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Building an Investor-Friendly Shareholder Derivative Lawsuit System in China*

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I. INTRODUCTION

Despite claims that China's capital markets resemble a "casino,"[1] China has in fact made extraordinary strides in its quest to develop stable and mature capital markets. Although the Shanghai and Shenzhen stock exchanges only opened in the early 1990s,[2] by the end of 2004 they boasted a com-

* This Note won the Harvard International Law Journal's 2004 Student Note Competition. Except for the SPC Draft (see *infra* note 153), all Chinese laws and regulations referred to in this Note are correct as of February 28, 2005.

Nevertheless, China's legal environment is highly dynamic. Part of the discussion contained in this Note is based on China's Company Law (see *infra* note 26). On April 1, 2005, the long awaited substantial amendment of the Company Law was promulgated. The Standing Committee of the National People's Congress introduced the first draft of the Amendment of the Company Law for its preliminary review. However, unlike practices in other jurisdictions, legislation currently in the drafting process is rarely published in China (see Peter H. Corne, *Creation and Application of Law in the PRC*, 50 AM. J. COMP. L. 369, 380 (2002)). The author was unable to access this draft and to update relevant discussion herein accordingly. As reported by certain news reports in China, this draft purports to substantially improve shareholder protection and may contain provisions permitting shareholder derivative lawsuits in general. (*See, e.g.*, *NPC Deliberates on Amendment Draft of Corporation Law*, XINHUA NEWS AGENCY, Feb. 28, 2005, *available at* http://www.chinadaily.com.cn/english/2005-02/28/content_420309.htm) (last visited Apr. 20, 2005).

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1. In January 2001, Wu Jinglian, a renowned Chinese economist with the Development Research Centre under the State Council, stated publicly that the stock markets in China were worse than a casino. "At least in a casino there are rules," he commented. Wu's attack sparked a heated debate among top economists inside and outside China. *See* Xin Zhiming, *Stock Market Causes Heated Debate*, CHINA DAILY, Mar. 13, 2001; Willy Wo-Lap Lam, *China's Dice-roll on Casino Culture*, CNN, Feb. 21, 2001, *at* http://edition.cnn.com/2001/WORLD/asiapcf/east/02/20/stockmkt.reform (last visited Apr. 20, 2005). For further information regarding this debate, see WU JINGLIAN, SHINIAN FENYU HUA GUSHI [TEN YEARS OF A DIVERSE STOCK MARKET] 1–33 (2003).

2. The Shanghai Stock Exchange was officially established on November 26, 1990, and securities trad-

bined list of 1377 corporations with a total market capitalization of RMB 3.7055 trillion ($447.5 billion).[3] Currently, China's capital markets rank as the twelfth largest in the world.[4]

What is most striking about Chinese capital markets is the dominance of individual investors. There are now more than seventy-two million securities trading accounts in China.[5] At the close of 2003, of the accounts trading shares on the Shenzhen Stock Exchange, only 172,700 out of 33.21 million were held by institutional investors.[6] Individual investors also generated more than 70% of the total trade turnover in 2003.[7] Most of these individual investors are middle-aged individuals or senior citizens, with an average age of 43.01 years.[8] The majority of them (86%) are low- or middle-income, and 55.63% have an annual income below RMB 20,000 ($2,418).[9] In addi-

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ing in the Shanghai market began on December 19, 1990. *See* Official Introduction of Shanghai Stock Exchange, *available at*: http://www.sse.com.cn/sseportal/ps/zhs/sjs/jysjs.shtml (last visited Apr. 20, 2005). The Shenzhen Stock Exchange was tentatively established on November 15, 1990, and officially established on April 11, 1991, but securities trading in the Shenzhen market began on December 1, 1990.

3. China Securities Regulatory Commission (CSRC), *Table 1-1 Major Index*, *at* http://www.csrc.gov.cn/cn/tongjiku/ehtml/y2004/12/A200412.html (Jan. 13, 2004) (last visited Apr. 20, 2005). Data such as the total number of public corporations listed in mainland China and the total market capitalization are available in the Major Index (*Tongji Xinxi*) section of the CSRC's official website *at* http://www.csrc.gov.cn/en/statinfo/index_en.jsp (last visited Apr. 20, 2005).

4. *See* Stephen Green, Better Than a Casino: Some Good News from the Frontline of China's Capital Market Reforms 3 (Royal Inst. of Int'l Aff., Asian Programme Working Paper No. 6, 2003), *available at* http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID431200_code030828500.pdf?abstractid=431200&mirid=1 (last visited Apr. 20, 2005).

5. As of March 31, 2005, there were 72,424,615 securities trading accounts in China. See data updated daily on the homepage of the website of China Securities Depositary & Clearing Co., Ltd., *at* http://www.chinaclear.com.cn/ (last visited Apr. 20, 2005). Note, however, that there are questions regarding the real number of individual shareholders in China. *See* Stephen Green, China's Stockmarket: A Guide to Its Progress, Players and Prospects (2003); Carl E. Walter & Fraser J. T. Howie, Privatizing China: The Stock Markets and their Role in Corporate Reform (2003). Both books show that the actual numbers of investors in China's stock markets are much smaller than that suggested by the aggregate number of trading accounts that have been opened. The number of traders is automatically reduced because some investors must open separate accounts to trade shares listed in Shenzhen and Shanghai. There also exists the considerable problem of multiple accounts being used and manipulated by institutional and individual investors (the apparently smaller converse problem of multiple investors using a single account exists as well). Professor Hutchens thus concludes that the number of active trading accounts in China may number only 5 million. *See* Walter Hutchens' blog, *70 Million Investment Accounts*, *at* http://www.rhsmith.umd.edu/faculty/whutchens/2004_01_01_blog_ archive.html (Jan. 28, 2004) (last visited Apr. 20, 2005).

6. Shenzhen Stock Exch., Shenzhen Stock Exchange Fact Book 2003 119 (Zhang Yujun ed., 2004), *available at* http://www.szse.cn/UpFiles/Attach/10/2003/11/13/ssefactbook2003.pdf (last visited Apr. 20, 2005).

7. *See* Zhou Han, *Jigou Touzizhe Duiwu Jiang Kongqian Zhuangda* [*Great Expectations of Institutional Investors*], Zhengquan Shibao [Securities Times] (P.R.C.), Feb. 18, 2004, *available at* http://www.ttstar.com.cn/starnews/displaynews.asp?id=455158 (last visited Apr. 20, 2005).

8. Chen Bing et al., Zhongguo Gushi Geren Touzizhe Zhuangkuang Diaocha [An Investigative Report on the Situation of Individual Investors in China's Securities Markets] 13 (Shenzhen Zhengquan Jiaoyisuo Zonghui Yanjiusuo [Research Inst. of the Shenzhen Stock Exch.] Paper No. 0055, 2002), *available at* http://yjwk.cninfo.com.cn/finalpage/2002-05-10/571541.PDF (last visited Apr. 20, 2005).

9. *Id.* at 16.

tion, many Chinese individual investors may lack basic financial or investment knowledge, as 43.81% of them have no higher education.[10]

Faced with booming capital markets packed with unsophisticated individual investors, China's securities regulators have faced tough questions about the adequacy of shareholder protections. The regulatory body adopted policies based on La Porta's scholarship on the positive link between capital market development and public shareholder protection.[11] As stated by Meilun Shi, former vice chairman of the China Securities Regulatory Commission ("CSRC"), "investors' confidence and participation are critical to the healthy and stable development of China's capital markets. They have a direct impact on the successful implementation of reform and the Open-Door Policy, as well as on social solidarity."[12] Since 2000, therefore, investor protection has consistently been "the top priority" of the CSRC.[13] In January 2004, China's State Council, in a policy declaration regarded as an important milestone in the history of China's capital markets, reiterated that "protecting the legitimate interests of investors, particularly those interests of public investors" shall be one of the ongoing guiding principles in the reform and development of capital markets. [14] Most recently, this principle was incorpo-

10. *Id.* at 14.

11. *See generally* Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (postulating that poor investor protections result in capital markets that are both smaller and narrower). In a speech given at the International Seminar on Investor Protection in June 2002, Zhou Xiaochuan, then the Chairman of the CSRC, specifically mentioned that "foreign research proves that the better investor protections in a country or a region, the better developed the capital market [in that country or region], and the stronger its capability to resist financial risks." Zhou Xiaochuan, *Baohu Touzizhe Quanyi Shuli Touzizhe Xinxin Guanxi Zhongda* [*To Protect Investors' Rights and Interests and to Build Up Investors' Confidence Are Critical*], ZHENGQUAN SHIBAO [SECURITIES TIMES] (P.R.C.), June 26, 2002, *available at* http://news.xinhuanet.com/fortune/2002-06/26/content_457416.htm (last visited Apr. 20, 2005).

12. Meilun Shi, *Touzizhe Jiaoyu Shi Jianguan Gongzuo Zhongyao Neirong* [*Investor Education is an Important Component of Regulatory Work*], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], July 21, 2001, *available at* http://www.cnstock.com/ssnews/2001-7-21/touban/200107210086.htm (last visited Apr. 20, 2005). Meilun Shi (a.k.a. Laura M. Cha) was a Vice Chairman of the CSRC from 2001 to 2004.

13. At the National Working Conference on Securities and Futures held in January 2003, Shang Fulin, the current chairman of the CSRC, reconfirmed that "investor protection" should be the most important work (*Zhongzhong zhi zhong*) of the CSRC during his tenure. Ma Teng, *Zhengjianhui Tancheng Jianguan Shiwu, Shang Fulin Fabiao "Pingmin Xuanyan"* [*CSRC Confessions on Regulatory Mistakes; Shang Fulin's Announced "Civilian Proclamation"*], 21 SHIJI JINGJI BAODAO [21ST CENTURY BUSINESS HERALD] (P.R.C.), Jan. 30, 2003, *available at* http://cs.2118.com.cn/news/2003/01/31/60.htm (last visited Apr. 20, 2005). In October 2000, Zhou Xiaochuan, Shang's predecessor, was the first high-ranking Chinese official to state openly that "investor protection" should be the top priority of the CSRC. Zhou Xiaochuan, *Baohu Touzizhe Shi Zhongzhong zhi Zhong* [*Protecting Investor Interests is the Top Priority*], ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES JOURNAL], Oct. 16, 2000, *available at* http://www.people.com.cn/zcxx/2000/10/ 101606.html (last visited Apr. 20, 2005).

14. Guowuyuan Guanyu Tuijin Ziben Shichang Gaige Kaifang he Wending Fazhan de Ruogan Yijian [Several Opinions by the State Council on Promoting the Reform, Liberalization, and Stable Development of the Capital Markets], State Council, *available at* http://www.chinacourt.org/flwk/show1.php?file_id=91328 (Jan. 31, 2004) (last visited Apr. 20, 2005). With respect to comments on this policy declaration, see Lin Jian, *Zhongyao de Lichengbei—Guowuyuan Guanyu Tuijin Ziben Shichang Gaige Kaifang he Wending Fazhan de Ruogan Yijian, Jiedu Zhiyi* [*An Important Milestone—Understanding the State Council's Several Opinions on Promoting the Reform, Liberalization, and Stable Development of the Capital Markets (Part*

rated for the first time into the State Council's Annual Government Work Report, which signifies the Chinese government's determination to further protect investors.[15]

Over the past five years, the CSRC and other administrative authorities in China have promulgated an array of regulations regarding investor protection.[16] On the judicial side, in January 2003 the Supreme People's Court ("SPC") of China promulgated the long-awaited Several Provisions for the Trial of Civil Damages Cases Arising from Misrepresentation in the Securities Market (the "PSL Provisions"),[17] which provided a judicial safeguard against infringement of investors' interests in Chinese private securities litigation.[18] As a result of these endeavors, some Chinese legal commentators contend that investor protection in China is improving.[19]

I)], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Feb. 3, 2004, *available at* http://www.cnstock.com/ssnews/2004-2-3/touban/t20040203_514042.htm (last visited Apr. 20, 2005).

15. *See* Shang Fulin Biaoshi Zhengfu Gongzuo Baogao Jinyibu Zhiming Shichang Jianguan Fangxiang [Shang Fulin Said the Government Work Report Further Points out the Direction of Market Regulation], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Mar. 7, 2005, *available at* http://sms.cnstock.com/ssnews/2005-3-7/jryw/t20050307_750070.htm (last visited Apr. 20, 2005).

16. For example, in August 2001, the CSRC issued Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de Zhidao Yijian [Guidelines on the Establishment of an Independent Directors System in Listed Corporations], C.S.R.C. 2001 No. 102, *available at* http://www.chinacourt.org/flwk/show1.php?file_id=38005 (Aug. 16, 2001) (last visited Apr. 20, 2005), which emphasizes that independent directors should fulfill their duty of loyalty and duty of care to uphold the interests of the company as a whole and should pay particular attention to ensure that the interests of minority shareholders are not harmed. In January 2002, the CSRC and the State Economic and Trade Commission promulgated the Shangshi Gongsi Zhili Zhunze [Code of Corporate Governance for Listed Corporations], S.E.T.C. 2002 No. 1, *available at* http://www.setc.gov.cn/qygg2001/setc_qygg2001_main0019.htm (Jan. 7, 2002) (last visited Apr. 20, 2005), which makes substantial progress toward shareholder protection in China. *See* Peter A. Neumann, *A New Commitment to Shareholder Rights in China*, M&A & CORP. FIN., Jan. 2003, *available at* http://www.faegre.com/articles/article_691.aspx (last visited Apr. 20, 2005). Most recently, in implementing the State Council's new policy on China's capital markets (see *supra* note 14), the CSRC promulgated Guanyu Jiaqiang Shehui Gongzhonggu Gudong Quanyi Baohu de Ruogan Guiding [Several Provisions on Strengthening the Protection of the Rights and Interests of Shareholders of Public Shares], C.S.R.C. 2004 No. 118, *available at* http://www.chinacourt.org/flwk/show1.php?file_id=98097 (Dec. 7, 2004) (last visited Apr. 20, 2005), which introduces mandatory class voting and cumulative voting mechanisms in public corporations to protect public investors. For a brief English introduction to CSRC's new Provisions, see Feng Jianhua, *Giving a Voice to Small Shareholders*, 48 BEIJING REV. 34 (Jan. 13, 2005).

17. Guanyu Shenli Zhengquan Shichang Yin Xujia Chenshu Yinfa de Minshi Peichang Anjian de Ruogan Guiding [Several Provisions for the Trial of Civil Damages Cases Arising from Misrepresentation in the Securities Market], S.P.C. 2003 No. 2, *available at* http://www.chinacourt.org/flwk/show1.php?file_id=82229 (Jan. 9, 2003) (last visited Apr. 20, 2005). The introduction of a private securities litigation system in China has not been straightforward. Before the promulgation of the PSL Provisions in 2003, the SPC first issued a circular on September 21, 2001, imposing a temporary ban on acceptance by lower courts of private securities fraud lawsuits on the ground that "legislative and judicial conditions were not ripe for hearing such cases." On January 15, 2002, the SPC issued the second circular lifting the temporary ban imposed in 2001 but allowing investors' lawsuits only after the CSRC or its local branches had imposed administrative sanctions. For an overview of the development of a private securities litigation system in China, see Guiping Lu, *Private Enforcement of Securities Fraud Law In China: A Critique Of The Supreme People's Court 2003 Provisions Concerning Private Securities Litigation*, 12 PAC. RIM L. & POL'Y J. 781 (2003); Walter Hutchens, *Private Securities Litigation in China: Material Disclosure About China's Legal System?*, 24 U. PA. J. INT'L ECON. L. 599 (2003).

