, there is a statutory oppression remedy for shareholders who complain that the affairs of their company are being conducted in an oppressive manner.29 This remedy is usually couched in very broad terms, such as ‘oppressive’, ‘unfairly prejudicial’ and ‘unfairly discriminatory,’ and the court is empowered to make a wide range of orders to remedy the matter. An oppression claim is based on the infringement of personal rights, and thus is in

27. Since late 2005, after several careful trials, China has been implementing a nationwide reform program for all listed companies in an effort to reduce the ratio of state-owned shares. See Shangshi Gongsi Guquan Fenzi Gaige Guanli Banfa [Governing Measures for Reforming the Ownership Structure of Listed Companies] (promulgated by China Securities Regulatory Commission on Sept. 4, 2005). However, this program is yet to be completed and it remains to be seen how it would impact the Chinese securities market.
nature a personal action as opposed to a derivative action. In practice, however, corporate rights often overlap with personal rights and the breadth of the oppression remedy often allows a shareholder to bring an essentially derivative action as a personal one. For example, mismanagement of the company's affairs by the directors can constitute oppressive or unfair conduct towards individual shareholders.

In this situation, discontented shareholders are much more likely to pursue the oppression remedy for several reasons. First, unlike the derivative action where the recoveries accrue to the company as a whole, the oppression remedy allows the plaintiff shareholder to fully enjoy the benefits granted by the court. Second, as shall be seen later, the derivative action has strict procedural requirements. To commence a derivative action, the complainant is required to apply for leave of the court, which is a rather difficult task. Third, a wider range of judicial remedies are available under the oppression remedy. Therefore, many commentators have argued that statutory derivative actions have failed to make a substantial impact, in large part due to the oppression remedy. However, since there is no such thing as the oppression remedy in China yet, the Chinese derivative action can be expected to play a more important role than its counterparts in other jurisdictions.

B. Overview of Derivative Actions in China

Since legal cases do not carry the force of precedent in China, they are not regularly compiled and reported as they would be in a case law country. Although the role of the cases is necessarily limited, they shed light on the application of relevant laws and provide important information for legal reform. We will now explore the derivative cases which have been dealt with so far and illustrate the above situation. As noted earlier, the statutory derivative action was introduced in China in 2005. It is worth noting that there were some derivative suit cases even before 2005. As early as in 2000, one derivative action was filed under the general corporate law principle of shareholder protection, but it was eventually settled due to the lack of functional rules at the time. The other earlier cases suffered the same fate.

The 2005 company law reform filled this gap by introducing the statutory

30. See, e.g., Brian Cheffins, The Oppression Remedy in Corporate Law: The Canadian Experience, 10 U. PA. J. INT’L BUS. L. 305, 333 (1980) (opining that the oppression remedy has effectively lessened the importance of the statutory derivative action in Canada); Cheffins & Dine, supra note 13 (stating that apparent corporate wrongs have been litigated under the oppression remedy); Thai, supra note 6, at 136–137 (arguing that Australian shareholders would prefer to proceed under the oppression provision).


33. Id. at 434.
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derivative action, though the regime is not without defects.\textsuperscript{34} Indeed, the statutory provisions only establish a general legal framework for bringing derivative suits; in many areas it needs to be fleshed out or clarified by more detailed rules. In China, this follow-on rule-making work is normally carried out by the Supreme People’s Court of the PRC. The Court has often issued interpretations on a specific law soon after the law has come into effect, and sometimes the interpretation is much more detailed than the original law. This judicial practice is not without theoretical problems. The legal status of judicial interpretations has been a topic of controversy, with scholars being divided as to whether the Court has exceeded its constitutional power and whether the content of judicial interpretations is just interpretative or actually legislative.\textsuperscript{35}

In practice, however, judicial interpretations are applied by all courts and they are very important, as it is practically impossible to enforce the original laws framed in general principles and vague terms.

The statutory derivative action is no exception to this pattern. Since the company law was substantially amended in 2005, the Court has been working hard on judicial interpretations. As the company law reform has introduced a considerable number of new regimes like the derivative action, the Court will promulgate a series of individual interpretations to facilitate implementation on an issue-by-issue basis.\textsuperscript{36} It has consulted widely through various means, including conferences, such as the one to which an earlier version of this article was presented.\textsuperscript{37} The Court also keeps a close eye on the relevant cases when drafting judicial interpretations.

It is estimated that since the new company law came into effect on January 1, 2006, there have been several derivative suits filed nationwide. Most of these suits are still in progress.\textsuperscript{38} Some of the cases appear to be relatively simple and the courts have reached a consensus on certain issues.\textsuperscript{39} These are some of the

\textsuperscript{34} See infra Part IV.

\textsuperscript{35} NANPING LIU, OPINIONS OF THE SUPREME PEOPLE’S COURT JUDICIAL INTERPRETATION IN CHINA 91–94 (1997).

