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**DERIVATIVE ACTIONS AS A MECHANISM FOR THE
PROTECTION OF MINORITY SHAREHOLDERS IN CHINA:
A RESULT OF CONVERGENCE OR DIVERGENCE**

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The protection of minority shareholders has become one of the key features of company law reform in many countries in recent years. Various mechanisms have been created to achieve this objective. Australia has introduced the statutory derivative action procedure mainly based on models drawn from Canada and New Zealand; this provision was inserted into the *Corporations Act* in March 2000. China has also adopted a similar mechanism – known as the shareholder representative action; this scheme was based upon China’s understanding of statutory derivative actions in Western countries. China’s derivative action mechanism is reflected in amendments to the 2005 *PRC Company Law* and 2005 *Securities Law* that both were passed on 27 October 2005 and came into effect on 1 January 2006. The development of statutory derivative actions in different countries demonstrates the interaction between forces of convergence and divergence in company law reforms. This article reviews different mechanisms adopted in the Chinese law for the protection of minority shareholders. It especially focuses on an analysis of the nature of the shareholder representative action and the procedures for its utilisation in China – the equivalent to Western countries’ derivative actions. In comparison with statutory derivative actions in Australia, this article argues that the concept of the shareholder representative action in China rests upon a misunderstanding of Western derivative actions; this has involved a compromise between the dire need to protect shareholders and the ambiguities of a weak court system. As a consequence, China’s reforms in this area are largely a tentative gesture and are therefore unlikely to be very effective.

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I INTRODUCTION

As a civil law country China's laws on the protection of minority shareholders are mainly found in two pieces of legislation,¹ namely, the Company Law and the Securities Law. These two Laws were enacted by China's highest lawmaking body – the Standing Committee of the National People's Congress (hereinafter NPC). Since their first enactment in 1993 and 1998 respectively, constant criticisms had been made of them. Prior to the major amendments of 2005, only a few minor amendments were made by China's legislature.²

One of the criticisms that had been made on the 1993 *Company Law* and the 1998 *Securities Law* was that they lacked effective mechanisms for the protection of shareholders.³ In response to the criticisms⁴ of these two laws,⁵ the 1993 *Company Law* and the 1998 *Securities Law* were both substantially amended at the Eighteenth Meeting of the Tenth Standing Committee of the NPC on 27 October 2005. Both Laws came into effect on 1 January 2006. One of the key areas of amendment was the introduction of various mechanisms which sought to enhance the protection of shareholders, especially minority shareholders. The shareholder representative action is one of these mechanisms.

¹ Legislation in China only refers to the law making of the National People's Congress and its Standing Committee.

² Before 2005, the 1993 *Company Law* was amended in December 1999 and August 2004. The 1998 *Securities Law* was amended in August 2004.

³ Dingbang Liang, 'Amending the Company Law from the Perspective of Securities Regulation' in Feng Guo and Jian Wang (eds), *On Amending the Company Law* (2000) 29, 32; Haifeng Xu, 'The Company Law Should Be Improved to Protect Minority Shareholders' in Feng Guo and Jian Wang (eds), *On Amending the Company Law* (2000) 134, 136; Xianglong Chen, 'On the Corporate Governance Structure in Joint Stock Limited Liability Companies' in Feng Guo and Jian Wang (eds), *On Amending the Company Law* (2000) 190, 194.

⁴ During the Second Plenary Meeting of the NPC in March 2004, there were 602 deputies of the NPC made a proposal to a substantial revision of the 1993 Company Law. The State Council and its ministries, local governments, enterprises and professionals and experts all suggested amendments to the Company Law. See Kangtai Cao, 'Explanations on the Amendments to the PRC Company Law' in Jian An (ed), *Annotation of the PRC Company Law* (2005) 349, 350.

⁵ *Ibid* 356.

China's 2005 *Company Law* and *Securities Law* both contain new provisions aimed to strengthen the protection of shareholders; most of these provisions are found in the *Company Law*. The new mechanisms include the shareholder representative action; this mechanism allows shareholders to bring actions against the wrongdoers when the interests of the company have been infringed. Shareholder representative actions are commonly referred to as derivative actions by Chinese legal scholars. They are intended to have an important impact on the improvement of corporate governance in Chinese companies and the development of China's socialist market economy.