18. *See* Hao Min, *Wei Zhengquan Shichang Fazhan Tigong Sifa Baozhang: Zuigao Renmin Fayuan Fuyuanzhang Li Guoguang Tan Guiding Lijie Yu Shiyong* [*Providing Judicial Safeguard for the Development of*

However, one vital aspect of the framework for investor legal protections—the shareholder derivative lawsuit system—is still underdeveloped in China. This Note discusses the vital role shareholder lawsuits should assume in China's newly emerging regulatory framework. Part II explores the justification for introducing the shareholder derivative lawsuit system in China. Part III contains an introduction to the substantive and procedural hurdles that currently exist within China's legal framework for shareholders wishing to initiate derivative lawsuits. Part IV discusses these problems in the context of two cases that appear to be very primitive forms of derivative lawsuits. Part V analyzes the derivative lawsuit system contemplated in the draft Regulations on Certain Issues Relating to Trial of Corporate Dispute Cases (Part I) promulgated by the SPC in November 2003. Finally, Part VI concludes that a strong and healthy capital market requires a shareholder derivative lawsuit system that allows and encourages individual investors to seek judicial protection of their interests. China should remove procedural and substantive legal hurdles to build an investor-friendly shareholder derivative lawsuit system if it wishes to protect its numerous unsophisticated public investors effectively.

II. The Justification for a Shareholder Derivative Lawsuit System in China

A shareholder derivative lawsuit "is an assertion of corporate claim"[20] that is initiated by one or more shareholders to prevent or remedy injury to a corporation.[21] Such a wrong or injury "derives from the fact that the alleged misconduct has reduced the value of the corporation's assets."[22] In a derivative lawsuit, plaintiff shareholders do not sue as individuals but rather in their representative capacity for a cause of action that belongs to the corporation.[23] In Western countries, the derivative lawsuit system is an important judicial mechanism "by which defrauded minority shareholders may call directors, officers, . . . controlling shareholders, [and other wrongdoers] to account for mismanagement, diversion of assets, and fraudulent manipulation of corporate affairs."[24] In China, where most listed corporations currently have little experience in looking after minority shareholders and only

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Securities Market: the SPC Vice President Li Guoguang on the Understanding and Application of the Provisions], Zhongguo Zhengquan Bao [China Securities Journal], Jan. 10, 2003, at 1.

19. *See, e.g.*, Sun Jing & Xu Jingbo, *2003 Nian Zhengquan Shichang Touzizhe Baohu Niandu Baogao* [*2003 Annual Report on the Protection of Investors in the Securities Market*], Shanghai Zhengquan Bao [Shanghai Securities News], Jan. 6, 2004, *available at* http://www.cnstock.com/ssnews/2004-1-6/shierban/t20040106_506761.htm (last visited Apr. 20, 2005).

20. *See* William T. Allen & Reinier Kraakman, Commentaries and Cases on the Law of Business Organization 349 (2003).

21. *See* Robert W. Hamilton, The Law of Corporations in a Nutshell 535 (5th ed. 2000).

22. Jesse H. Choper et al., Cases and Materials on Corporations 804 (5th ed. 2000); *See also* Allen & Kraakman, *supra* note 20, at 349.

23. *See* Hamilton, *supra* note 21, at 535.

24. *See* James D. Cox et al., Corporations, 398–99 (1997).

a partial understanding of modern corporate governance concepts,[25] an institutionalized shareholder derivative lawsuit system will enable shareholders to monitor corporate management effectively.

Under China's current Company Law,[26] the power to monitor corporate management (directors and officers) is vested in two internal organs: the shareholder meeting and the board of supervisors.[27] Both of these organs, however, hold only limited and weak monitoring powers. This is particularly true of the many public corporations in which the State is the ultimate controlling shareholder.[28]

Although defined as a corporation's highest organ of authority under the Company Law,[29] in reality, a shareholder meeting is often simply a "rubber stamp for the wishes of the majority shareholders."[30] Due to the fact that most of the directors and officers of listed corporations are nominated, appointed, and dismissed predominately by the majority shareholders,[31] there is "little

25. *See Fools Rush In: The CAO Derivatives Fiasco,* ECONOMIST, Dec. 11, 2004, at 72. The scandal of China Aviation Oil ("CAO"), the Singapore-listed subsidiary of mainland China's monopoly supplier of jet fuel, is a recent example that raises questions about the standards of corporate governance at Chinese corporations. In total ignorance of disclosure rules and internal risk control requirements, the CAO management doggedly gambled against rising global oil prices from June 2003 to October 2004, resulting in a staggering loss of $550 million and CAO's request for bankruptcy protection in November 2004.

26. Zhonghua Renmin Gongheguo Gongsi Fa [COMPANY LAW of the P.R.C.], Chairman's Order 2004 No. 20, *available at* http://www.chinacourt.org/flwk/show1.php?file_id=96089&str1 (Aug. 28, 2004) (last visited Apr. 20, 2005). Different authors refer to this statute as the Company Law, Corporate Law, or Corporation Law. In this Note, I follow its English translation, the "Company Law."

27. For specific provisions regarding shareholders' meetings, see *id.*, Articles 37–44 and 102–10. Particularly, Articles 38(2)&(4) provide that shareholders' meetings in limited liability companies have the power to "elect and replace directors" and "to consider and approve reports of the board of directors"; Articles 103(2)&(4) provide shareholders' meetings in companies limited by shares with parallel powers. For specific provisions regarding boards of supervisors, see *id.*, Articles 52–54 and 124–28. In particular, Articles 54(2)&(3) provide that boards of supervisors in limited liability corporations have the power to "supervise the directors and the managers to see whether they violate laws, regulations or the company's articles of association during their performance of company duties" and "to require a director or a manager to correct their acts which are harmful to the company's interest"; Articles 126(2)&(3) provide for boards of supervisors. In addition, each publicly listed corporation in China must have a board of supervisors under the Company Law.

28. The mission of China's capital markets is still mainly to refinance its SOE sector. In most listed corporations that are restructured from SOEs, an average of only one-third of shares are issued to the public with the rest remaining non-tradable as state shares or state-owned legal person shares. *See* GREEN, *supra* note 4, at 4–5. The average state ownership in China's stocks was forty-five percent as of Jan. 31, 2002, with a maximum of eighty-nine percent. *See* Sheldon Gao, *China Stock Market in a Global Perspective*, DOW JONES INDEXES (Dow Jones & Company, Inc.), at 16 (Sept. 2002) (on file with Harvard International Law Journal). For a general discussion regarding the early history and development of China's capital markets in English, see Fang Liufang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149 (1995).

29. Company Law, arts. 37, 102.

30. Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1, 36 (2002).

31. Chinese academics describe this situation as "*yi gu du da*" ("one shareholder dominates the board of directors"). *See* Mary Comerford Cooper, *The Politics of China's Shareholding System*, STANFORD ASIA/PACIFIC RESEARCH CENTER 17 (June 2003). *See also* BEIJING LIANCHENG INTERNATIONAL CONSULTING LTD., 2003 NIAN ZHONGGUO SHANGSHI GONGSI DONGSHIHUI ZHILI LANPISHU [YEAR 2003 BLUEBOOK ON THE GOVERNANCE OF BOARDS OF DIRECTORS OF CHINA'S LISTED CORPORATIONS] (2003), *available at* http://www.dongshihui.net/Article_Show.asp?ArticleID=953 (last visited Apr. 20, 2005). Based

or no opportunity for minority shareholders to be heard."[32] Professor Donald C. Clarke concludes, "[W]here a controlling shareholder unilaterally calls the shots," shareholder meetings "are reduced to a formality."[33]

In China, a board of supervisors may lack independence as well. Under the Company Law, a board of supervisors must consist of members from the ranks of shareholders and employees.[34] In most cases, shareholder board members are predominantly appointed by majority shareholders and therefore represent only majority interests.[35] Furthermore, since employee board members rely on top management for annual evaluations, promotions, and remuneration decisions, they find it difficult to play a totally independent role without considering their personal career interests.[36] Consequently, a board of supervisors in China is "merely a figurehead and not a monitor in [any] real sense."[37]

Given the ineffectiveness of shareholder meetings and boards of supervisors, shareholders should be empowered to monitor corporate management through an institutionalized shareholder derivative lawsuit system. Such lawsuits are, as noted by Professor Robert Clark, "one of the most interesting and ingenious of accountability mechanisms" for large, formal organizations such as modern corporations.[38] Experience in the United States and Japan has proven that this system helps minority shareholders monitor management's conduct and would help "ensure careful and faithful business decisions."[39]

Needless to say, derivative lawsuits do not come without costs. They "clearly impose costs on the judicial system, the parties, corporate managers, and corporations."[40] In addition, there are concerns that derivative litigation may be abused.[41] Nevertheless, the introduction of the shareholder derivative lawsuit system in China is justified by the following three types of benefits it could bring to China's existing legal structure.

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upon empirical research, the latter report concludes that most boards of directors of listed corporations in China are still controlled by majority shareholders, although the percentage of independent directors had reached 23.1% by 2002 year-end.

32. Schipani & Liu, *supra* note 30, at 36.

33. Donald C. Clarke, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV. 494, 502 (2003).

34. Company Law, arts. 52, 124.

35. *See* Yuwa Wei, *Seeking a Practicable Chinese Model of Corporate Governance*, 10 MSU-DCL J. INT'L L. 393, 408 (2001) (taking it a step further and concluding that in corporations where the State acts as controlling shareholder, "[t]he State was therefore able to control . . . the supervisory board easily").

36. Katrina Tai & Calvin Wong, *Corporate Governance in China*, STANDARD & POOR'S (Standard & Poor's), at 10 (Nov. 2003), *available at* http://www.acga-asia.org/loadfile.cfm?SITE_FILE_ID=187 (last visited Apr. 20, 2005).

37. Anyuan Yuan, *Foreign Direct Investments In China—Practical Problems Of Complying With China's Company Law and Laws For Foreign-Invested Enterprises*, 20 NW. J. INT'L L. & BUS. 475, 489 (2000). For a detailed discussion of the role that boards of supervisors currently play in China's listed corporations, see Jason Zezhong Xiao, Jay Dahya and Zhijun Lin, *A Ground Theory Exposition of the Role of the Supervisory Board in China*, 15 BRIT. J. MGMT. 39, 39–55 (2004).

38. *See* ROBERT C. CLARK, CORPORATE LAW § 15.1 (1986).

39. Shiro Kawashima & Susumu Sakurai, *Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms*, 33 STAN. J. INT'L L. 9, 10 (1997).

40. *See* ALLEN & KRAAKMAN, *supra* note 20, at 387.

41. *See* HAMILTON, *supra* note 21, at 542.

A. Benefit of the System as a Remedial Device

The shareholder derivative lawsuit system can provide direct remedies to corporations, as well as indirect remedies to their shareholders and other corporate stakeholders. In derivative lawsuits, any recovery generally goes to the corporation.[42] Thus, the lawsuits may confer something of value on a corporation as the corporation benefits directly from compensation recovered for past injury inflicted by defendants.[43] "[B]ecause a recovery by the corporation will raise the value of each share equally,"[44] this mechanism also ensures that the fruits of such lawsuits are distributed to all shareholders, especially those of minority shareholders, in proportion to their interests. In addition, since "the recovery goes into the corporate treasury," corporations and shareholders will not profit at the expense of other stakeholders such as creditors and employees.[45] Therefore, a properly structured shareholder derivative lawsuit system in China would enable effective protection of corporations, shareholders, and other entities concerned with corporate welfare.[46]

B. Benefit of the System as a Deterrent Device

The shareholder derivative lawsuit system also increases corporate value by deterring wrongdoing that might otherwise occur in the future.[47] As has long been recognized by courts in the United States, "[t]he minatory effect of such [derivative] actions has undoubtedly prevented diversion of large amounts from stockholders to management and outsiders."[48] More specifically, the imposition of personal liability and sanctions, as well as the consequences derivative lawsuits can have for defendants' reputations, serve as deterrents.[49] Moreover, an economically feasible derivative lawsuit system that enables shareholders to obtain judicial recourse enhances their power. Influenced by such powerful deterrents, would-be wrongdoers might refrain from harmful activities if they believe they will be the target of lawsuits should they breach their duties.[50] Some Chinese legal practitioners have therefore concluded that the deterrence benefit should be the ultimate purpose and essence of China's shareholder derivative lawsuit system.[51]

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42. *See* ALLEN & KRAAKMAN, *supra* note 20, at 350. Occasionally, however, courts approve direct payment to minority shareholders. *See* A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE § 7.01(d) (1992).

43. *See* ALLEN & KRAAKMAN, *supra* note 20, at 388.

44. *See* COX ET AL., *supra* note 24, at 401 n.8.

45. *See* Watson v. Button, 235 F.2d 235, 237 (9th Cir. 1956). *See also* COX ET AL., *supra* note 21, at 401 n.7.

46. *See* CHOPER ET AL., *supra* note 22, at 804.

47. *See* ALLEN & KRAAKMAN, *supra* note 20, at 388.

48. Brendle v. Smith, 46 F. Supp. 522, 526 (S.D.N.Y. 1942).

49. *See* Harry G. Hutchison, *Presumptive Business Judgment, Substantive Good Faith, Litigation Control: Vindicating the Socioeconomic Meaning of* Harhen v. Brown, 26 J. CORP. L. 285, 289 (2001); *see also* James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 5 (1999).

50. *See* ALLEN & KRAAKMAN, *supra* note 20, at 388.

51. *See* Xuan Weihua & Song Yixing, *Zhengquan Minshi Peichang Zhidu Jiqi Xingshi Chutan* [*A Preliminary Study on the Securities Civil Compensation System and Its Structure*], ZHENGQUAN FALÜ PINGLUN [SECU-

C. Social Benefits of the System in Improving Corporate Governance in China

Shareholder derivative lawsuits play an important role in enhancing corporate governance. Though China is not a common law country, its corporations may nonetheless benefit from judicial decisions that clarify the scope of permissible conduct, and that may subsequently be generalized by the CSRC, the SPC, or other Chinese authorities. The benefit of such clarification is the identification of a rule around which the parties (shareholders and management) can transact.[52] Given the benefits it has shown in the United States, a well-instituted shareholder derivative lawsuit system may also help produce a better corporate governance regime in China.[53]

Because such a system could serve as an effective external monitor and provide a number of benefits, there is now an "almost unanimous understanding" that China must introduce its own shareholder derivative lawsuit system modeled after those seen in Western countries.[54] It is widely believed that a properly structured shareholder derivative lawsuit system is vital for improved protection of public investors, for improved monitoring of management, and for improved corporate governance generally in China.[55]

III. Deficiencies in China's Existing Shareholder Derivative Lawsuit System

As discussed above, the derivative lawsuit is an extremely important remedial and deterrent device for policing and preventing management abuses and to protect minority shareholders and others concerned about the welfare of the corporation.[56] Unfortunately, the existing Chinese legal provisions that shareholders must rely upon to initiate derivative lawsuits are vague, rudimentary, and difficult to enforce. Consequently, certain commentators have

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rities Law Review] 247, 259 (Vol. 2, 2002).