\textsuperscript{36} Wang & Huang, supra note 1. Thus far, only one judicial interpretation has been promulgated with respect to the new company law. See Zuigao Renming Fayuan Guanyu Shiyong, Zhonghua Renmin Gongheguo Gongsiifa Ruogan Wenti de Guiding [Rules by the Supreme Court on Various Issues Regarding the Application of the New Company Law], available at http://www.court.gov.cn/lawdata/explain/main/200605090020.htm. This judicial interpretation has only six provisions which are basically about the retrospective application of the new company law to cases filed before January 1, 2006. More judicial interpretations of substantive rules in the new company law are certainly needed.

\textsuperscript{37} The conference, titled "Company Law in Practice," was co-hosted by Tsinghua Law School and the Supreme Court of the PRC with the primary purpose of seeking advice on the implementation of China’s new company law which came into effect on January 1, 2006. A total of more than 50 judges from provincial high courts and the Supreme Court attended the conference.

\textsuperscript{38} Telephone Interview with Dr. Yongjian Zhang, Senior Judge, P.R.C. Supreme Court (Jan. 16, 2007). As noted above, since there is no systematic effort to compile decided cases in China, Justice Zhang based his estimation on the briefing of some lower courts and media reports.

\textsuperscript{39} BAOSHU WANG & QINZHI CUI, ZHONGGUO GONGSIFA YUANLI [PRINCIPLES OF CHINA’S COMPANY LAW] 220 (3d ed. 2006). For example, the new company law does not provide for the legal
positive ramifications of the newly introduced derivative action regime. However, in other cases where more complicated issues may have arisen from pre-trial procedures and litigation costs, lower courts have generally stayed the proceedings pending the Supreme Court’s judicial interpretations. Further, as the courts have no power to make case law in China, judicial interpretations also need to proactively address those issues which may occur in the future. Drawing upon all the advice received and the first-hand experience of lower courts, the Court is expected to promulgate a judicial interpretation of the statutory derivative action in due course, most likely before the end of 2007.

III. THE LEGAL FRAMEWORK OF THE CHINESE DERIVATIVE ACTION

A. Standing to Sue

According to Article 150 of the Company Law, if the director, supervisor or senior manager causes a loss to the company in violation of the law, administrative regulation, or the articles of association during the course of performing their duties, he or she shall be liable. In this situation, it is expected that the company itself will usually bring legal proceedings to recover damages. Where the company does not bring the legal proceedings in some circumstances, the derivative action becomes an effective remedy. Under Article 152, if the director, supervisor or senior manager is in the situation as referred to in Article 150, the right to bring the derivative suit is given to the following persons: the shareholder(s) of the limited liability company (“LLC”); the shareholder(s) of the joint stock limited company (“JSLC”) who separately or aggregately hold one percent or more of the total shares in the company for more than 180 consecutive days.

Hence, the issue of standing to sue is treated differently depending on the type of company involved. In the case of the LLC, any shareholder has standing to sue while with the JSLC, stock ownership requirements are imposed, including separate or aggregate ownership of stock above a certain level and the specified length of time of the ownership. Thus, the law takes a

status of the affected company in the statutory derivative action, but in practice the courts have almost invariably treated the company as a third party. This is in contrast with the U.S. practice where the company is both a nominal party defendant and a real party plaintiff. See HARRY G. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 358, at 750 (2d ed. 1970). This treatment is likely to be formalized in the future judicial interpretations.

40. See infra Part IV.

41. Telephone Interview with Dr. Yongjian Zhang, Senior Judge, P.R.C. Supreme Court (Jan. 16, 2007) (specializing in commercial law cases, the Supreme Court).

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more restrictive approach to derivative actions involving the JSLC.

This differentiated treatment appears to be distinctive of the Chinese derivative action. Indeed, at the international level, few jurisdictions take such approach to the issue of standing.43 There is, however, merit in this approach, particularly when the Chinese local circumstances are taken into account. First, the plight of minority shareholders in the LLC is generally graver than that of their counterparts in the JSLC. While disgruntled shareholders of the JSLC have the avenue to leave the company by selling their shares on the stock market, the LLC does not have a liquid market for their shares. This situation is exacerbated by the legal requirement that a member must obtain the consent of at least half of other shareholders prior to the member selling their shares.44 Second, the proceedings and performance of the JSLC are already closely monitored by various regulatory authorities, such as the China Securities Regulatory Commission and the relevant stock exchanges. Consequentially, corporate governance of the JSLC is generally better than that of the LLC. For example, it is required that listed companies have independent directors.45 The function of derivative actions to improve corporate governance is thus more relevant to the LLC. In sum, from the viewpoint of either shareholder remedy or corporate governance, there is clearly a greater need for derivative actions in the context of the LLC. This has been supported by empirical findings that the vast majority of derivative actions have been with respect to closely-held companies.46

Several other good reasons can be identified to account for the above standing rule. It can be argued that the risk of abuse in the case of the LLC is much lower than with the JSLC where shareholders are larger in number and outsiders can more easily buy shares to become a shareholder for the purpose of obtaining standing to sue.47 Moreover, in the JSLC with its relatively dispersed ownership, shareholders with more than one percent holding are mostly institutional investors. Thus, the ownership requirement for standing effectively limits the right of action to institutional investors. This can nurture institutional investment in China, encouraging investors to play a more active role in China’s corporate governance.48