However, by analysing the concept of shareholder representative actions and the problems involved with the proceedings for bringing such actions in Chinese courts, this article argues that although the shareholder representative action mechanism in China has been strongly influenced by Western models, as a result of the forces of convergence, it was built upon a misunderstanding of Western derivative actions. The recent company law reforms in China reflect an uneasy compromise between the dire need for the protection of shareholders and the ambiguities that arise in legal proceedings because of China's weak court system. The effect of the corporate law convergence has been such as to lead China to create a mechanism of shareholder representative actions; however, the effect of path dependence is such that China's shareholder representative action is far different from its equivalence in Western countries, such as that in Australia.

This article concludes that the mechanism of shareholder representative actions is not viable in its current form and actually causes great confusion. Instead of being effective in protecting minority shareholders the current form of this mechanism is largely symbolic; due to the forces of path dependency in China, this mechanism is merely a tentative gesture with few real functions.

This article is structured as follows: Part II reviews the background to the making of China's 2005 *Company Law* and *Securities Law* with the focus on the introduction of shareholder representative actions. Part III compares the provisions on the protection of minority shareholders in the 1993 *Company Law* and the 1998 *Securities Law* with

those found in the 2005 *Company Law* and *Securities Law*. It focuses on shareholder representative actions in comparison with statutory derivative actions in Australia. Part IV offers some conclusions.

II BACKGROUND

When the first PRC *Company Law* was enacted on 29 December 1993, the aim of this law was to ‘meet the need of a socialist market economy and establish a modern enterprise system by adopting a shareholding system in state-owned enterprises (SOEs)’.⁶ The provisions of the 1993 *Company Law* were focused on transforming SOEs into either limited liability companies or joint stock limited liability companies. Due to lack of experience in developing a market economy it soon became apparent that the old *Company Law* and *Securities Law* would not suit the development of China’s economy.⁷ One of the major problems with the 1993 *Company Law* was that it did ‘... not have effective mechanisms for the protection of shareholders, especially minority shareholders’⁸ and that it also lacked ‘... effective tools to protect creditors, other stakeholders and public interests’.⁹ For a long time the Chinese securities market had often been described as being worse than a ‘casino’¹⁰ and it was said that investing in such market was like ‘dancing with wolves’.¹¹ Thus the aims of the 2005 amendments were to ‘adjust relevant systems, maintain the market economic order and reduce transaction risks so as to make the Company Law more suitable for the economic and social development, and provide legal protection for the overall development of economy and society’.¹²

⁶ Jian An (ed), *Annotation of the PRC Company Law (Zhonghuarenmin Gongheguo Gongsifa Shiyi)* (2005) 1.

⁷ Cao, above n 4, 349.

⁸ Ibid.

⁹ Ibid.

¹⁰ In 2001, Professor Wu Jinglian, one of most influential economists in the Chinese economic reform, alleged that China’s securities market was even worse than a casino as ‘a casino at least has rules for games’. See Wu Jinglian, *On Ten Years of the Securities Market (Shinian Fengyu Hua Gushi)* (2003) 1.

¹¹ See Jiangyu Wang, ‘Dancing with Wolves: Regulation and Deregulation of Foreign Investment in China’s Stock Market’ (2004) 5 *Asian-Pacific Law and Policy Journal* 1, 1.

¹² Ibid 351.

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During the drafting process, the drafters conducted studies of foreign company laws by visiting foreign countries and holding symposia in China on foreign company laws with the participation of foreign company law experts.¹³ The major foreign models that China studied were those of the USA, Germany, Japan, Korea and Hong Kong.¹⁴

Several drafts of the Company Law Amendment Bill (hereinafter the Bill) were prepared. The last version of the Bill drafted by the State Council was sent to the Standing Committee of the National People's Congress for the first reading in December 2004. The second, third, and final versions of the Company Amendment Bill were written by the Legislative Affairs Commission (LAC) of the Standing Committee of the National People's Congress based on the Bill of the State Council.¹⁵ The LAC acknowledged that its Bill was still transitional and that some of its aspects remained unchanged either due to lack of experience or lack of consensus.¹⁶ The 2005 *Company Law* contains thorough amendments to the old law with almost every old article being rewritten.