52. *See* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. Econ. & Org. 55, 80 (1991), *cited in* Allen & Kraakman, *supra* note 20, at 391.

53. *See, e.g.*, Stephen P. Ferrisa et al., Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings 7 (Contracting and Orgs. Research Inst., Working Paper No. 2001-03, Sept. 2001), *available at* http://ssrn.com/abstract=495583 (last visited Apr. 20, 2005) (suggesting that shareholder derivative suits do achieve the intended results, producing better corporate governance).

54. Mingyuan Zhang, *Gudong Paisheng Susong Falü Zhidu Yanjiu (Xia)* [*A Study on The Legal System of Shareholder Derivative Suits (Part II)*], Zhongguo Minshang Falü Wang [China Civil and Commercial Law Web], *at* http://www.civillaw.com.cn/jinrong/papers/student/STU12.asp (2002) (last visited Apr. 20, 2005). The proposed provisions of the SPC Draft regarding the shareholder derivative lawsuit system illustrate endorsement of this system from China's highest judicial authority.

55. *See, e.g.*, Guanghua Yu, *Towards an Institutional Competition Model of Comparative Corporate Governance Studies*, 6 J. Chinese & Comp. L. 31, 56 (2003) (H.K.) (concluding that: (i) the lack of shareholders' remedies is a factor contributing to the weak corporate governance system in China; and (ii) "[w]ithout the threat of derivative actions, the interest of minority shareholders is unlikely to be well protected").

56. *See* Choper et al., *supra* note 22, at 804. *See also* Liu Junhai, *Gudong de Daibiao Susong Tiqiquan de Bijao Yanjiu (Yi)* [*A Comparative Study on Shareholder's Rights to Initiate Derivative Lawsuits (Part I)*], Zhongguo Minshang Falü Wang [China Civil and Commercial Law Web], *available at* http://www.civillaw.com.cn/weizhang/default.asp?id=8842 (last visited Apr. 20, 2005). Liu Junhai is a law professor at Institute of Law, China Academy of Social Sciences.

concluded that those legal provisions are only "cosmetic."[57] The discussion that follows explores the existing substantive and procedural problems faced by shareholders who wish to initiate derivative lawsuits under China's current legal framework.

A. Substantive Provisions

1. The Company Law

Article 111 of the Company Law is regarded as the "single most important" legal provision for shareholder lawsuits within the current corporate law framework.[58] Its full text reads:

> In the event the resolutions of shareholders' meetings or the resolutions of the board of directors are in breach of laws and administrative regulations or infringe on shareholders' legal interests and rights, the shareholders shall have the right to initiate litigation to stop such breach or infringement.

Although this provision clearly provides the shareholder with a private right of action, its text fails to indicate whether the Company Law directly permits shareholder derivative lawsuits. Some Chinese legal practitioners and scholars contend that it provides a legal basis for shareholders to initiate derivative actions,[59] or interpret it broadly to include such actions.[60] These arguments may be incorrect. Under Article 111, shareholders can institute actions only when resolutions infringe upon "*shareholders'* legal interests or rights." The purpose of derivative lawsuits, however, is to remedy or prevent "a wrong to the *corporation*" (emphasis added).[61] Therefore, strictly interpreted, the Company Law does not provide an express legal basis for derivative lawsuits; an action instituted under Article 111 is a direct action rather than a derivative action.[62]

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57. Xuan & Song, *supra* note 51, at 260.

58. Xuan Weihua, *Gudong Daibiao Susong Chutan* [*A Preliminary Study on Shareholder Representative Lawsuits*], 211 FAXUE [LAW SCIENCE MONTHLY] 36 (1999) (China).

59. *See* KONG XIANGJUN, MINGSHANGFA REDIAN NANDIAN JI QIANYAN WENTI [HEATED, DIFFICULT, AND FOREFRONT ISSUES IN CIVIL AND COMMERCIAL LAW] 248 (People's Court Publishing House) (1996) (China). Kong Xiangjun is currently a senior judge of the SPC.

60. *See* ZHAO SHANLI, ZHONGRI GONGSIFA SHANG GUDONG SUSONG ZHIDU BIJIAO YANJIU [A COMPARATIVE STUDY OF SHAREHOLDER SUITS IN CHINESE AND JAPANESE CORPORATE LAWS], *in* LI LIMING: ZHONGRI QIYE FALÜ ZHIDU BIJIAO [THE COMPARISON OF CHINESE AND JAPANESE ENTERPRISE LEGAL SYSTEMS], 258 (China Law Press 1998), *cited in* Wei, *supra* note 35, at 404. The author of this Note disagrees with this opinion. Such a broad interpretation indeed is inconsistent with the spirit and the principle of the Company Law. While shareholder derivative lawsuits are still in their embryonic stages in China, any distorted interpretation will likely cause confusion.

61. *See* HAMILTON, *supra* note 21, at 535.

62. *See* Robert C. Art & Minkang Gu, *China Incorporated: The First Corporation Law Of The People's Republic Of China*, 20 YALE J. INT'L L. 273, 297 (1995); and Xianchu Zhang, *Practical Demands to Update the Company Law*, 28 HONG KONG L.J. 248, 251 (1998).

Furthermore, Article 111 itself is vague, narrow, and impracticable. First, it does not clearly elaborate the circumstances under which an action can be initiated. Article 111 requires the existence of both a "violation" (of laws or administrative regulations) and an "infringement" (upon shareholder rights) to justify a shareholder action.[63] By the operation of this provision, if resolutions violate laws or administrative regulations but do not immediately harm shareholder interests, shareholders are not permitted to sue.[64] On the other hand, even though shareholder interests are infringed upon by resolutions legally adopted at a shareholders' meeting or by a board of directors, Chinese shareholders may still be unable to apply for injunctions against such resolutions—a right enjoyed under the American framework.[65]

Second, the types of defendants and actionable infringements provided for under Article 111 are "excessively narrow."[66] As discussed above, because actions brought by shareholders under Article 111 must be direct actions, only corporations can be defendants in such actions.[67] Therefore, senior management, controlling shareholders, or other potential wrongdoers are excluded from the scope of liability even if their illegal activities have harmed the interests of a corporation and its minority shareholders. Moreover, the statute fails to indicate whether shareholders can sue those wrongdoers who violate corporate articles of association.

Third, the remedy that shareholders may seek under Article 111 is restricted to "demanding that the illegal and infringing resolution be stopped," which is similar to injunctive relief in many Western systems. However, it is unclear whether shareholders may also request compensation if they have suffered any loss as a result of such illegal and infringing resolutions.[68] Without proper compensation as an incentive, a collective action problem—a fundamental problem stemming from the dispersed share ownership of public corpora-

63. *See* Zhang, *supra* note 62, at 252 (suggesting two possible readings of Article 111: "the grammar of Art. 111, separating the two phrases (violation and infringement) by only a comma, makes the confusion even worse because it may suggest two reasonable readings: violation and infringement are two conditions that need to exist at the same time to justify a shareholders' action; or they are two separate conditions and each may independently constitute the ground of the action").

64. *See* Gu Gongyun, *Gongsifa Xiuding de Ruogan Jianyi* [*Several Suggestions on the Amendment of the Company Law*], SHANGSHI GONGSI [LISTED COMPANY] Vol. 5, 2000, *available at* http://www.people.com.cn/GB/paper87/703/84318.html (last visited Apr. 20, 2005). Apparently, Professor Gu's reading of Article 111 is consistent with the first reading suggested by Professor Zhang. *See id.* (claiming that "violation and infringement are two conditions that need to exist at the same time to justify a shareholders' action").

65. In the United States, it has long been established that an inequitable action infringing upon shareholder franchises, though legally permissible, will not be tolerated by the courts. *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, (Del. 1971).

66. Mi Xinli, *Paisheng Susong-Xiaogudong Quanyi de Shihou Jiuji* [*Derivative Lawsuits—Ex Post Remedies of Minority Shareholders*], FAZHI RIBAO [LEGAL DAILY] (P.R.C.), May 16, 2001, at 8.

67. *See* Zhang, *supra* note 54. *See also* Guanyu Shenli Gongsi Jiufen Anjian Ruogan Wenti de Zhidao Yijian (Shixing) [Interim Guiding Opinions on Several Issues in Trials of Corporate Dispute Cases], High People's Court of Beijing 2004 No. 50, *available at* http://law.chinalawinfo.com/newlaw2002/SLC/slc.asp?db=lar&gid=16830043 (Feb. 24, 2004) (last visited Apr. 20, 2005) (providing that in any actions involving resolutions of shareholders' meetings or boards of directors, defendants must be corporations).

68. *See* Gu, *supra* note 64.

tions—will arise. [69] Individual shareholders may not have any interest in spending time and money to bring lawsuits solely for the benefit of their corporations without any compensation.

Finally, Article 111 fails to provide detailed guidance directing shareholders as to how to pursue their lawsuits. Specifically, neither Article 111 nor any other article of the Company Law provides any of the restrictive conditions typically required in derivative lawsuits in other jurisdictions, such as eligibility of standing, the demand requirement, security for expenses, and res judicata effect of judicial decisions.[70]

In addition to Article 111, other legal provisions exist under the Company Law that could provide the legal basis for shareholders to initiate derivative lawsuits, such as those articles providing for the duties and liabilities of directors, supervisors, and managers.[71] For example, Article 63 holds directors, supervisors, and managers liable to their corporations for all damages resulting from their violation of the duty of care and the duty of loyalty provisions under the law, administrative regulations, and the corporations' articles of association.[72] Nevertheless, these articles fail to provide clear guidelines as to whether shareholders can sue derivatively if the corporations are unwilling to sue or are prevented from bringing suit against the actual wrongdoers. Consequently, in practice, actions under these articles have seldom been brought.[73]

The problems discussed above are partially resolved in Article 4 of the Code of Corporate Governance for Listed Corporations (the "Code") promulgated in January 2002.[74] While incorporating both Articles 111 and 63 of the Company Law, Article 4 of the Code goes on to state that: (i) shareholders can seek protection of their rights through civil litigation or other legal ave-

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69. *See* ALLEN & KRAAKMAN, *supra* note 20, at 351.

70. *See* Zhang, *supra* note 62, at 252. All of these restrictive conditions are discussed in Part V *infra*.

71. Specifically, those articles are Articles 59–63, and Article 123 of the Company Law. For a detailed discussion of the duties and liabilities of directors and officers in China, see Yingxi Fu-Tomlinson and Franklin D. Chu, *Duties and Responsibilities of Directors and Managers*, *in* DOING BUSINESS IN CHINA § 15.03 (Freshfields, Bruckhaus & Deringer eds., 2001).

72. *See* Michael Irl Nikkel, *"Chinese Characteristics" in Corporate Clothing: Questions of Fiduciary Duty in China's Company Law*, 80 MINN. L. REV. 503, 527 (1995). Article 63 of the Company Law reads: "If a director, a supervisor or a manager violates laws, administrative regulations or the corporation's articles of association in the execution of his duties, causing losses to the corporation, he shall be liable for compensation."

73. *See* Guo Feng, *Gongsifa Xiugai Ying Jiaqiang Minshi Zeren Zhidu* [*Civil Liability System Should Be Enhanced In the Amendment of the Company Law*], FAZHI RIBAO [LEGAL DAILY] (P.R.C.), June 28, 2000, at 7.

74. The full text of Article 4 reads:

> Shareholders shall have the right to protect their interests and rights through civil litigation or other legal means in accordance with the laws and administrative regulations. In the event the resolutions of shareholders' meetings or the resolutions of the board of directors are in breach of laws and administrative regulations or infringe on shareholders' legal interests and rights, the shareholders shall have the right to initiate litigation to stop such breach or infringement. The directors, supervisors and managers of the company shall bear the liability of compensation in cases where they violate laws, administrative regulations or articles of association and cause damages to the company during the performance of their duties. Shareholders shall have the right to request the company to sue for such compensation in accordance with law.

nues in accordance with the laws or administrative regulations, and (ii) shareholders shall have the right to demand that a corporation initiate an action for damages from directors, supervisors, or managers if they have violated Article 63 of the Company Law. Some legal practitioners have thus concluded that Article 4 of the Code expressly provides for "shareholder derivative lawsuits in China for the first time."[75] Nevertheless, because this Code is neither formal law nor a judicial explanation promulgated by the SPC, it carries weak legal authority, casting doubt on whether courts in China would recognize its legal effects.[76] Furthermore, it fails to provide administrable details that can guide both lower courts and individual investors in the enforcement of shareholders' rights to sue.[77]

2. *The Securities Law*[78]

Securities law offers another legal channel to protect the substantive rights of shareholders. Although China's current Securities Law lacks detailed investor protection provisions (such as those that elaborate on civil liabilities, private rights of action, and compensation), thereby leaving serious loopholes,[79] the Law still contains two articles regarding senior management's liability to pay damages to listed corporations.[80] However, neither of these articles serves as a solid legal basis for shareholders to initiate derivative lawsuits. Instead, they may even have negative impacts on corporations and their minority shareholders.

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75. Xuan Weihua & Li Chen, *Shangshi Gongsi Zhili Zhunze Ruogan Wenti Pingxi* [*Comments on Several Issues in the Code of Corporate Governance for Listed Corporations*], SHANGSHI GONGSI [LISTED COMPANY], Vol. 7 2002, *available at* http://www.people.com.cn/GB/paper87/7526/721417.html (last visited Apr. 20, 2005).

76. *See* Donald C. Clarke, *Duli Dongshi Yu Zhongguo Gongsi Zhili* [*The Independent Director and Chinese Corporate Governance*], *in* Fang Liufang ed., FADA PINGLUN [CHINA UNIVERSITY OF POLITICS AND LAW REVIEW] 110 (Vol. 2, 2003) (concluding that the Code is not mandatory). *See also* Song Yixin, *Jiji Tuijing Gudong Daibiao Susong Zhidu Jianshe* [*Rigorously Promoting the Construction of Derivative Lawsuits System*], ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES JOURNAL], Oct. 29, 2002. The *Sanjiu* case, which occurred after the Code was enacted, illustrates that lower courts would typically refuse to accept a shareholder derivative lawsuit despite permission given under the Code.

77. *See* Xuan & Li, *supra* note 75 (complaining that the Code fails to provide details pursuant to which individual shareholders can act to enforce their rights to sue in court). On the other hand, lack of administrable details may also result in lower courts' reluctance or even hostility to accepting shareholder derivative lawsuits. One analogous example is the SPC's treatment of private securities litigation in China. Professor Nicholas Howson observed that the SPC provides comprehensive procedural details in the PSL Provisions, and he attributed this caution and particularity to the SPC's desire to aid lower courts in handling private securities actions, which are still complicated and unfamiliar to most unsophisticated lower courts in China.

78. Zhonghua Renmin Gongheguo Zhengquan Fa [Securities Law of the P.R.C.], Chairman's Order 2004 No. 21, *available at* http://www.chinacourt.org/flwk/show1.php?file_id=96090 (Aug. 28, 2004) (last visited Apr. 20, 2005).