43. One notable exception is the Singaporean legislation, which is inapplicable with respect to listed companies. Choo, supra note 25, at 81.
44. Company Law, art. 72.
45. Company Law, art. 123.
46. See, e.g., Ramsay & Sauners, supra note 6, at 27 (finding that the vast majority of derivative suits involved privately held companies); Choo, supra note 25, at 86 (stating that all applications of derivative actions in New Zealand and the majority of cases in Canada have occurred in relation to closely held companies).
47. The maximum number of shareholders of an LLC is 50. Company Law, art. 24.
48. Some U.S. commentators have argued that there is room to open the door for institutional investors to utilize derivative actions to police corporate misconduct. See Thompson & Thomas, supra note 23, at 1789-92.
B. Preconditions to the Bringing of Derivative Actions

Article 152 sets out the preconditions to the qualified shareholder bringing the derivative action. It provides,

If a director or senior manager is under the circumstance as mentioned in Article 150 of this Law...[the qualified shareholder(s)] may request in writing the board of supervisors or the supervisor of the limited liability company with no board of supervisors to initiate a lawsuit in the people’s court. If the supervisor is under the circumstance as mentioned in Article 150 of this Law, the aforesaid shareholder(s) may request in writing the board of directors or the acting director of the limited liability company with no board of directors to lodge an action in the people’s court.

If the board of supervisors, or supervisor of a limited liability company with no board of supervisors, or board of directors or acting director refuses to lodge a lawsuit after it or he receives a written request as mentioned in the preceding paragraph, or if it or he fails to initiate a lawsuit within 30 days after it receives the request, or if, in an emergency, the failure to lodge an action immediately will cause irreparable injury to the interests of the company, the shareholder(s) as listed in the preceding paragraph may, on their own behalf, directly lodge a lawsuit in the people’s court.49

Thus, the shareholder wishing to bring a derivative action needs to make a demand on the board of directors to bring suit to remedy the alleged harm, or demonstrate that any delay in initiating the action would be prejudicial to the interest of the company. In other words, the plaintiff-shareholder is required to exhaust all intra-company remedies before bringing a derivative action.

Several justifications exist for this rule. First, since a derivative action is based on a corporate claim, the company is the real party in interest. Second, it offers corporate management an opportunity to remedy the matter without the expense, publicity, and delay of litigation. Indeed, the decision whether to bring suit requires delicate business judgment, involving not only cost-benefit analyses, but also considerations of potential damage to the company’s reputation.50 Third, even if it is necessary for the company to go to court, the interest of the company can be better served by having the board of directors bring suit given that the company is in a more desirable position to do so in terms of resources, such as funding, human capital and information. It allows the company’s board of directors to control the litigation and thereby leaves significant decisions in the hands of management who are qualified and well-placed to make those decisions.51 Finally, it can reduce the scope for vexatious litigation and thus foster judicial economy because it serves as a screening mechanism, sifting out cases that are without merit.52

49. Company Law, art. 152.
50. See, e.g., Hale, supra note 5, at 225 ("[T]here will often be sound reasons for avoiding the washing of corporate linen in the courtroom.").
52. Choo, supra note 25, at 72-73.
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Similar rules can be found in various jurisdictions permitting the derivative action. In the U.S., generally when a shareholder wishes to commence a derivative action, the first requirement is to serve a demand on the company. The company is usually given 90 days to respond to the demand, but the plaintiff may specify a shorter time frame if it can be established that the delay would cause "irreparable injury to the corporation." Under Australian law, leave of the court must be obtained to bring a derivative action. Pursuant to the Australian provision, the court must grant the application if it is satisfied that:

(a) it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the steps in them; and
(b) the applicant is acting in good faith, and
(c) it is in the best interests of the company that the applicant be granted leave, and
(d) if the applicant is applying for leave to bring proceedings—there is a serious question to be tried; and
(e) either:

(i) at least 14 days before making the application, the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying; or
(ii) it is appropriate to grant leave even though subparagraph (i) is not satisfied.

In substance, this leave requirement serves the similar function to the U.S. demand requirement of affording the board of directors an opportunity to conduct the company's affairs and screen out vexatious or frivolous suits.

Compared to its overseas counterparts, the precondition to the derivative suit in China displays two notable characteristics. First, the notice requirement is rather strict in the sense that it can be waived only in cases of emergency. By contrast, there is more room for dispensation from the notice requirement in other jurisdictions. As discussed above, in both the United States and Australia, the courts enjoy wide discretion in deciding whether a notice is necessary. This carries the advantage of giving the courts more flexibility to effectively respond to various situations in practice.

On the other hand, the precondition has the danger of destroying the requirement itself, as it enables the plaintiff-shareholder to easily circumvent it. Indeed, it is not completely clear when demand can be excused. In most states in the United States, the plaintiff-shareholder can bypass the demand requirement by alleging that a demand would be useless or "futile" because a

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53. The basis for the requirement of the demand on the board is found in Rule 23.1 of the Federal Rules of Civil Procedure. FED. R. CIV. P. 23.1.
54. MODEL BUS. CORP. ACT § 7.42 (This rule has been adopted by many states in the U.S., such as Arizona, Connecticut, Iowa, Michigan, Texas, Virginia and Wisconsin).
56. The leave requirement, however, has significant procedural implications. In Australia, a derivative suit basically comprises of two components: a leave application and the actual trial. This two-step process is of relevance to the issue of litigation costs. For a detailed discussion of the cost of litigation, see infra Part IV.C.
majority of the directors are interested parties incapable of reaching an impartial decision to pursue litigation.\textsuperscript{57} One such instance arises when the directors are defendants and thus, in practice, plaintiff-shareholders invariably name the entire board of directors as defendants.\textsuperscript{58} A recent empirical study suggests that in all derivative cases filed in the Delaware Chancery Court in 1999 and 2000, none of them involves the making of a demand on the directors.\textsuperscript{59} In order to restore the utility of the requirement and preclude lengthy litigation over whether making a demand is futile, the American Law Institute has recommended that a demand on directors be required in every case and that it be "excused only if the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result, and in such instances, demand should be made promptly after commencement of the action."\textsuperscript{60} As shown earlier, it appears that the Chinese rule in this regard is essentially consistent with this recommendation.\textsuperscript{61}

The selection of the corporate organ to which the notice should be sent is made in the light of the Chinese local situation. Unlike the Anglo-American system with a one-tier structure of the board of directors, Chinese corporate governance traditionally has a two-tiered structure with a supervisory board independent from a board of directors. This feature was taken into consideration when the Chinese derivative action was cast. As noted earlier, if directors have allegedly caused harm to the company, a demand is to be made on the supervisory board rather than the board of directors, unlike the Anglo-American system. In the common law jurisdictions, the demand requirement, which is based upon the board of directors, has been the object of sustained criticism. In \textit{Lasker v. Burks}, the Court of Appeals for the Second Circuit expressed serious concern over the structural bias problem with the special litigation committee appointed by the board of directors, holding that a litigation committee composed of non-defendant directors could never be

\textsuperscript{57} See, e.g., Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) (stating that "in determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the . . . [alleged] facts . . . , a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."); see also Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254 (Del. 1995); Katz v. Pels, 774 F. Supp. 121 (S.D.N.Y. 1991); Ono v. Itoyama, 884 F. Supp. 892 (D.N.J. 1995).


\textsuperscript{59} Thompson & Thomas, supra note 23, at 1782. It should be noted that even if the court has excused demand, the company may still move for dismissal of the derivative action on the ground that the suit is not in the company's best interests. For a detailed discussion of this issue, see infra Part IV.B.

\textsuperscript{60} AMERICAN LAW INSTITUTE, \textit{PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS} 7.03(b) (1994).

\textsuperscript{61} Some states in the United States have followed the American Law Institute (ALI) recommendation, such as Arizona, Connecticut and Iowa, whereas some important corporate law jurisdictions like Delaware and California have not yet done so.
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unbiased and independent when evaluating whether to continue derivative litigation brought against other directors.\textsuperscript{62}

In the context of China’s corporate governance, the supervisory board is structured independent of the board of directors and is specifically charged with the task of monitoring the latter. In order to preserve the independence of the supervisory board, directors and senior executives cannot concurrently serve as supervisors.\textsuperscript{63} Under Article 54 of the Company Law, the supervisory board is given wide powers to bring checks on directors and management.\textsuperscript{64} Therefore, in comparison with the directors-based Anglo-American system, the Chinese supervisors-based precondition to the bringing of derivative action appears more appropriate in terms of the structural bias problem.\textsuperscript{65}

That said, it should be noted that there are two main problems with the Chinese system. First, it is not without doubt that the supervisory board is totally independent from the board of directors. Although the supervisory board is designed as an independent organ, its independence may be compromised in many ways. For historical reasons, the board of directors wields enormous influence over the personnel and funding of the supervisory board. More importantly, it is unclear whether, as a matter of business, the supervisory board has the capacity to deal with the complex issue of whether to bring suit against misbehaving directors. Indeed, as noted before, decisions to litigate are essentially commercial decisions. Compared with the commercially-minded board of directors, supervisors are generally ill-equipped for the assigned task because they usually do not have a professional level of expertise\textsuperscript{66} and are not directly involved in the day-to-day management of the company.\textsuperscript{67} However, the above concerns could be alleviated by further strengthening the role of the supervisory board. Relevant measures have been introduced to the Company Law in 2005 with a view of improving the independence and effectiveness of the supervisory board, including the provisions with respect to its organizational structure, funding and power.\textsuperscript{68}

\begin{itemize}
\item \textsuperscript{63} Company Law, art. 52.
\item \textsuperscript{64} Company Law, art. 54.
\item \textsuperscript{65} As early as in 2003, well before China introduced the statutory derivative action, the author proposed that the supervisory board act as the corporate organ to conduct the pre-trial screening procedure in China’s future derivative action. Now, the author is very pleased to see that this proposal has eventually been adopted. See Hui Huang, Research on the Shareholder Derivative Action, 7 SHANGSHIFA LUNJI [COMMERCIAL LAW REVIEW] 448-49 (2003).
\item \textsuperscript{66} According to Article 52 of the Company Law, the supervisory board must comprise of the representatives of shareholders and the representatives of employees whose percentage is no less than one third.
\item \textsuperscript{67} Under Articles 47 and 50 of the Company Law, the board of directors and senior management are given the power to manage the company on a daily basis.
\item \textsuperscript{68} Company Law, arts. 52-57. See also WANG & CUI, supra note 39, at 111-12.
\end{itemize}