79. *See* Wang Feiping, *Zhengquanfa—Falü Zeren De Shiheng* [*The Imbalance of the Liability System under the Securities Law*], 209 FAXUE [LAW SCIENCE MONTHLY] 52 (1999) (China). Wang found that among the 36 articles regarding legal liability under the Securities Law, only two articles are on civil liabilities. Wang thus concludes that there is an imbalance in the accountability mechanism under China's current Securities Law.

80. *See* Song, *supra* note 76.

a. Article 42

Article 42 of the Securities Law provides that if a shareholder holding five percent or more of the issued shares of a corporation sells the shares in his possession within six months of purchase, or if he repurchases them within six months after selling them, the profits generated from such sale or repurchase shall be disgorged. Moreover, the corporation's board is responsible for collecting the profit from the shareholder.[81] If the board fails to collect, other shareholders may demand that the board do so. If the board does not collect the profit from the shareholder and a loss to the corporation results, the responsible directors shall be held jointly and severally liable to compensate the corporation for damages.

Article 42 is targeted at speculative share trading. However, the absence of detailed specifications and mechanisms within the language are likely to cause confusion and inconsistencies in enforcement.[82] Although other minority shareholders of the listed corporation are authorized to make demands of the board, this provision does not expressly entitle them to sue derivatively if the corporation, because of manipulation by its board or its majority shareholders, is unwilling to sue, or is prevented from bringing a lawsuit against culpable directors or majority shareholders. If neither the corporation nor other shareholders initiates such a lawsuit, the directors' joint and several liability to the corporation is not enforceable.[83]

b. Article 63

Article 63 of the Securities Law provides that, in the event that any issuer or underwriter makes a misrepresentation, misleading statement, or material omission in a corporation's prospectus, financial and accounting reports, or annual report that causes losses to investors in securities transactions, such issuer and underwriter shall be obligated to compensate investors for their losses. Furthermore, the responsible directors, supervisors, and managers of the issuers or underwriters are jointly and severally liable for damages to investors.

Article 63 is the only provision under the Securities Law that relates to civil remedies for misrepresentation made in securities transactions.[84] The underlying rationale of this provision is delineated and supplemented by the aforementioned Several Provisions for Trial of Civil Damages Cases Arising from Misrepresentation in the Securities Markets (the "PSL Provisions") promulgated by the Supreme People's Court in January 2003. The PSL Pro-

81. Securities Law, art. 42. This restriction does not apply to securities companies that acquire five percent or more of the shares in the corporation as part of an underwriting arrangement for the securities of the corporation.

82. *See The PRC Securities Law*, Allen & Overy Publication, 7–8 (Apr. 1999), *available at* http://www.allenovery.com/pdf/the%20prc%20securities%20law.pdf (last visited Apr. 20, 2005).

83. *See* Mi, *supra* note 66.

84. *See* Hongcuan Liu, *Halfway to Effective Shareholder Protection*, CHINA L. & PRACTICE (Mar. 2003).

visions substantially increase the class of defendants that can be held liable for misrepresentation. Issuers, underwriters, and their directors, as well as supervisors and managers, are provided for in Article 63. The PSL Provisions further provide that the sponsors, promoters, and actual controllers of an issuer, professional intermediary agencies (such as accounting firms, law firms, and asset appraisal firms), and persons within those entities directly responsible for misrepresentation can also be held jointly and severally liable for damages to investors.[85]

Nevertheless, although Article 63 and the PSL Provisions pave the way for shareholders to pursue direct lawsuits arising from misrepresentation in the stock market, they are far from perfect from the perspective of shareholder protection. In direct lawsuits instituted under Article 63 or under the PSL Provisions, the issuer is always the main defendant bearing strict liability for misrepresentation[86] as well as the primary liability for payment of compensation to aggrieved shareholders. Such compensation, however, constitutes corporate losses that will be shared by the prevailing shareholders together with other non-suing shareholders. This result not only impairs the actual recovery achieved by the prevailing shareholders and harms the corporation itself, but it further harms those shareholders who did not participate in the lawsuit.[87]

Moreover, the current legal provisions cannot substantially deter wrongdoers. Even though Article 63 and the PSL Provisions provide that directors, supervisors, managers, actual controllers, or other wrongdoers can also be liable for damages, the problem in the enforcement of Article 42 of the Securities Law persists. After corporations make restitution, they may be unwilling to sue, or may be obstructed from bringing suits in tandem to seek further redress from the actual wrongdoers. In other words, the actual wrongdoers can easily evade personal liability by hiding behind the corporate veil.[88]

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85. *See* PSL Provisions, arts. 21–28. For a detailed discussion of the relationship between Article 63 of the Securities Law and the PSL Provisions, see Hutchens, *supra* note 17, at 631–35.

86. *See* Hao, *supra* note 18.

87. Some Chinese legal practitioners therefore contend that the underlying policy of these provisions under the PSL Provisions is neither reasonable nor equitable. *See* Ma Hongli & Liang Lingling, *Zhengquan Shichang Touzizhe Suquan Zhuangkuang Jiqi Wanshan* [*Current Situation of Securities Market Investors' Right to Sue and Its Improvement*], Zhe Hang Law Firm, *available at* http://www.lawyerof.com/views.asp?BcgID=36&BcgID2=40&id=349 (Oct. 25, 2004) (last visited Apr. 20, 2005).

88. To address these problems, the best solution is to combine a direct lawsuit brought pursuant to Article 63 or the PSL Provisions with a shareholder derivative lawsuit. The first step is for shareholders, through direct lawsuits against the misrepresenting corporations, to sue for damages they have suffered. If they prevail, they will be compensated by the defendant corporations. However, in order to avoid corporate losses, shareholders will then proceed with the second lawsuit in the form of derivative action, so as to hold the actual wrongdoers liable for compensation to the corporation. Some Chinese legal practitioners contend that only through a combination of these two types of lawsuits "can the wrongdoers be ultimately punished, will the listed corporations suffer the least loss, and can the relationship between the listed corporations and their shareholders be maintained harmoniously." Xuan & Song, *supra* note 51, at 253.

B. Procedural Provisions

Aside from the substantive problems in the areas of corporate and securities law, several procedural problems remain as well.

1. Shareholder's Plaintiff Standing

The Civil Procedure Law[89] provides that in order to institute a lawsuit, a plaintiff must have a "direct interest" (*zhijie lihai guanxi*) in the case.[90] In contrast, a derivative lawsuit initiated by a shareholder is usually for the benefit of a corporation. Therefore, in practice, the immediate impression of most courts when a shareholder files a derivative lawsuit is to assume "the shareholder is not qualified to be the plaintiff" and "the case should not be accepted."[91] The fundamental reason is that neither substantive nor procedural law in China has provided the criteria by which a shareholder achieves adequate standing (i.e., "direct interest") to bring a derivative lawsuit on behalf of a corporation.

2. The Role of the Corporation in a Derivative Lawsuit

Even if a court can accept a derivative lawsuit in China, another problem arises: the role of the corporation in this special type of lawsuit. First, a corporation should not be placed in the role of plaintiff. A derivative lawsuit, in essence, is an action brought by shareholders to enforce a right that belongs to a corporation but that the corporation has failed to enforce.[92] Therefore, it is illogical to place a corporation that is unwilling to sue voluntarily in the role of a plaintiff.

Second, it is improper to place the corporation in the role of defendant. In common law countries, the corporation on whose behalf a derivative suit is brought is aligned as a nominal defendant.[93] This method, however, may cause confusion in the context of Chinese law.[94] Under the Civil Procedure Law, a plaintiff "must have a specific claim and a specific factual basis and

89. Zhonghua Renmin Gongheguo Minshi Susong Fa [Civil Procedure Law of the P.R.C.], Apr. 9, 1991, *available at* http://law.chinalawinfo.com/newlaw2002/slc/slc.asp?db=chl&gid=5110 (last visited Apr. 20, 2005).

90. *Id.*, art. 108(1).

91. *See* Ying Sun, *Lun Gudong Daibiao Susong Zhidu* [*A Discussion of the Shareholder Derivative Lawsuit System*], 5 SHANDONG DAXUE XUEBAO (ZHEXUE SHEHUI KEXUE BAN) [JOURNAL OF SHANDONG U. (PHIL. & SOC. SCI. VERSION] 99 (2000).

92. *See* FED. R. CIV. P. 23.1.

93. *See* HAMILTON, *supra* note 21, at 538. In the United States, this arrangement is mainly for procedural reasons: "the Supreme Court has held that a corporation in a derivative suit should be considered to be a defendant for purposes of diversity jurisdiction in cases in which the plaintiff shareholder has made a demand that the corporation's board of directors has rebuffed, or when the board is otherwise demonstrably antagonistic to the interests of the plaintiff shareholders." *See* RALPH C. FERRARA ET AL., SHAREHOLDER DERIVATIVE LITIGATION: BESIEGING THE BOARD § 9.02[1] (1998).

94. Even in common law countries, some scholars recognize that placing a corporation in the role of defendant is confusing. *See* PAUL L. DAVIES, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 658 (6th ed. 1997).

grounds" for a lawsuit against the defendant.[95] However, in a derivative lawsuit, the shareholder plaintiff usually represents the interests of the corporation.

Finally, it also may not be appropriate to place the corporation in the role of a third party either with or without an independent right of claim. Under the Civil Procedure Law, a third party with an independent right of claim may join in a pending action only by voluntary application,[96] which apparently is not applicable in the case of an unwilling corporation. Neither is the corporation a third party without an independent right of claim;[97] the corporation does, in fact, have such an independent right. However, this right must be enforced derivatively by a shareholder.[98]

In light of this, although the corporation is a very important and a necessary party in a shareholder derivative lawsuit, any placement of the corporation in the suit would be awkward under the constraints of China's current civil procedure rules.[99]

3. Settlement

In the United States, settlements of derivative lawsuits are now bound by special procedures: "[T]he action shall not be dismissed or compromised without the approval of the court."[100] However, settlements of civil actions in China usually are not subject to the approval of the courts.[101] Absent specific restrictions, a "serious evil"—the secret settlement of shareholder lawsuits—would be possible in China.[102] In secret settlements, plaintiff shareholders (rather than the totality of aggrieved shareholders or the corporation) receive a settlement that is basically a price paid by corporate wrongdoers to buy immunity.

4. Filing Fees

In practice, filing fees create a substantial financial obstacle for Chinese shareholders, particularly individual shareholders, who are seeking to initiate derivative lawsuits. In China, filing fees are calculated on a sliding scale according to the amount in controversy,[103] and generally, the plaintiff must

95. Civil Procedure Law, art. 108(3).

96. *Id.*, art. 56(1).

97. *Id.* Under Article 56, if a third party has no independent right of claim against the object of the action of the two parties, but the outcome of the lawsuit will affect his or her legal interests, he or she may apply to join in the action, or the people's court shall notify him to join the lawsuit.

98. *See* Sun, *supra* note 91, at 104 (explaining that under the current legal framework, it is more appropriate for the corporation to be regarded as a new type of third party altogether, as differentiated from third parties with or without an independent right of claim).

99. *See* HAMILTON, *supra* note 21, at 538.

100. FED. R. CIV. P. 23.1.

101. Article 51 of the Civil Procedure Law provides in its entirety that "the two parties may reach a settlement on their own," without imposing any further requirement or restriction.

102. *See* HAMILTON, *supra* note 21, at 540.

103. *See* Civil Procedure Law, art. 107; Renmin Fayuan Susong Shoufei Banfa [Provisions Regarding

pay the fee to the court in full before the commencement of any litigation.[104] Therefore, the more shareholder plaintiffs want to recover for corporations, the higher the upfront filing fees. While shareholder plaintiffs can only receive indirect benefits from corporations if they win the lawsuits, they will recover none of their expenses (including filing fees) if they do not prevail. An imbalance between cost and benefit will obviously discourage, or even effectively prohibit, shareholders from bringing meritorious actions in China.[105]

C. Summary

The foregoing discussion suggests that shareholders, especially individual minority shareholders, in China will encounter both substantive and procedural law hurdles in pursuing derivative lawsuits. The underlying reasons for these difficulties are twofold.

First, on the substantive law side, both the current Company Law and the Securities Law were adopted and are applied by the Chinese government primarily to advance the reform of its ailing state-owned enterprises (in short, the reforms consist of transforming those enterprises into modern public corporations by listing them on capital markets and raising funds from investors).[106] Shareholder protection is—or at least at the time when the two statutes were adopted, was—subordinated to this primary purpose. Many effective shareholder protection mechanisms (such as the shareholder derivative lawsuit system) are therefore missing in China's current legislation. Consequently, now that "investor protection" has become a top priority and shareholder activism has begun to sprout in China, individual shareholders still cannot readily or easily petition the court to protect their own legitimate interests or those of corporations.

Second, on the procedural law side, a shareholder derivative lawsuit does not fit well into China's traditional procedural framework. Worse, a lack of clear, substantive provisions adds to the courts' difficulties in handling this type of complicated lawsuit. As a result, a derivative lawsuit could be highly contested. Courts may either refuse to take cases or request that cases be set-

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Collection of Litigation Fees by People's Courts], S.P.C. 1989 No. 14, *available at* http://www.chinacourt.org/flwk/show1.php?file_id=9342 (July 12, 1989) (last visited Apr. 20, 2005).

104. Although courts in China are allowed to reduce or waive filing fees, they depend heavily on the fees and many lawyers fear requests for waivers might result in bias against their clients. *See* Benjamin Liebman, *Class Action Litigation in China*, 111 HARV. L. REV. 1523, 1534 (1998).

105. *See* Kawashima & Sakurai, *supra* note 39, at 19–20. Japan also used to calculate the filing fee of derivative lawsuits on the amount of recovery sought by shareholder plaintiffs. In 1993, Japan changed the filing fee to a small fixed sum, the result of which was that derivative lawsuits in Japan "have become more prevalent and grown in size." *Id.* at 20.

106. For detailed discussions regarding the legislative intent of China's Company Law and Securities Law and the implication of such intent on China's current legal framework, see Fang, *supra* note 28; Schipani & Liu, *supra* note 30; Clarke, *supra* note 33; and William I. Friedman, *One Country, Two Systems: The Inherent Conflict Between China's Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT'L L. 477 (2002).

tled without touching upon their merits. The discussion in Part IV illustrates Chinese courts' responses to crude forays into shareholder derivative litigation.

IV. Preliminary Precedents in Chinese Shareholder Derivative Litigation

Despite the absence of clear legal provisions concerning shareholder derivative lawsuits under China's current legal framework, some derivative lawsuits have proceeded in Chinese courts. This Part reviews two such precedents—the *Pure* case and the *Sanjiu* case.

A. The Pure *Case*

Certain key corporate law mechanisms—including the enterprise legal personality, limited liability, boards of directors, shareholders' rights, corporate charters (articles of association), liquidation and dissolution, and others—were first introduced into post-1949 China through specific laws governing foreign direct investment.[107] The shareholder derivative lawsuit system, to a certain extent, also falls within this scope. In a circular issued by the SPC (the "SPC Circular") in November 1994, the SPC affirmed that a lower court can accept an action filed by the Chinese party of an equity joint venture ("EJV") in order to protect the legitimate interests of the EJV if its board of directors refuses to exercise its right to sue a defendant seller because the foreign party of the EJV also controls the defendant seller.[108] This document is regarded as the first legal instrument that directly touches upon shareholder derivative lawsuits in China,[109] yet its legal effectiveness is still limited because it "fails to specify any necessary substantive and procedural conditions of such an action."[110]

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107. Thanks to Professor Nicholas C. Howson for his insight on this point.