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IV. PROBLEMS AND PROSPECTS

The introduction of the statutory derivative action is certainly a major development of the Chinese company legislation. This occurs against the background that China is trying to establish a modern company law to better serve its rapidly-growing economy. As discussed above, the Chinese provisions have set up a basic legal framework for the bringing of derivative suits and, to some extent, have made efforts to keep a balance between giving an effective remedy to shareholders while at the same time protecting a company from unmeritorious or vexatious litigation. It is expected that the statutory derivative action will have far-reaching implications for corporate governance and shareholder remedies in China.

However, there are some serious problems that need to be properly dealt with to allow the derivative action to function more effectively. In some areas, the right balance is not maintained between facilitating the bringing of derivative actions and protecting the company from mala fide interference in its internal management. This is understandable since Chinese legislators, in introducing the statutory derivative action, were engaged in a project without domestic precedent. International experience has the capacity to provide a range of possibilities. Therefore, those problems will be looked at below from a comparative perspective—drawing on overseas experience—and sets out reform proposals, taking into consideration the Chinese local situation.

A. Eligible Plaintiffs: Both Under-inclusive and Over-inclusive

There are some problems with the way the standing issue is dealt with in China. As discussed earlier, the right to bring the derivative action is given to any shareholders of the LLC and the shareholder(s) of the JSLC separately or aggregately holding one percent or more of the total shares in the company for more than 180 consecutive days.\(^{69}\) This rule appears to be both under-inclusive and over-inclusive, and thus it may restrict some meritorious actions while at the same time fail to discourage vexatious ones.

For one thing, the right to bring the derivative action is given only to current shareholders to the exclusion of former members. This appears to be overly restrictive in comparison with some overseas jurisdictions, such as Australia and Canada. In the Australian context, the scope of eligible plaintiffs is so broad as to include not only a current member, but also a former member or a person entitled to be registered as a member of the company or a related body corporate, or an officer of former officer of a company.\(^{70}\) Former

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69. See supra Part III.A.
70. Corporations Act, 2001, § 236 (Austl.). As to shareholder plaintiffs, there are no formal requirements with respect to the time period and size of their shareholding. Since officers are also allowed to bring derivative actions under the Australian provision, it is more accurate to refer to the
members are included because they may have been compelled to leave the company due to the underlying dispute; members of a related company are included because they may have been adversely affected.\textsuperscript{71} This position is similarly broad in Canada.\textsuperscript{72}

It is worth noting that although the scope of potential plaintiffs is very broad in Australia and Canada, in practice, the persons who are allowed to bring a derivative action are actually limited. As mentioned before, in Australia, the bringing of a derivative action is not automatic; the complainant must apply for leave of the court to institute derivative proceedings and the tests on locus standi are quite difficult to meet. When deciding whether to grant leave, the court will consider a wide range of relevant factors, such as whether the applicant has fulfilled the notice requirement, whether the applicant is acting in good faith, and whether the derivative action would be in the best interests of the company.\textsuperscript{73} In Canada, many courts held that former shareholders lack sufficient interest in the outcome of the derivative action and thus are unlikely to act in good faith.\textsuperscript{74} Empirical studies have shown that most derivative actions are brought by current shareholders both in Australia and in Canada.\textsuperscript{75} Nevertheless, bona fide former members are given an opportunity to initiate derivative actions. To enhance the deterrence aim of the derivative action, China should allow bona fide former members to bring suit.

On the other hand, the Chinese provisions appear to be over-inclusive and have difficulty discouraging unmeritorious actions. As discussed earlier, any shareholders of the LLC and the shareholders of the JSLC who meet the relevant stock ownership requirements have standing to sue, regardless of whether they were shareholders at the time of the alleged harm to the company. This is to be contrasted with the so-called requirement of ‘contemporaneous ownership of shares’ in the U.S., under which the plaintiff “must have been a shareholder or member of the corporation or association at the time of the transaction of which complaint is made or that the share or membership, if acquired thereafter, devoid by operation of law.”\textsuperscript{76} There is some authority that

\textsuperscript{73} See supra Part III.B. The test for granting leave will be discussed further in the following parts.
\textsuperscript{74} See, e.g., Jacobs Farms Ltd. v. Jacobs, [1992] 32 A.C.W.S. (3d) 1142 (Can.).
\textsuperscript{75} B. R. Cheffins, Reforming the Derivative Action: The Canadian Experience and British Prospects, \textit{COMPANY, FIN. \& INSOLVENCY L. REV.} 227, 239 (1997); \textit{RAMSAY \& SAUNERS, supra} note 6, at 26-27.
\textsuperscript{76} \textit{FED. R. CIV. P.} 23.1. In the United States, this rule governs all federal court derivative actions.
a plaintiff must also be a shareholder at the commencement of the suit and during the pendency of the suit. The requirement of ‘contemporaneous ownership of shares’ is intended to “prevent what has been considered an evil, namely, the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of the stock.” Under the current Chinese provisions, however, it is possible to bring action opportunistically by acquiring shares after finding a potential derivative case. This would open the floodgates to strike suits and thus the problem should be addressed by examining the U.S. experience.

B. Pre-trial Procedures: Can the Company Terminate Derivative Suits?

The provision governing the pre-trial procedures is also in need of reform. To begin with, while Article 152 imposes on the shareholder plaintiff an obligation to give a written notice, it is silent on the form and content of the notice. This may adversely affect the functioning of the derivative action as the information communicated by the notice to the company is vitally important to the company’s decision making process. In the United States, the demand must be adequate for its purpose and it must contain information reasonably specific for the board of directors to make an informed business assessment as to what is the most appropriate way to deal with the matter. In practice, the demand should at least include “the identity of the alleged wrongdoers, the factual basis for the allegation, the harm caused to the corporation, and the remedial relief requested.”

More significantly, the Chinese regime fails to set out clear rules as to whether the relevant corporate organs are able to stop shareholders from bringing derivative suits or to terminate shareholder derivative suits in cases where the notice requirement is waived. As discussed before, Article 152 provides that if the company decides not to bring suit upon receipt of the notice, or fails to bring suit within 30 days after it receives the notice or in case of an emergency where the notice requirement is to be waived, the shareholder may institute a derivative action. The wording of the provision suggests that as long as the company itself refuses to bring an action, the shareholder will be able to bring the derivative action, regardless of the reasoning behind the company’s decision. This is inconsistent with the need to balance the

and is emulated by many states. See, e.g., DEL. CODE ANN. tit. 8, § 327; OHIO CIV. R. § 23.1; N.Y. BUS. CORP. LAW § 626. It is worth noting that there is another important restriction on standing in Rule 23.1, namely the requirement that the plaintiff must “fairly and adequately represent” the interests of other shareholders “in enforcing the right[s] of the corporation.” FED. R. CIV. P. 23.1.

77. See, e.g., Depass v. Empire Petroleum Co., 435 F.2d 1223 (10th Cir. 1970); Rothenberg v. United Brands Co., 573 F.2d 1295 (2d Cir. 1979).
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competing interests of the shareholder in maintaining a derivative action and of the company in dismissing detrimental litigation.

In general, upon receipt of the demand notice, the company can respond in several ways. First, the company may decide to take over and litigate the suit itself, in which case there is no need for the derivative action. Second, instead of bringing suit, the company elects to take internal corrective measures to remedy the matter as the suit is not in the best interests of the company. Third, the company rejects the suit without taking steps to effectively deal with the issue. Clearly, in the second instance, although the company refuses to bring suit, the shareholder should not be given the green light to go ahead. Therefore, the refusal of the company to bring suit itself should not automatically justify the bringing of the shareholder derivative suit. Otherwise, the notice requirement could not fulfill its mission of giving the company an opportunity to conduct its affairs in accordance with its best interests.

As noted earlier, in Australia, leave of the court must be obtained to bring a derivative action. In a leave application, there is no formal defendant; if the leave sought is granted, there may be a defendant in the actual trial depending upon the allegations pleaded. Thus, the court plays a pivotal role in deciding whether to allow a derivative action to proceed. In practice, it is not uncommon that the directors will oppose the application so as to prevent the case from going to trial, particularly in cases where breach of directors’ duties is alleged.

At this leave application stage, the court is essentially filtering out unmeritorious actions. When deciding whether to grant the leave sought, the court will consider a number of factors, such as the fulfillment of the notice requirement, the possibility of the company itself bringing suit, the subjective motivation of the application, and the best interests of the company. Among these leave criteria, the best interests of the company is probably the most difficult one to meet. In practice, the court needs to look at the true nature and purpose of the proceedings, weigh the benefit of an action versus any potential detriment, and consider the probability of the action succeeding. Further, there is a rebuttable presumption in the Australian law that the granting of leave to bring statutory derivative actions is not in the best interests of the company if it is established that:

81. *See supra* Part III.B.
82. RAMSAY & SAUNERS, supra note 6, at 31.
83. *See supra* Part III.B.
84. An empirical study shows that more than half of the unsuccessful leave applications made since 2000 in Australia were due to the failure to satisfy the criterion of the best interests of the company. *See RAMSAY & SAUNERS, supra* note 6, at 32.
85. Explanatory Memorandum to the Corporate Law Economic Reform Program Bill of 1999 at [6.38].
The proceedings are by the company against a third party or by a third party against the company; and

The company has decided not to bring the proceedings or not to defend the proceedings or to discontinue, settle, or compromise the proceedings; and