108. *See* Zuigao Renmin Fayuan Fa Jing [Reply of the SPC to the Supreme People's Court of Jiangsu Province], Fa Jing (1994) No. 269, *available at* http://www.chinacourt.org/flwk/show1.hp?file_id=21043 (Nov. 4, 1994) (last visited Apr. 20, 2005). The factual background of this SPC Circular case is as follows: The EJV in this case is Zhangjiagang Jixiong Chemical Fiber Co., Ltd., jointly established by Zhangjiagang Dacron Factory (the "Chinese Party") and Hong Kong Jixiong Co., Ltd. (the "Hong Kong Party"). The EJV entered into a sales contract with the seller Hong Kong Daxing Engineering Co., Ltd. (the "Seller"), which was controlled by the Hong Kong Party. When the Seller breached the sales contract, the Hong Kong Party prevented convening of the board, precluding the EJV from suing the Seller. The Chinese Party therefore initiated the lawsuit. The High People's Court of Jiangsu Province was uncertain about whether the Chinese Party could sue derivatively for the EJV and thus reported the situation to the SPC. Note, however, that despite the rule in this SPC Circular, due to the specific facts of this case (such as relevant arbitration clauses between the parties), the SPC directed that the High People's Court of Jiangsu Province be barred from hearing this particular case.

109. *See Quanyi Baohu Youyou Zhongda Lihao* [*More Good News for Interest Protection*], Shanghai Fazhi Bao [Shanghai Legal News], Jan. 1, 2003, at 6. *But see* Sun, *supra* note 91, at 104 (disagreeing generally that this SPC Circular is a direct provision on shareholder derivative lawsuits).

110. *See* Zhang, *supra* note 62, at 253 (concluding that the SPC Circular "may only be applicable to joint ventures, rather than companies in general," as it "addresses merely infringement of the joint venture's interests as a whole, not violation of the lawful rights of minority shareholders").

Zhong Tian Int'l Co. v. Shanghai Bi Chun Trade Dev. Co. ("the *Pure* Case") was a high-profile[111] case that formally brought shareholder derivative lawsuits to the attention of the Chinese legal profession.[112]

1. Facts

In 1992, Zhong Tian International Co., a Hong Kong company ("Zhong Tian"), Shanghai Yan Zhong Industrial Co., Ltd. ("Yan Zhong"),[113] and Shanghai Jian Bang Second Industrial Co. ("Jian Bang"), set up an equity joint venture company named Shanghai Yan Zhong Drinking Water Co., Ltd. (the "JV"). Zhong Tian held a 60% interest in the JV, while Yan Zhong and Jian Bang held 30% and 10% interests, respectively. The JV's board of directors consisted of six directors, three of whom were appointed by Zhong Tian and the other three by Yan Zhong. The JV's articles of association provided that the chairman of the JV should be appointed by Yan Zhong while the vice chairman and general manager should be appointed by Zhong Tian.

The JV enjoyed great success in the manufacturing and marketing of bottled distilled water carrying the brand name "Pure."[114] The Shanghai court acknowledged during the trial that Pure water was a well-known product in the Shanghai local market and that the appraised value of the JV's brand Pure was approximately RMB 74 million ($8.94 million).

Inspired by the success of the JV, Yan Zhong expanded its position in the drinking water market by establishing two subsidiaries (collectively, the "Yan Zhong Subsidiaries") in September 1995 and February 1996. The Yan Zhong Subsidiaries manufactured and marketed drinking water with packages, identifying marks, and marketing materials similar to the JV's Pure water products. The court acknowledged that fifty-four percent of consumers confused the Yan Zhong Subsidiaries' product with that manufactured by the JV. The court further recognized that the JV suffered direct losses in the amount of RMB 10.14 million ($1.22 million) due to the new competition.

In June 1996, Zhong Tian proposed that Yan Zhong hold a board meeting, but the proposal was rejected. On July 1, 1996, the three directors appointed by Zhong Tian called for an extraordinary board meeting without the attendance of the Yan Zhong directors. At this extraordinary board meet-

111. *See* Zhong Tian Int'l Co. v. Shanghai Bi Chun Trade Dev. Co. et al., *reprinted in* RENMIN FAYUAN ANLI XUAN [SELECTED CASES OF PEOPLE'S COURTS] Vol. 24, at 222 (Zuigao Renmin Fayuan Zhongguo Yingyong Faxue Yanjiusuo [Applied Jurisprudence Research Institute of the Supreme People's Court] ed., People's Court Press 1998). *See also* Zhong Tian Int'l Co. v. Shanghai Bi Chun Trade Dev. Co. et al., *reprinted in* '98 SHANGHAI FAYUAN ANLI JINGXUAN [SELECTED CASES DECIDED BY SHANGHAI COURTS IN '98], at 321 (Li Changdao ed., Shanghai People's Publishing House 1999). The case brief herein is based on these two court reports.

112. *See* Zhu Lanye et al., *"Bichun" Shui Qingquanan Tantao* [*Discussion of the "Bichun" Tort Case*], 193 FAXUE [LAW SCIENCE MONTHLY] 53 (1997) (China). *See also* Chen Fang, *Bichun/Yanzhong Anjian Yinqi de Falü Sikao* [*Legal Considerations Triggered By the Bichun/Yanzhong Case*] 28 FAZHI YU JINGJI [LEGAL SYSTEM AND ECONOMY] 24 (1997) (China). *See also* Zhang, *supra* note 62.

113. Yan Zhong is among the first eight public corporations listed in the Shanghai Stock Exchange.

114. "Pure" is the brand's English name, and *Bichun* is the brand's Chinese pinyin.

ing, the Zhong Tian directors adopted a resolution that deprived the three directors from Yan Zhong of their voting rights due to their conflict of interest. Moreover, with the unanimous approval of the three Zhong Tian directors, it further authorized the JV to sue the Yan Zhong Subsidiaries. On July 5, the general manager of the JV, who was appointed by Zhong Tian, filed a lawsuit in the Second Intermediate People's Court of Shanghai requesting that the Yan Zhong Subsidiaries compensate the JV in the amount of RMB 10 million ($1.26 million) ("Suit I"). However, the chairman of the JV, who was appointed by Yan Zhong and simultaneously served as the chairman of both Yan Zhong Subsidiaries, applied on behalf of the JV to withdraw Suit I. The chairman argued that: (1) the resolution adopted at the extraordinary board meeting held in the absence of the directors from Yan Zhong should be invalidated;[115] and (2) the suit had not been authorized by the chairman, the legal representative of the JV.

While the decision as to whether Suit I should be withdrawn was still pending, in September 1996, Zhong Tian brought a separate lawsuit in the Second Intermediate People's Court of Shanghai against Yan Zhong and the Yan Zhong Subsidiaries demanding compensation for itself in the amount of RMB 10 million ($1.26 million) ("Suit II"). In order to weaken Suit II, in January 1997, the chairman of the JV brought a new lawsuit in the name of the JV against the Yan Zhong Subsidiaries in the First Intermediate People's Court of Shanghai,[116] asking for compensation of a significantly smaller amount, RMB 1.5 million ($181,160) ("Suit III").

On April 8, 1997, both Suit I and Suit III were dismissed by the Second and the First Intermediate People's Court of Shanghai, respectively, on identical rationales: that "the plaintiff is unqualified to institute the lawsuit." After a delay of several months, Suit II was finally settled under the auspices of the Second Intermediate People's Court of Shanghai in September 1997. All parties voluntarily reached a settlement agreement in which, among other things, the three defendants (i.e., Yan Zhong and the two Yan Zhong Subsidiaries) agreed to pay Zhong Tian RMB 1.7 million ($205,314) and the Yan Zhong Subsidiaries promised to cease infringement.[117]

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115. The JV's Articles of Association require five board members for a quorum.

116. There are two Intermediate Courts in Shanghai Municipality handling cases on a separate geographical jurisdiction basis. Yan Zhong and the two Yan Zhong Subsidiaries happened to be in different geographical jurisdictions of the two Intermediate Courts.

117. The arbitration clause in the JV contract adds to the complexity of the *Pure* case. After filing Suit II, Yan Zhong argued that the Second Intermediate Court should have no jurisdiction because of the arbitration agreement. Nevertheless, the Second Intermediate Court ruled, and the Higher People's Court of Shanghai affirmed, that the court had jurisdiction because, in essence, the case was a tort-based case and the Yan Zhong Subsidiaries, the tortfeasors, were not bound by the arbitration clause between the parties to the JV. *See* Zhong Tian Int'l Co. v. Shanghai Bi Chun Trade Dev. Co. et al., *reprinted in* '98 Shanghai Fayuan Anli Jingxuan [Selected Cases Decided by Shanghai Courts in '98], at 325 (Li Changdao ed., Shanghai People's Publishing House 1999).

2. Analysis

Although the *Pure* case was settled without a decision on the merits, the *Pure* court's treatment of several issues in this case warrants further discussion.

a. Zhong Tian's Standing To Sue

Disputes within the Shanghai courts regarding whether Zhong Tian had standing to sue the infringers illustrate that a shareholder derivative lawsuit was not well accepted in China. The prevailing opinion was that if Zhong Tian, instead of the JV, had been permitted to sue the infringers, the case would have been a derivative lawsuit for which there are no relevant provisions under China's Civil Procedure Law or Company Law.[118] The opponents of derivative lawsuits argued that taking Chinese law to the greatest permissible extent, Zhong Tian could only sue the board of the JV compelling it to cause the JV to sue the infringers directly.[119]

Without resorting to the derivative lawsuit argument, the *Pure* court had to employ another less convincing legal basis. On the one hand, the court argued that the aforementioned SPC Circular could be used as the legal basis for accepting the lawsuit that had been initiated when the JV was obstructed in its enforcement of its right to sue. On the other hand, the *Pure* court based Zhong Tian's standing mainly on its status as the indirect co-owner of the brand "Pure."[120] The court concluded that as the holder of sixty percent interest in the JV, Zhong Tian was the major beneficiary of the *Pure* brand and, consequently, it should be permitted to sue directly when the brand was infringed upon. Following this logic, the *Pure* case was reduced to an action in which Zhong Tian pursued the protection of its own rights, rather than for the benefit of the JV. As a result, Zhong Tian received compensation from its settlement with the infringers leaving the interests of the JV, the direct competitor of the infringers, and Jian Bang (a ten percent minority shareholder of the JV) without any compensation.

b. The Dismissal of Suit I

Within the current Chinese legal framework, a chairman is the legal representative of a corporation[121] and enjoys the exclusive privilege of representing the corporation in lawsuits.[122] Without the proper authorization of a

118. *Id.* at 325.

119. *See also id.*

120. The JV's brand names ("*Pure*" (in English) and "*Bichun*" (in Chinese pinyin)) were, at the time of proceedings, pending trademark registration, and the JV was not the legal owner of these marks under Chinese law.

121. *See, e.g.*, Zhongwai Hezi Jingying Qiye Shishi Tiaoli [Implementation Regulations of Sino-Foreign Equity Joint Venture Law], State Council 2001 No. 311 at art. 34, *available at* http://www.chinacourt.org/flwk/show1.php?file_id=37808 (last visited Apr. 20, 2005).

122. Civil Procedure Law, art. 49(2) ("Legal persons shall be represented in litigation by their legal

legal representative, a lawsuit cannot be brought.[123] Furthermore, a legal representative can apply to the court to withdraw a case after its filing, although the court retains the final say. The *Pure* court ultimately dismissed Suit I initiated by the Zhong Tian directors because it was not authoized by the JV's chairman.[124]

The *Pure* court's dismissal of Suit I illustrates the need for shareholder derivative lawsuits in China. First, under current Chinese law, if an interested chairman refuses to authorize the corporation to sue, the corporation is virtually deprived of that right. Second, if an individual happens to be the legal representative of both the plaintiff and of the defendant in a lawsuit (e.g., the JV's chairman in the *Pure* case), current Chinese law is not sufficiently equipped to prevent such a person from manipulating the entire proceeding.[125] Therefore, in order to protect the legitimate interests of both the corporation and its shareholders effectively, a derivative lawsuit system should be introduced.

c. The Dismissal of Suit III

With respect to the dismissal of Suit III, the *Pure* court first applied the legal principle that "no single case should be handled twice."[126] The court ruled that the JV should not be permitted to initiate Suit III based on the same facts and reasons which its shareholder Zhong Tian had used for Suit II. The court also found that the main purpose of Suit III was to deliberately mitigate the infringers' liability rather than to protect the JV's legitimate interests and, therefore, the court would not accept a lawsuit that "was brought with the intent to evade the law."[127]

Nevertheless, the *Pure* court failed to provide a convincing answer to an important question in derivative lawsuits: after a shareholder institutes a lawsuit on behalf of a corporation, can that corporation sue separately on the same grounds? The *Pure* court's dismissal of Suit III was proper because Suit

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representatives.").

123. *See* Guanyu Renmin Fayuan Shouli Jinji Jiufen Anjian Zhong Jige Wenti de Fuhan [The Reply on Several Issues Regarding the Acceptance of Economic Cases by the People's Court], S.P.C. 1990 No. 91, *available at* http://www.chinacourt.org/flwk/show1.php?file_id=11736 (last visited Apr. 20, 2005) (providing that any complaint filed by a business organization must be executed by its legal representative).

124. The *Pure* court also ruled that no legal provisions supporting the Zhong Tian directors' decision to unilaterally deprive the three Yan Zhong directors of their voting rights and to convene a special board meeting in the absence of the Yan Zhong directors. Zhong Tian should have resorted to arbitration to resolve this type of internal conflict in the JV pursuant to the provisions under the JV Contract. *See Zhong Tian Int'l Co. (Li)* at 329.

125. *See* Liufang Fang, *Guoqi Fading Daibiaoren de Falü Diwei, Quanli and Liyi Chongtu* [*The Legal Standings, Powers, and Conflicts of Interests of Legal Representatives in State-Owned Enterprises*], BIJIAOFA YANJIU [JOURNAL OF COMPARATIVE LAW] (Vol. 3 1999) (China). Based upon the problems revealed in the *Pure* case, Professor Fang criticized the current legal representative system and the exclusive privileges possessed by them in representing business organizations under Chinese law.

126. *"Yi Shi Bu Zai Li"* in Chinese.

127. *See Zhong Tian* at 329–30.

III could not be justified by the apparent bad faith of the JV's chairman in initiating the action. However, the *Pure* court's first reason—the guiding principle "no single case should be handled twice"—may be incorrect for two reasons. First, this principle is derived from, and should be applied consistently with, res judicata theory.[128] In this case, however, the *Pure* court had not yet made any decision on the merits of the case when the JV instituted Suit III. Second, since the JV was the party whose rights were directly infringed, it should have stronger standing than Zhong Tian, its shareholder. Assuming the chairman of the JV was disinterested and had duly authorized the JV to sue, Suit III instituted by the JV should have superseded Suit II brought by Zhong Tian.

d. The Role of the JV in Suit II

Aside from the aforementioned procedural issues, the *Pure* court's treatment of the JV in Suit II resonates with the previous discussion in Part III.B.2 regarding the role of corporations in shareholder derivative lawsuits. In sum, the JV was not treated as the co-plaintiff because its failure to act deprived it of plaintiff status; nor could the JV be treated as the co-defendant because the court thought Zhong Tian's lawsuit would benefit the JV. Finally, the JV was not treated as a third party. The court recognized that the JV had an independent right to sue, but that right was enforced by Zhong Tian instead of the JV. Interestingly, although the JV was acknowledged by the *Pure* court as having "a very special status" in the lawsuit, ultimately it was not listed as any type of party in Suit II.[129]

e. Fairness of the Settlement

Even though the settlement of Suit II was reached voluntarily under the auspices of the court, its integrity and fairness are still questionable. Although the court had recognized that the JV suffered direct losses in the amount of RMB 9.4 million ($1.12 million), Zhong Tian, the sixty percent shareholder of the JV, recovered only RMB 1.7 million ($205,314) from the infringers through the settlement. In other words, the JV still suffered approximately RMB 7.57 million ($914,251) in losses without any remedy.[130] Furthermore, as mentioned previously, the parties to the settlement agreement (and the *Pure* court as well) completely neglected the interests of Jian Bang, the ten percent minority shareholder of the JV.

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128. *See* Zhou Yan, *Lun Minshi Susong Zhong "Yi Shi Bu Zai Li" Yuanze de Shiyong Fanwei* [*The Application Scope of the "No Single Case Should be Handled Twice" Principle in Civil Litigation*], Zhongguo Minshang Falü Wang [China Civil and Commercial Law Web], *at* http://www.civillaw.com.cn/weizhang/default.asp?id=9908 (last modified June 27, 2003) (last visited Apr. 20, 2005).

129. *See Zhong Tian* at 328.

130. Zhong Tian received RMB 1.7 million because of its sixty percent holding in the JV; the JV therefore proportionately received RMB 2.83 million compensation in total.

B. The Sanjiu Case

1. Facts

Sanjiu Medical and Pharmaceutical Co., Ltd. ("Sanjiu") is China's largest public pharmaceutical corporation and is listed on the Shenzhen Stock Exchange. In September 2001, the CSRC discovered that Sanjiu had allowed its majority shareholders and other affiliated parties, without proper disclosure, to misappropriate RMB 2.5 billion ($302 million) of corporate funds in violation of securities laws and other regulations. The misappropriated funds amounted to ninety-six percent of Sanjiu's corporate net assets, and posed a considerable threat to the corporation's operation.[131]

On July 4, 2002, the CSRC fined Sanjiu RMB 500,000 ($60,380), its Chairman Zhao Xinxian RMB 100,000 ($12,077), and its Board Secretary RMB 50,000 ($6,038). The CSRC also imposed fines of RMB 30,000 ($3,623) on each of the seven board members.[132]

After the PSL Provisions came into effect on February 1, 2003, Sanjiu was made a defendant in the first wave of private securities litigation in China.[133] Its chairman at the time, Zhao Xinxian, became the first defendant in a shareholder derivative lawsuit involving a listed corporation in China.

On April 8, 2003, one of Sanjiu's individual shareholders in Shanghai applied to the Shenzhen Futian District People's Court to file a lawsuit against Zhao Xinxian.[134] There were three claims in Mr. Shao's complaint: (i) that Zhao should pay RMB 10,000 ($1,208) to Sanjiu as compensation for damages in connection with the misappropriations in Sanjiu; (ii) that Zhao should pay RMB 10,000($1,208) to Sanjiu as compensation for mismanagement that resulted in the CSRC fine for disclosure irregularities; and (iii) that the filing fee of this lawsuit should be paid by Zhao.[135]

Shao's application was removed to the Intermediate People's Court of Shenzhen on April 14, 2003.[136] A week later, the Shenzhen Court notified Shao's

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131. *See* Steven Shi & Drake Weisert, *Corporate Governance with Chinese Character*, 29 CHINA BUS. REV. 40 (2002).

132. Zhenjianhui Guanyu Chufa Sanjiu Yiyao Ji Geren Weigui de Jueding [The Disciplinary Decision of the China Securities Regulatory Commission on Sanjiu Medical and Pharmaceutical Co., Ltd.], CSRC. Disciplinary Action 2002 No. 12, *available at* http://www.cnm21.com/xinwen/yytx_559.htm (July 4, 2002) (last visited Apr. 20, 2005).

133. *See* Hutchens, *supra* note 17, at 607 n.31.

134. Sanjiu is registered in Shenzhen; Zhao Xinxian resided in Futian District, Shenzhen. Further factual background regarding Shao, the plaintiff, and the *Sanjiu* case can be found in Xu Guojie, *Zhiye Weiquanzhe de Xin Shiming* [*New Mission of the Preserver of Business Rights*], ZHONGGUO ZHENGQUAN BAO [CHINA SECURITIES JOURNAL], Apr. 19, 2003, *available at* http://cs.com.cn/csnews/20030419/356031.asp (last visited Apr. 20, 2005).

135. *See* Wang Lu, *Zhengquan Shichang You Chu Diyi An—Gudong Daibiao Gongsi Zhuanggao Dongshizhang* [*Another First in Stock Market—Shareholder Sues Chairman on Behalf of the Corporation*], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Apr. 9, 2003, *available at* http://www.cnstock.com/ssnews/2003-4-9/touban/t20030409_396554.htm (last visited Apr. 20, 2005).

136. *See* Wang Lu, *Sanjiu Yiyao An You Xinjinzhan* [*New Developments in the Sanjiu Medical Case*], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Apr. 15, 2003, *available at* http://www.cnstock.com/ssnews/2003-4-15/siban/t20030415_399279.htm (last visited Apr. 20, 2005). *See also* Xu,

attorney by telephone that the case would not be accepted. The Shenzhen Court stated that Shao "must obtain authorization from *all* shareholders of Sanjiu before bringing the lawsuit to the court if Shao wants to institute an action in the interest of all Sanjiu shareholders" (emphasis added).[137]

2. Analysis

The aborted *Sanjiu* shareholder derivative lawsuit is regarded as a negative development in the improvement of China's inchoate private securities litigation system.[138] This case unearthed a host of problems within China's existing legal framework.

a. Shenzhen Court's Request To Obtain Authorization from All Shareholders

The Shenzhen Court's demand that Shao should first obtain the authorization of all Sanjiu shareholders was unreasonable and without legal warrant. The concentrated ownership of Sanjiu is typical of China's publicly listed corporations. As disclosed in its 2002 Year-end Annual Report, Sanjiu's two largest shareholders collectively owned 72.91% of Sanjiu. Both of them were Sanjiu affiliates that were involved in the misappropriation of Sanjiu's corporate funds. In addition, Zhao Xinxian held positions in both.[139] Because of the special shareholding structure of Sanjiu, certain commentators have concluded that the Shenzhen Court's groundless request amounted to a virtual ruling that the individual shareholders would not prevail.[140]

From the perspective of modern corporate governance theory, the unanimous authorization of shareholders as a prerequisite to initiating a derivative lawsuit is largely outdated.[141] As explained by the American Law Institute, "informed collective [shareholder] consideration of a proposed litigation is

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supra note 134. According to these two news reports, Mr. Shao actually filed two lawsuits. One was the derivative lawsuit against Zhao Xinxian discussed in this Note; the other was the direct lawsuit against Sanjiu that ultimately was accepted by the Intermediate People's Court of Shenzhen.

137. *See* Wang Lu, *Shouli Gudong Daibiao Susong Weihuo Shouli* [*The First Shareholder Derivative Lawsuit Was Not Accepted*], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Apr. 22, 2003, *available at* http://www.cnstock.com/ssnews/2003-4-22/touban/t20030422_403145.htm (last visited Apr. 20, 2005).

138. *See* Zhang Wei, *Gudong Daibiao Susong Weishouli Cheng Yihan* [*Regret That the Shareholder Derivative Lawsuit Was Not Accepted*], ZHONGGUO JINGJI SHIBAO [CHINA ECONOMIC TIMES], Apr. 24, 2003, *available at* http://finance.anhuinews.com/system/2003/04/24/000317499.shtml (last visited Apr. 20, 2005).

139. *See id. See also* Xuan Weihua, *Jujiao Sanjiu Yiyao Gudong Daibiao Susong An* [*Focusing on the Sanjiu Medical Shareholder Derivative Lawsuit*], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Apr. 22, 2003, *available at* http://www.cs.com.cn/csnews/20030422/357312.asp (last visited Apr. 20, 2005.) According to Sanjiu's 2002 Year-end Annual Report, *available at* http://www.cninfo.com.cn/finalpage/2003-04-09/10466008.PDF (last visited Apr. 20, 2005), and these two news reports, Sanjiu's then largest majority shareholder was Sanjiu Pharmaceutical Co., Ltd., holding 62.72% of Sanjiu and with Zhao Xinxian as its General Manager. Sanjiu's then-second largest majority shareholder was Sanjiu Enterprise Group, holding 10.19% of Sanjiu with Zhao Xinxian as its President. *See also* CSRC, *supra* note 132 (stating that both of these corporations were involved in the misappropriation of Sanjiu's corporate assets).

140. *See* Zhang, *supra* note 138.

141. *See* COX ET AL., *supra* note 24, at 408.

not feasible [because the shareholders, as a body], cannot realistically discuss or evaluate the often complex factual and legal issues raised by derivative actions."[142] In addition, it is extremely difficult for individual shareholders to call a shareholders' meeting and conveniently present to other shareholders their demand to sue.[143] Therefore, the current practice is for a shareholder to bring his demand of a derivative lawsuit to the board of directors in a common law country, while in a civil law country he would bring it to the board of supervisors.[144]

In conclusion, the Shenzhen Court's demand revealed either its ignorance of modern shareholder derivative lawsuits or, to be more cynical, its unwelcoming attitude toward shareholder derivative lawsuits.[145]

b. Reasons For and Against Acceptance of the Sanjiu Case

On the substantive side, Shao claimed that Zhao had violated the relevant securities laws and regulations governing the disclosure and disposal of raised capital. Therefore, according to Article 63 of the Company Law (as discussed above in Part III.A.1), Zhao should be held liable to Sanjiu for all incurred damages. Shao's claims were solid because the CSRC had expressly ruled in its decision that Zhao had violated the Securities Law.[146]

On the procedural side, since there were no legal provisions expressly permitting shareholders to sue the wrongdoers directly, Shao tried to justify his initiation of the suit using the statements of Justice Li Guoguang. In his speech dated December 11, 2002, Justice Li, then vice chief justice of the SPC, said that "shareholders can represent corporations when suing senior management and controlling shareholders whose wrongdoings are believed to have harmed corporate interests. The court should accept these types of

142. *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, § 7.03(c) (1992), *cited in* COX ET AL., *supra* note 24, at 408.

143. According to Article 104(3) of the Company Law, only shareholders owning ten percent or more can request an extraordinary shareholders' meeting of a listed corporation. Furthermore, there are no detailed rules similar to the proxy rules in the United States that govern how individual shareholders should present their requests to all shareholders.

144. *See* Liu Junhai, *Gudong de Diabiao Susong Tiqiquan de Bijian Yanjiu (San)* [*Comparative Study on Shareholder's Rights to Initiate Derivative Lawsuits (Part III)*], Zhongguo Minshang Falü Wang [China Civil and Commercial Law Web], *available at* http://www.civillaw.com.cn/weizhang/default.asp?id=8863 (last visited Apr. 20, 2005).

145. *See* Wang Lu, *Yi Shifa Shijian Tuidong Shichang Fazhihua Jianshe* [*To Promote Legal System Construction in the Market Through Judicial Practice*], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Feb. 25, 2004, *available at* http://www.cnstock.com/ssnews/2004-2-25/qiban/t20040225_ 523657.htm (last visited Apr. 20, 2005). As supporting evidence of the latter conclusion, (i) the Intermediate People's Court of Shenzhen notified Shao's attorney only by telephone on April 21, 2003, that the case was not accepted; and (ii) lawyer Yan Yiming, Shao's attorney in the *Sanjiu* case, mentioned in an interview that the Intermediate People's Court of Shenzhen "even refused to accept the complaint and case files." As a result of these practices, the Intermediate People's Court of Shenzhen would not have issued any written material in denying the acceptance of Shao's case; consequently, technically it would be impossible for Shao to appeal to a higher court for further remedy.

146. CHINA SECURITIES REGULATORY COMMISSION, *supra* note 132.

lawsuits."[147] However, despite this clear instruction, the Shenzhen Court argued that Justice Li's statement could only be used as a reference and not a direct legal basis for it to accept the *Sanjiu* case.[148]

c. The Amount of Claims and the Filing Fee

Compared to the amount of the funds misappropriated (RMB 2.5 billion, or $300 million) by its controlling shareholders and the fines imposed by the CSRC on Sanjiu (RMB 500,000, or $60,380), the total amount of the claims sought by Shao against Zhao was relatively small (RMB 20,000, or $2,418). According to the explanation given by Shao's attorney, the main obstacle discouraging Shao from requesting more for Sanjiu was that Shao could not afford a higher filing fee.[149] As discussed in Part III.B.4, filing fees in China are calculated on a sliding scale according to the amount in controversy. Under the prevailing filing fee calculation model in China, Shao would need only to pay RMB 810 ($98) for his claim of RMB 20,000. Had Shao claimed for the entire amount of the fine levied by the CSRC on Sanjiu (RMB 500,000), the filing fee would have increased more than tenfold to RMB 10,010 ($1,208).[150] Some legal practitioners have concluded that this investor-unfriendly filing fee calculation model poses a challenging ethical dilemma; few individual shareholders in China would risk investing in a high filing fee in exchange for indirect and proportional compensation resulting from an award to the corporation. It has therefore been suggested that China follow the Japanese model and collect a fixed filing fee in derivative lawsuits.[151]

V. Building an Investor-Friendly Shareholder Derivative Lawsuit System in China

As discussed in Parts I–IV, China currently has failed to expressly provide a shareholder derivative lawsuit system. Such lawsuits, "if allowed, would in

147. Wang, *supra* note 135. *See also* Tian Yu & Yang Jinzhi, *Konggu Daqudong Sunhai Gongsi Liyi Yinqi Jiufen, Xiaogudong Qisu Fayuan Ying Shouli* [*Courts Should Accept Lawsuits Brought by Minority Shareholders in Disputes Arising from Infliction of Harm to Company Interests by Controlling Shareholders*], Shanghai Zhengquan Bao [Shanghai Securities News], Dec. 12, 2002, *available at* http://www.cnstock.com/ssnews/2002-12-12/touban/200212120103.htm (last visited Apr. 20, 2005) (reporting on Justice Li's original remarks at the National Court's Civil and Commercial Litigation Adjudication Working Meeting).

148. *See* Wang, *supra* note 135. At the time the Shenzhen Court refused to accept the *Sanjiu* case, Justice Li Guoguang had retired from his position as Vice Chief Justice of the SPC in April 2004. Although in China a justice's speech is not legally binding on lower courts, it is interesting to consider whether the Shenzhen Court would have followed Justice Li's instruction if he were still on the bench.