All of the directors who participated in that decision acted in good faith for a proper purpose, did not have a material personal interest in the decision, informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate, and rationally believed that the decision was in the best interests of the company.8

This is the application of the business judgment rule in the context of the derivative action.8 Underlying the rule is the notion that decisions regarding transactions at arm's length by the company are most appropriately made by its directors and that external interference in them is generally not in the best interests of the company.89

Since leave of the court is not required for the bringing of derivative actions in China, the Australian experience, while highly instructive, cannot be implanted into China without substantially changing the Chinese law. Therefore, a more feasible solution is that if the shareholder brings suit as a result of the company's refusal to act, the company should be able to terminate the derivative action on the grounds that the suit is not in the company's best interest. In this regard, the U.S. model is more relevant and thus merits serious consideration.

*Zapata Corp. v Maldonado*90 is a leading case on this issue in the U.S. In *Zapata*, the Delaware Supreme Court rejected the argument that once demand on the board is made and subsequently refused, a stockholder possesses an independent and absolute right to continue the derivative suit over the company's objection.91 The court held that the company's decision not to sue terminates a derivative action unless the refusal was wrongful92 or demand on the board would be futile.93 As noted earlier, in the United States, demand is often excused on the basis of futility and the shareholder is able to directly commence a derivative action. However, the company may still have the power to dismiss properly initiated derivative suits because "circumstances may arise when continuation of the litigation would not be in the corporation's best interests."94 In other words, the excusal of demand does not remove the

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88. The third limb of the rebuttable presumption is expressed in identical terms with the conditions of the business judgment rule contained in Corporations Act, 2001, § 180(2) (Austl.).
89. Explanatory Memorandum to the Corporate Law Economic Reform Program Bill 1998, at [6.4.1].
90. 430 A.2d 779 (Del. 1981).
91. Id. at 782.
92. Id. at 784.
93. Id.
94. Id. at 785.
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company’s ability to terminate the derivative action.

In practice, the company will commonly delegate to a special litigation committee usually composed of independent directors who have the authority to decide whether to pursue the derivative action. After weighing a variety of considerations, such as the relative costs and benefits of litigation, the committee decides whether continuation of the suit is in the best interests of the corporation and then recommends that the company either move for dismissal or pursue the suit. The Delaware Supreme Court set out a two-step test for courts to follow when evaluating a recommendation of the committee to dismiss. First, the court should evaluate the independence and good faith of the committee and the reasonableness of its decision. The burden of proof is placed on the company to demonstrate the good faith, independence and reasonableness of the committee. Second, the court should apply its own business judgment to determine whether dismissal is appropriate. Later in Kaplan v Wyatt, the Delaware Supreme Court provided more specific guidelines for the judicial review of those recommendations to terminate a derivative action.

It should be noted that in almost all reported cases, the litigation committees have recommended termination of the derivative suit on the ground that the suit does not serve the best interests of the corporation and the courts have tended to respect the committee’s recommendations. This situation has drawn a considerable body of criticism. However, it should not pose too big a problem for China because, as discussed before, China has taken advantage of its dual board structure, choosing the independent supervisory board as the body to respond to the demand of shareholders. Therefore, China should be able to learn from the U.S. practice of allowing the company to terminate a derivative action on the basis of its best interests without worrying too much

95. Id. at 788-89.
96. Id.
97. Id. at 789.
98. 499 A.2d 1184 (Del. 1985).
99. The court stated that whether a special litigation committee’s recommendation to dismiss a derivative action is independent or not depends on the “totality of the circumstances” and relevant factors for consideration include: (1) a committee member’s status as a defendant, and potential liability; (2) a committee member’s participation in or approval of the alleged wrongdoing; (3) a committee member’s past or present business dealing with the corporation; (4) a committee member’s past or present business or social dealings with the individual defendants; (5) the number of directors on the committee; and (6) the “structural bias” of the committee. Id. at 1192.
102. See, e.g., Dent, supra note 58 (arguing that the committee’s members can never be independent); John C. Coffee & Donald E. Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 COLUM. L. REV. 261, 323 (1981) (suggesting that there should be limits placed on the use of the special litigation committee).
about its side effect of inhibiting derivative actions.

C. The Cost of Litigation: The Lack of Incentives for Shareholders

As discussed earlier, the derivative action is of particular importance to China and this is the very first time that China introduces this system. It is therefore desirable to encourage the use of this tool to reach its full potential. However, there are significant disincentives attaching to the Chinese derivative action since the question of who bears the cost of litigation is not addressed properly.

The cost of litigation has traditionally been a key issue in the derivative action. In general, if the derivative action is successful, the recoveries accrue to the company as a whole with the plaintiff shareholder receiving only a small pro rata benefit. The fact that other shareholders will have a free ride on the plaintiff shareholder’s effort creates a disincentive for the bringing of a derivative action. This problem is further exacerbated by the fact that as a general rule in China, the plaintiff shareholder will have to bear the legal costs of the action. Therefore, it is crucially important that some special cost arrangements be put into place to deal with the imbalance of costs and benefits in the derivative action.