149. *See* Wang, *supra* note 135.

150. Filing fees may be calculated using the automatic calculator on the website of the Intermediate People's Court of Shenzhen, *available at* http://www.szcourt.gov.cn/ssxz-jfbz.htm (last visited Apr. 20, 2005).

151. *See* Zhang Wei, *Gudong Daibiao Susong Zhi Heshi Cheng Li Qi* [*When the Shareholder Derivative Lawsuit System Can Be Used as a Sharp Weapon*], Zhonggruo Jingji Shibao [China Economic Times], Apr. 10, 2003. *See also* Xuan, *supra* note 139.

all likelihood be unsuccessful."[152] In order to protect minority shareholders' interests adequately, to deter misconduct by management, controlling shareholders, and other wrongdoers, and to improve corporate governance in China, it is necessary for Chinese legislators and judicial authorities to provide clear substantive and procedural rules to develop an investor-friendly shareholder derivative lawsuit system.

Fortunately, we may not have to reinvent the wheel. In November 2003, the SPC published the draft of the Regulations on Certain Issues Relating to Trial of Corporate Dispute Cases (Part I) (the "SPC Draft") to solicit public comments.[153] The SPC Draft contains five articles regarding shareholder derivative lawsuits. This Part will discuss these provisions and suggest some other meaningful mechanisms to supplement China's proposed derivative lawsuit system.

A. The Scope of Defendants and Misconduct Allowed in Shareholder Derivative Lawsuits

Under Article 43 of the SPC Draft, there are two types of defendants: (i) directors, supervisors, managers, or other members of senior management who have violated their duty of loyalty, damaged the interests of the corporation, and caused losses to the corporation; and (ii) controlling shareholders who have, in their controlling position, caused losses to a corporation and damaged its interests.[154]

Compared to Article 63 of the Company Law—wherein directors, supervisors, and managers are liable to their corporations for all damages resulting from violations of their mandatory duties of care and loyalty—the current provision extends liability to other members of the management staff and to controlling shareholders, but limits liability to breaches of duty of loyalty alone.

While the inclusion of controlling shareholders as defendants is correct, limitation of liability to violations of the duty of loyalty may not be sufficient. As discussed previously, the purpose of a derivative lawsuit is to remedy or to prevent wrong or injury to a corporation. But wrong or injury may result from violation of the duty of care as well as from violation of the duty of loyalty. In the *Sanjiu* case, Zhao Xinxian failed to carry out his duty of care

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152. Art & Gu, *supra* note 62, at 299.

153. Guanyu Shenli Gongsi Jiufen Anjian Ruogan Wenti de Guiding (Yi) [Regulations on Certain Issues Relating to Trial of Corporate Dispute Cases (Part I)], S.P.C., *available at* http://www.lawyerhyh.com/gs2.HTM (Nov. 4, 2003) (last visited Apr. 20, 2005). As of the writing of this Note, the Supreme People's Court [hereinafter SPC] has not yet promulgated the final version of this document.

154. Article 43 of the SPC Draft in its entirety provides as follows:

> Where directors, supervisors, managers, or other members of senior management of a corporation violate the duty of loyalty, or controlling shareholders used their controlling power damaging corporate interest and causing damages to a corporation, shareholders can initiate derivative lawsuits and people's court must accept these lawsuits. "Controlling shareholders" as used in this Regulation means shareholders who actually are involved in the operations and management of a corporation and who can influence major corporate decisions.

in assuring Sanjiu's compliance with the mandatory fund use and disclosure requirement and thus caused the misappropriation and the CSRC fine.[155] It would be unfair to both Sanjiu and its shareholders if, according to the SPC Draft, shareholders could not hold Zhao liable to the corporation through derivative actions for his violation of the duty of care.

B. Standing Requirement

Article 44 of the SPC Draft indicates that China still plans to set highly restrictive requirements for plaintiff shareholders intending to institute derivative lawsuits.[156]

The first standing requirement, that the plaintiff must have been a shareholder when the cause of action arose and continuously since that time, is the same as the "contemporary ownership requirement" in the United States.[157] Originally, the contemporary ownership requirement in the United States was created for procedural reasons.[158] Nowadays, this requirement is also applied by some courts for the "prevention of strike suits and speculative litigation."[159] The contemporary ownership requirement, however, has been heavily criticized for its "antipathy" toward derivative litigation[160] because this requirement assists wrongdoers in escaping liability simply because the shareholder did not hold the stock at the time of the wrongdoing. This is unfair to shareholders who discover facts giving rise to a lawsuit only after becoming shareholders. Also, from the perspective of minority shareholder protection, it would appear to be a good idea for minority shareholders who are not competent enough to initiate lawsuits themselves to sell their shares to other more daring investors who are willing to act as prosecutors on behalf of all shareholders. Thus, Professor Robert Clark has concluded that "it is difficult to justify the continued existence of the contemporary ownership rule."[161]

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155. Management's failure to supervise or detect a failure in corporate compliance is generally regarded as a passive violation of the standard of duty of care. *See* ALLEN & KRAAKMAN, *supra* note 20, at 265.

156. Article 44 of the SPC Draft in its entirety provides as follows:

> To institute a derivative lawsuit, a shareholder should fulfill the following requirements: (i) own shares in the corporation at the time of the activities damaging corporate interests, and continue to own them uninterruptedly (another idea under consideration is as follows: own shares in the corporation uninterruptedly for six months prior to the occurrence of the activities damaging corporate interests); and (ii) the shareholder instituting a derivative lawsuit should own no less than ten percent of the shares of the company if he or she is a shareholder in a limited liability company; or should hold in aggregate no less than one percent of the shares of the corporation if he or she is a shareholder in a corporation limited by shares.

157. *See* HAMILTON, *supra* note 21, at 543.

158. The purpose is to deter the purchase of shares in order to create diversity of citizenship and thereby gain access to the federal courts. *See* CLARK, *supra* note 38, at 651.

159. *See* COX ET AL., *supra* note 24, at 425.

160. *See* HAMILTON, *supra* note 21, at 544.

161. CLARK, *supra* note 38, at 651.

The proposed alternative of "six-month shareholding" to the "contemporary ownership" requirement in the first standing requirement, together with the minimum shareholding percentage requirement in the second standing requirement of the SPC Draft, are the prevailing standing requirements for plaintiffs in derivative lawsuits of civil law countries.[162] However, they also seem to be overly restrictive for most individual shareholders in China.

First, the requirement that the plaintiff shareholder own shares in the corporation for an uninterrupted six-month period prior to the occurrence of wrongdoing is derived from the requirement in Japanese law.[163] The Japanese rule aims to deter unmeritorious strike suits, but it has been criticized for its arbitrariness.[164] The proposed requirement under the SPC Draft, however, is even more restrictive because it further requires that a shareholder have held shares for six months "prior to the occurrence of wrongdoing." As pointed out by Professor Wang, such a requirement would in fact preclude most shareholders from acting as plaintiffs. This result contradicts the investor-protection purpose of the derivative lawsuit system.[165]

In the United States and Japan, if shareholders fulfill the contemporary ownership or six-month ownership requirement, they generally are not subject to any other additional minimum shareholding requirement.[166] In contrast, in addition to the onerously long period of ownership requirement, the SPC Draft takes the dubious approach of making the minimum shareholding requirement another prerequisite.

In closely held limited liability companies and foreign investment enterprises in which the number of shareholders is limited,[167] each shareholder should be entitled to equal protection no matter how few shares he or she holds. If, as provided by the SPC Draft, only ten percent of shareholders have access to derivative lawsuits, it would be extremely difficult for such minority shareholders to protect themselves when the interests of limited liability companies are damaged by management or controlling shareholders because, under such circumstances, those minority shareholders could neither easily

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162. *See* Wang Xinxin, *Gudong Daibiao Susong Zhong de Yuangao Zige Wenti* [*Qualification of Plaintiffs in Shareholder Derivative Lawsuits*], RENMIN FAYUAN BAO [PEOPLE'S COURT NEWS], Jan. 28, 2004 (China).

163. *See* Kawashima & Sakurai, *supra* note 39, at 30 *citing* SHŌHŌ [JAPANESE COMMERCIAL CODE] art. 267(1).

164. *See* Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW. U.L. REV. 1436, 1447 n.49 (1994) (stating that "the six-month rule is an arbitrary method of determining which claims are meritorious. The claim of a shareholder who buys stock on May 1 is no less meritorious than that of a shareholder who buys stock on May 2."). *See also* Kawashima & Sakurai, *supra* note 39, at 31 (claiming that "in sum, the harm caused by the six-month holding requirement may significantly outweigh its benefits.")

165. *See* Wang, *supra* note 162.

166. *See* Kawashima & Sakurai, *supra* note 39, at 30 (allowing the owner of a single share to bring a derivative action in Japan); in the United States, a shareholder plaintiff should also fulfill the requirement that the plaintiff should "fairly and adequately represent the interests of the shareholders." FED. R. CIV. P. 23.1(2).

167. According to Article 20 of the Company Law, "a limited liability company shall be jointly invested in and established by not fewer than two and not more than 50 shareholders."

sell their shares in the open market nor resort to the court to seek remedy through derivative actions.[168] Therefore, the proposed shareholding requirement for shareholders in limited liability companies should be eliminated altogether.[169]

The one percent shareholding requirement for all public corporations may also be unrealistic because of the dispersed nature of individual shareholding in China's capital markets. As of December 31, 2004, for example, the second largest shareholders in China Unicom and Bao Steel (two blue-chip Chinese public corporations) owned only 0.54% and 0.56% of the outstanding shares in these two corporations, respectively. [170] Also, in the *Sanjiu* case, although its first and second largest shareholders own 62.72% and 10.19% of the company's shares respectively, Sanjiu's third largest shareholder owns only 0.40% of that company's stock. Furthermore, a literal reading of the SPC Draft does not address whether the plaintiff's shareholdings can be calculated in aggregate. Therefore, the one percent requirement would deprive most individual shareholders of their right to sue derivatively. To rectify this problem, Professor Wang Xinxin's suggestion is insightful. If the SPC adopts a minimum shareholding requirement, (i) the benchmark should only be reasonably higher than the average number of tradable shares held by shareholders; and (ii) it should permit calculations of plaintiffs' shareholdings in aggregate.[171]

C. Demand Requirement

Article 45 of the SPC Draft provides that shareholders who want to institute derivative lawsuits must first demand that their corporations sue.[172] Only if there is no response within two months may the demanding shareholders initiate a derivative action on behalf of their corporation. The waiting period, however, may be forgone and plaintiff shareholders may act immediately in cases where waiting two months would cause irreparable harm to their corporation.

In general, the demand requirement is mandated in almost all jurisdictions permitting derivative lawsuits because it provides corporations with

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168. *See* COX ET AL., *supra* note 24, at 430 n.7 ("[i]n the close corporation, it is quite likely that the derivative suit is the only effective discipline that the small holder has against the much larger owner-defendant.").

169. *See* Wang, *supra* note 162. Professor Wang Xinxin has suggested decreasing the shareholding requirement for shareholders of limited liability companies to one percent or even lower.

170. *See id.* The second largest shareholders' holdings data are based on the data posted at the website of the Shanghai Stock Exchange, *available at* http://www.sse.com.cn/sseportal/en_us/ps/home.shtml (last visited Apr. 20, 2005).

171. *See* Wang, *supra* note 162.

172. Article 45 of the SPC Draft in its entirety provides as follows:

> A shareholder wishing to institute a shareholder derivative lawsuit should provide evidence to prove the existence of any of the following facts: (i) he or she made demands on the corporation to sue two months prior, but the corporation has not sued; (ii) relevant properties are to be transferred, the time limitation for the performance of certain rights is to expire, or the statutory limitation to institute a lawsuit is to lapse; or (iii) any other urgent circumstances that make it necessary for the shareholder to institute lawsuit immediately.

the opportunity to exhaust internal remedies and to involve centralized management in the decision of whether to sue or not.[173] It also spares the court from hearing cases that are not ripe for decision and protects corporations from the harassment by litigious shareholders in allowing the corporation to reject a proposed action.[174]

Nevertheless, the current provision contained in Article 45 of the SPC Draft may still require clarification or elaboration in the following respects:

First, the current draft does not clearly specify to which corporate unit shareholders should submit their demands, or, in other words, which unit should be responsible for shareholders' demands. As suggested by Professor Liu Junhai, this responsibility should generally be taken on by boards of supervisors or, in listed companies that have implemented an independent director system, by the independent directors.[175]

Second, the current provision in the SPC Draft follows the universal demand model, i.e., some forms of demand are required in all derivative lawsuits, with exception only when plaintiffs can show that irreparable harm would otherwise result (such as conveyance of property or expiration of statutory limitation).[176] This universal demand model is distinguishable from the approach applied in some states of the United States wherein demand is exempted when it would be futile. Typically, demand is futile when the alleged offenders control the management of the corporation.[177] In order to avoid wasting two months and to provide a timely remedy for shareholders, the SPC may wish to follow this approach and exempt futile demands. Specifically, demand is unnecessary if a majority within the corporate organ to which shareholders must make demand are neither disinterested nor independent. Here, interest refers to a member's personal stake in the challenged transaction. "Independence . . . refers to the degree to which [such member will] make his own decisions as opposed to being controlled or dominated by [the wrongdoers]."[178]

Finally, the current draft fails to specify whether shareholders can continue with derivative lawsuits if their demands are rejected by the corporation. Because China has no express legal doctrine equivalent to the "business judgment rule" recognized in most Western countries where corporate governance is more developed,[179] the rejection of demands may not be justified

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173. *See* Marx v. Akers, 666 N.E.2d 1034 (1996), *reprinted in* CHOPER ET AL., *supra* note 22, at 808; *see also* CLARK, *supra* note 38, at 641 (concluding that "the management of the corporation is entrusted to the board of directors, not to the shareholders. Whether to sue or not to sue is ordinarily a matter for the business judgment of directors").

174. *See id.*

175. *See* Liu, *supra* note 144.

176. The universal demand requirement is recommended by the American Law Institute Corporate Governance Project and the Revised Model Business Corporation Act, and was adopted by Japan. *See* Kawashima & Sakurai, *supra* note 39, at 46.

177. *See* HAMILTON, *supra* note 21, at 544.

178. *See* FERRARA ET AL., *supra* note 93, at § 6.04[5].

179. *See* Wei, *supra* note 35, at 406 ("[T]here are no such provisions [in China's Company Law] in re-

even though such decision is made on an informed basis and as part of a good faith effort to advance corporate interests.[180] Therefore, as the doctrine of the business judgment rule has not been formally transplanted into China's corporate law system, the SPC should provide that, subject to the court's case-by-case review and approval, shareholders may be permitted to proceed with derivative lawsuits even though their demand is rejected by the corporation.

D. Participants in Derivative Lawsuits

Article 46 of the SPC Draft outlines the role of certain other participants in derivative lawsuits.[181] First, other shareholders who have standing under Article 44 of the SPC Draft, unless they have additional separate claims, are permitted to join in a pending derivative lawsuit. This approach follows the practice in other major jurisdictions.[182] However, as the SPC Draft does not require the plaintiff in a shareholder derivative lawsuit to notify other shareholders of a pending suit, the opportunity for other shareholders to participate may not always be assured.