There are two main ways to deal with this issue overseas. In Australia, Canada, and many other Western jurisdictions, the cost of litigation has long been a vexing problem at common law, which has been a contributing factor to the introduction of the statutory derivative action. The special arrangement these jurisdictions have adopted in their statutory regimes is to give the court wide power to issues orders about the costs of the applicant, the company or any other party to the derivative proceedings. The court can order the company to pay the applicant’s reasonable legal costs. However, it is unclear when the court will make such an order. In practice, the court has been very cautious about the cost issue and has refused to order the company to pay the applicant’s legal costs on various grounds. Many commentators have argued that the statutory provisions have failed to provide any certainty of litigation funding and that this problem is largely responsible for the relative unpopularity of derivative actions in practice.

103. WEIPING ZHANG, CIVIL LITIGATION LAW [MINSHI SUSONGFA JIAOCHENG] 258-62 (1998). Since the Company Law does not provide for any special rule regarding the cost of litigation, this general rule applies to the derivative action.

104. In some common law jurisdictions, the problem may be worse as the general rule is that the shareholder may have to bear the legal costs of the defendant if the action is unsuccessful. See Ramsay, supra note 19, at 163.


106. See, e.g., RAMSAY & SAUNERS, supra note 6, at 36-38.

107. See, e.g., Choo, supra note 25, at 89-92; Thai, supra note 6, at 136.
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The other way to deal with the issue of costs is the U.S. contingency fee arrangement. Under this system, the attorney’s fees are contingent on the case being successfully litigated or settled. There are two methods for calculating attorney’s fees in the derivative action, depending upon the form of relief awarded. If the case generates monetary relief, the attorney’s fees will be paid at a fixed percentage of the amount recovered whether by judgment or settlement. In practice, the agreed percentage is normally in the range of 20-30 percent. If a derivative action results in a substantial non-monetary benefit to the company, the attorney will be paid for his or her work done. The fees will be calculated on the basis of the number of hours reasonably spent on the work and the applicable market hourly rate. In the United States, this fee arrangement has provided sufficient incentives for the attorney to act as the driving force behind most derivative actions. It is widely believed that this is one of the key reasons why derivative actions are much more popular in the United States than in other common law jurisdictions like Australia and Canada where the contingency fee arrangement is not recognized.

Compared with the first model, the U.S. model is more suitable for China for the following reasons. First, as noted above, in practice, the contingency fee arrangement appears to be more effective in encouraging the bringing of derivative actions, which is currently the primary objective of the Chinese law. Second, the first model does not fit neatly into the Chinese system as leave of the court is not required in China. In the first model, whether the shareholder is granted leave is a very important consideration when the court decides whether the company should pay the cost of litigation. Finally, it is safe to say that if the Western judges, who are usually chosen from among leading lawyers in relevant areas, find it difficult to handle the complex issue of costs, then the Chinese judges, who are ill-equipped in terms of education and experience, may only find it even harder.

112. Indeed, some Australian commentators have argued in favor of the contingency fees arrangement. See Thai, supra note 6, at 137 (stating that “[f]or statutory derivative actions to be truly effective, it may be necessary for the contingency fees rules to be introduced into Australia”).
113. It has been argued that once the court grants leave to the applicant to commence derivative proceedings, it should be mandatory for the company to pay the costs of the proceedings. See Ramsay, supra note 19, at 164.
V. CONCLUSION

The introduction of the statutory derivative action is certainly a major development in Chinese company legislation and will have far-reaching implications for corporate governance and shareholder remedy in China. In general, the Chinese provisions have set up a basic legal framework for the bringing of derivative suits and, to some extent, made efforts to keep a balance between giving an effective remedy to shareholders while simultaneously protecting a company from unmeritorious litigation.

However, there are serious problems in some areas, such as the scope of eligible plaintiffs, preconditions to the bringing of derivative action, and the cost of litigation. These problems need to be properly dealt with to allow the derivative action to function more effectively. To begin with, the scope of eligible plaintiffs appears to be both under-inclusive and over-inclusive, which may preclude some meritorious derivative suits while failing to screen out vexatious ones. The U.S. rule of "contemporaneous ownership of shares" is recommended to address this issue.

More importantly, the Chinese regime fails to set out clear rules whether the relevant corporate organs have the power to terminate derivative suits which have already been initiated. This can lead to the potential for abusing the statutory derivative suit since shareholders may opportunistically circumvent the management to bring suit for ulterior purposes. It is submitted that China learn from the U.S. practice of allowing companies to form special litigation committees to decide whether the derivative suit is in the best interests of the company and then recommend continuation or dismissal of the suit.

Another significant deficiency in the Chinese provisions relates to the cost of litigation. If not addressed properly, this issue will cast serious doubts on the prospect of a Chinese statutory derivative action. In practice, the introduction of statutory derivative actions in overseas jurisdictions has failed to make a substantial impact in large part due to the issue of litigation costs. In order to avoid suffering the same fate, China should look to examples of success overseas, particularly the U.S. contingency fees arrangement, which appears to be suitable for the Chinese local conditions.