Second, the SPC Draft provides that parties who damage corporate interests in collusion with the management or controlling shareholders can be sued as co-defendants or third parties in the same lawsuit as well.

Finally, the SPC Draft provides that the corporation should be made a third party participating in a derivative lawsuit upon notification by the court. Although the corporation and the parties acting in collusion under the preceding paragraph can both participate in derivative lawsuits in the capacities of "third parties," they are of different legal natures. Parties acting in collusion that participate in a lawsuit at the request of the plaintiff-shareholders are third parties lacking independent claims. In contrast, corporations in derivative lawsuits, as discussed previously, are a new type of participant whose legal status is to be further clarified through the development of China's

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spect to such basic matters as the duty of care or the business judgment rule."). *See also* Yuan, *supra* note 37, at 493 ("Directors, supervisors, and managers in China, unlike their U.S. counterparts, have no business "judgment rule" on which to rely or with which to protect themselves.").

180. *See* A.B.A., CORPORATE DIRECTOR'S GUIDEBOOK (2d ed. 1994), *cited in* ALLEN & KRAAKMAN, *supra* note 20, at 251 (defining the business judgment rule).

181. Article 46 of the SPC Draft in its entirety provides as follows:

> After one shareholder instituted a derivative lawsuit, if other shareholders who meet the qualifications under Article 44 of this Regulation apply to join the lawsuit with the same claims, they shall be permitted to join the lawsuit as co-plaintiffs, provided however, that they shall institute lawsuit separately if they have additional claims. People's court shall permit shareholders to list opposing parties in relevant transactions as defendants or third parties when the shareholders institute derivative lawsuit. After one shareholder institutes the derivative lawsuit, the people's court shall inform the corporation to join the lawsuit as a third party.

182. *See, e.g.*, *In re* Maxxam Inc., 698 A.2d 949, 956 (Del. Ch. 1996) (explaining that because "a derivative claim belongs to the corporation . . . the identity of the specific representative shareholder plaintiff is not a paramount concern"). In the United States, intervention and consolidation of shareholder derivative lawsuits are generally granted by statute. *See* CHOPER ET AL., *supra* note 22, at 875. In Japan, "other shareholders may participate in pending litigation to protect their interests, provided that their participation does not result in undue delay or considerably burden the reviewing court." Kawashima & Sakurai, *supra* note 39, at 32, *citing* SHŌHŌ [JAPANESE COMMERCIAL CODE], art. 268(2).

civil procedural law. The current draft, however, is not clear on the role of the corporation. For example, it remains unclear whether the corporation can be represented by its own attorney in a derivative lawsuit.

E. Security for Expenses

Article 47 of the SPC Draft provides that if defendants can present evidence to prove that plaintiffs are suing in "bad faith," courts may, at the request of defendants, order shareholder plaintiffs to post security for defendants' reasonable litigation expenses.[183]

"The primary purpose [of the security for expenses] provision is to reduce strike suits."[184] The introduction of this device will be a breakthrough in China's civil procedure law system.[185] Nevertheless, certain issues in the current draft still require clarification.

First, the SPC Draft grants courts the discretion to order the posting of a security payment when defendants claim that a plaintiff is suing in bad faith, but does not explicitly define situations that constitute "bad faith." Shareholder plaintiffs' right to sue, therefore, may be compromised by courts' possibly arbitrary determinations. A finding of subjective bad faith is also difficult. To address these problems, China may refer to the Japanese approach, which focuses on more objective circumstances in determining whether plaintiffs have brought suit in "bad faith." Such recognized situations include instances where plaintiffs have brought a suit (i) expecting little possibility of success but without significantly modifying or supplementing their complaints, (ii) where a case is difficult to prove, and (iii) where it is likely that the defendants would succeed in getting the case dismissed.[186]

Second, the current draft is silent as to the result of the shareholder plaintiffs' failure to post security. Following similar provisions under the Civil Procedural Law,[187] the SPC should expressly stipulate that failure to post security as ordered by courts will result in the dismissal of the lawsuit.

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183. Article 46 of the SPC Draft in its entirety provides as follows:

> After one shareholder instituted a derivative lawsuit, if the defendant, in his pleading, is able to provide evidence to prove the plaintiff is suing in bad faith and applies to the people's court to demand that the plaintiff post security for expenses, the people's court should approve such application. The amount of security should be equal to reasonable expenses in connection with the defendant's participation in the lawsuits.

184. COX ET AL., *supra* note 24, at 434.

185. *See* Liu Junhai, *Gudong de Daibiao Susong Tiqiquan de Bijiao Yanjiu (Si)* [*Comparative Study on Shareholder's Rights to Initiate Derivative Lawsuits (Part IV)*], Zhongguo Minshang Falü Wang [China Civil and Commercial Law Web], *available at* http://www.civillaw.com.cn/weizhang/default.asp?id=8977 (last visited Apr. 20, 2005).

186. Article 47 of the SPC Draft is substantially the same as its counterpart under Article 267(6) of the Japanese Commercial Code. Article 267(6) also fails to provide a definition of "bad faith." In Japan, the objective approach as introduced here has now been adopted as the prevailing method in determining what constitutes "bad faith." KAWASHIMA & SAKURAI, *supra* note 39, at 43.

187. *See* Civil Procedure Law, art. 92(2) (providing that a court may order an applicant for attachment measures to post security; if the applicant fails to provide security, the application will be dismissed).

Finally, the SPC Draft fails to explain the purpose of such security and does not define the scope of "reasonable expenses in connection with the defendant's participation in the lawsuit." The attempted clarification of these ambiguities is explored in Part V.F.1 *infra*.

F. Additional Useful Mechanisms

In addition to the current five provisions under the SPC Draft, the following mechanisms should also be included to build an investor-friendly shareholder derivative lawsuit system in China.

1. Reimbursement of Expenses

To promote shareholder derivative lawsuits in China, it is advisable to allow prevailing shareholders to demand reimbursement from corporations for any reasonable expenses incurred in connection with the lawsuit, including attorney fees. These costs, together with the filing fees, should ultimately be paid by the liable wrongdoers. The practice of allowing reimbursement of shareholder plaintiffs' attorney fees along with other reasonable expenses is permitted in other jurisdictions.[188] "The rationale underlying this doctrine is that the [shareholder] plaintiff's efforts have conferred a benefit on the corporation for which the corporation would otherwise have had to pay, and fairness requires that the plaintiff be reimbursed the necessary expenses of conferring that benefit."[189]

In contrast, when shareholder plaintiffs are unsuccessful in pursuing their derivative lawsuits, they may also be responsible for defendants' reasonable expenses incurred in the lawsuits, in addition to filing fees. However, they should only be responsible for those costs if they had pursued the lawsuits in bad faith.[190] Article 47 of the SPC Draft provides that a plaintiff should post security if the defendant can prove that the plaintiff is suing in bad faith. This provision implies that if the plaintiff loses the case, such security will be applied to reimburse "reasonable expenses in connection with the defendant's participation in the lawsuit." The scope of these "reasonable expenses" to should also include reasonable attorney fees and other necessary costs.

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188. In Japan, shareholders may demand that the company pay a "reasonable amount within the scope" of the attorneys' actual fees. SHŌHŌ [JAPANESE COMMERCIAL CODE], art. 268(2), *cited in* WEST, *supra* note 164, at 1460. In the United States, a successful plaintiff "who has conferred a substantial benefit on the corporation is entitled to recover reasonable expenses, including attorneys' fees, from the corporation in whose name the action is brought." A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE § 7.17 cmt.a (1992).

189. COX ET AL., *supra* note 24, at 445.

190. If a corporation incurs expenses in its participation in a derivative lawsuit, a bad faith plaintiff may also be responsible for the corporation's reasonable expenses. This is the practice of certain foreign jurisdictions (e.g., Japan). *See* Kawashima & Sakurai, *supra* note 39, at 16 ("Unsuccessful shareholders may be liable for damages to the corporation if they pursued the derivative action in bad faith.").

2. Settlement and Withdrawal

In order to police confidential settlements between plaintiff shareholders and defendant wrongdoers, courts should have authority to review and approve voluntary withdrawals by plaintiffs that are accompanied by out-of-court settlements.[191] In addition, as a fall-back the SPC should expressly allow other shareholders or the corporation to petition courts for a retrial if shareholder plaintiffs and defendant wrongdoers have been found to have colluded in effecting settlements or judgments detrimental to the corporation.[192]

On the other hand, with respect to settlements reached under the auspices of the court, where courts engage in substantive and procedural review to ensure the fairness of settlement agreements, in order to avoid possible unfairness (such as that in the *Pure* case), the SPC should require that the content of a proposed settlement agreement be provided to the corporation and to other non-litigating shareholders. Such a procedural safeguard would enable other shareholders as well as the corporation to have the opportunity to curb inadequate or unfair settlements.

3. Res Judicata

Res judicata is the civil procedure rule regarding the finality of a particular issue or of a judgment that precludes parties from relitigating a dispute once it has been decided on the merits.[193] In order to avoid disrupting daily corporate operation with repetitive litigation, as well as to encourage the active participation of other aggrieved shareholders, it is advisable for the SPC to integrate a res judicata rule in China's shareholder derivative lawsuit system.

Specifically, the SPC should stipulate that a judgment based on the merits acts as res judicata and would thus preclude additional suits on the same claim since the claim was already litigated on behalf of the corporation.[194] Also, settlements reached under the auspices of the court should have the same effect as a final judgment on the merits.

In contrast, the res judicata effect of voluntary withdrawals should be evaluated case by case. Voluntary dismissal by plaintiff-shareholders or court-ordered dismissals (e.g., the plaintiff-shareholders do not have proper stand-

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191. The settlement issue in derivative lawsuits seems to have caught the SPC's attention. *See* Tian & Yang, *supra* note 147 (reporting on remarks by Justice Li regarding the courts' handling of proposed settlement offers in ongoing litigation).

192. *See* Zuigao Renmin Fayuan Guanyu Renmin Fayuan Tiaojie Gongzuo Ruogan Wenti de Guiding [The Regulations Regarding Certain Issues in Handling Civil Settlements in People's Courts], SPC. 2004, *available at* http://www.chinacourt.org/flwk/show1.php?file_id=96343 (Aug. 18, 2004) (last visited Apr. 20, 2005). In China, retrial of a settled case is possible. Courts in China will not recognize a settlement agreement that violates any other third party's legitimate interests. *See also* SHŌHŌ [JAPANESE COMMERCIAL CODE], art. 268-3(1) and FED. R. CIV. P. 60 (providing relief upon a finding of fraud and on various other grounds).

193. *See generally* Nanping Liu, *A Vulnerable Justice: Finality of Civil Judgment in China*, 13 COLUM. J. ASIAN L. 35 (1999). *See also* Yan, *supra* note 128.

194. *See* HAMILTON, *supra* note 21, at 555.

ing or fail to post security for expenses) should not be binding on other non-suing shareholders. However, if the case is dismissed on its merits, the decision should have res judicata effect.[195]

4. Filing Fee

As discussed previously, and illustrated by the *Sanjiu* case, filing fees calculated under the current model can sometimes be prohibitively expensive and may discourage a potential shareholder plaintiff from validly seeking a large judgment for a corporation. The SPC should give preferential treatment in encouraging derivative lawsuits. One approach is to follow the Japanese model, which regards derivative actions as non-monetary for the purpose of calculating the filing fee.[196] Under China's current law, the filing fee for derivative lawsuits of a non-economic nature would therefore not exceed RMB 50 ($6), an amount easily affordable in China.[197] Alternatively, derivative lawsuits could be regarded as a special type of lawsuit aimed at protecting the public interest of shareholders. Thus, according to the proposed amendments to the Civil Procedure Law, the filing fee of derivative lawsuits would be capped at a fixed amount.[198]

If, due to the constraints of the current civil procedure framework, the filing fee of derivative lawsuits cannot be reduced immediately, another meaningful solution would be the establishment of investor protection funds or associations in China.[199] Through such mechanisms, individual investors could obtain the financing needed to pursue derivative lawsuits.

In summary, since the SPC Draft has already provided for effective and subtle control devices in standing and demand requirements, it would be pointless to place the filing fee as an extra unfriendly hurdle to deter plaintiff-shareholders,[200] particularly since a smaller filing fee would not necessarily encourage strike suits.[201]

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195. *Id.*

196. *See* Kawashima & Sakurai, *supra* note 39, at 20.

197. *See* SPC., *supra* note 103.

198. Under the proposed amendments, the disputed amount of a lawsuit for public interest is capped at RMB 50,000 ($6,000). Therefore, the filing fee thereof would be fixed at approximately RMB 2,000 ($240). W. Jiang & B. Sun, *Zhonghua Renmin Gongheguo Minshi Susong Fa Xiugai Jianyi Gao* [*Proposed Amendments to the Civil Procedure Law of the P.R.C.*], Zhongguo Minshang Falü Wang [China Civil and Commercial Law Web], *available at* http://www.civillaw.com.cn/weizhang/default.asp?id=18323 (last visited Apr. 20, 2005).

199. *See* Guo Feng, *Baohu Zhongxiao Touzizhe de Guanjian: Wanshan Falü Jizhi* [*The Key to Protecting Medium and Minority Shareholders is Improvement of the Legal System*], Zhongguo Minshang Falü Wang [China Civil and Commercial Law Web], *available at* http://www.civillaw.com.cn/weizhang/default.asp?id=8589 (last visited Apr. 20, 2005). There are recent reports that the CSRC, in conjunction with other authorities, will soon launch Securities Investor Protection Funds in an expected total amount of RMB 60 billion ($7.25 billion). *See* Lin Jian, *Woguo Jiang Chouji Sheli Zhenquan Touzize Baohu Jijin* [*China to Establish Securities Investor Protection Fund*], SHANGHAI ZHENGQUAN BAO [SHANGHAI SECURITIES NEWS], Feb. 21, 2005, *available at* http://www.fsi.com.cn/news100/100_0502/100_ 05022101.htm (last visited Apr. 20, 2005).

200. *See* Liu, *supra* note 185.

201. *See id.*

VI. Conclusion

This Note has reviewed China's current legal framework regarding the shareholder derivative lawsuit system. Frustratingly, this review indicates that at present, such suits may not be welcomed by legislators and courts in China. It may be understandable that, because of their utilitarian purpose in guiding China's corporate reform, both the Company Law and the Securities Law, initially promulgated or drafted about a decade ago, have failed to introduce derivative lawsuits as an effective remedial and deterrent device to protect minority investors and to monitor corporate management. However, considering the priority that the Chinese government has afforded investor protection, it is puzzling to find that the SPC Draft still contains a draconian standing requirement and a vague demand procedure. Along with an unchanged, prohibitively expensive filing fee, all of these factors serve to thwart the establishment and development of a derivative lawsuit system in China. In sum, the primary task of China's legislators and courts should be to institute and encourage a shareholder derivative lawsuit system in China, rather than to restrict its development.[202]

This Note has argued that a properly structured shareholder derivative lawsuit system will ensure improved protection of minority shareholders, improved monitoring of corporate management and controlling shareholders, and improved corporate governance in China. In order to develop strong and healthy capital markets, China should remove all procedural and substantive law hurdles to building an investor-friendly shareholder derivative lawsuit system.

202. *See id.*