Before the 1993 *Company Law* was enacted, the drafting of the *Securities Law* had already started. In August 1992, the Fiscal and Finance Committee of the Standing Committee of the NPC formed a Securities Law Drafting Group.¹⁷ A draft Securities Bill was prepared in August 1993 after the study of foreign securities market regulations and practices, as well as the study of experiences in the Shanghai, Shenzhen and Hong Kong Stock Exchanges. The aims of the draft Securities Bill included: the improvement of the development of the socialist market economy; ensuring openness, justice, fairness, efficiency and unity in the securities market; and the protection of the interests of investors.¹⁸

¹³ Ibid 350.

¹⁴ Ibid.

¹⁵ Ibid 4.

¹⁶ Ibid 5.

¹⁷ The Securities Law Drafting Group, 'Explanations of the Securities Bill' in Shuqiang Liu, *Annotation of the PRC Securities Law* (1999) 342, 342.

¹⁸ Ibid.

However, due to the short history of the Shanghai and Shenzhen Stock Exchanges and lack of experience from practice, China's cautious legislators postponed the drafting.¹⁹ The *Securities Law* was not enacted until 29 December 1998. This is a very narrow and simple piece of legislation; its principal focus is upon the regulation and supervision of the securities market.

After some 15 years of practice and learning, the legislators had released the serious inadequacies of the 1998 *Securities Law*. They also realised the importance for the introduction of mechanisms for the protection of minority shareholders as this market 'is predominated by retail investors'.²⁰ New Provisions on shareholder representative actions were introduced in both *Company Law* and *Securities Law*.

The following Part reviews these new provisions. Rationales for shareholder representative actions will be analysed. The procedures for such actions will also be investigated.

III PROTECTION OF MINORITY SHAREHOLDERS AND SHAREHOLDERS REPRESENTATIVE ACTIONS IN CHINA

A Schemes for the Protection of Minority Shareholders

It is clear from analysed above that the 1993 *Company Law* did not focus on the protection of minority shareholders, although this matter was declared as one of its purposes.²¹ The 2005 *Company Law*, however, has strengthened the protection of shareholders, especially minority shareholders. It has imposed clear duties on directors, supervisors and other senior officers of the company. These provisions have indirectly provided a possibility for the protection of minority shareholders. The 2005 *Company Law* has also added articles with respect to the direct protection of shareholders. First, shareholders are now given the right to know about the company's business. This right is seen as the foundation for the protection of minority shareholders. This type of right includes the right to inspect and make a copy of the

¹⁹ Law Committee of the NPC, 'Report on Opinions on the Amendments to the Securities Bill' in Shuqiang Liu, *Annotation of the PRC Securities Law* (1999), 445.

²⁰ See Wang, above n 11.

²¹ The 1993 *PRC Company Law*, art 1.

company's articles of association, the resolutions of the meetings of the board of directors, the resolutions of the meetings of the supervisory board, as well as the financial accounting reports of the company;²² Companies have a duty to prepare and provide relevant information and documents at designated places,²³ and must provide shareholders with periodic reports of the remuneration paid to directors, supervisors and senior managerial officers of the company.²⁴

Secondly, the provisions dealing with the calling of shareholders' general meetings and meeting rules have been improved.²⁵

Thirdly, the provisions on the shareholder representative action provide the ultimate remedy for the minority shareholders. The shareholder representative action mechanism will be discussed in detail later.

Following the amendments made in the 2005 *Company Law*, corresponding changes were made in the 2005 *Securities Law*:

- (i) some misconduct in securities market such as insider trading, fraud and market manipulation will bear civil compensation liability as well as criminal liability;²⁶
- (ii) when a takeover bidder company or its controlling shareholder has infringed the interests of the target company or the interests of other shareholders and caused loss to them, the bidder company and its controlling shareholder must bear liability to pay compensation;²⁷
- (iii) in particular, shareholder representative actions can be brought by shareholders when directors, supervisors, senior managerial staff or shareholders holding more than five per cent or more of the company

²² Ibid arts 34, 98.

²³ Ibid art 97.

²⁴ Ibid art 141.

²⁵ Ibid arts 40, 101, 102, 103, 105, 106.

²⁶ The 2005 *Securities Law*, arts 69, 76, 77, 79.

²⁷ Ibid art 124.

shares have breached the restriction on trading in company shares during a six-month period.²⁸

Obviously the shareholder representative action has been introduced into Chinese law as an important mechanism aimed at the protection of minority shareholders.²⁹ The following parts of this article will deal with the issues with respect to the shareholder representative action.

B The Concepts of Shareholder Representative Action, Derivative Action and Shareholder Direct Action in China

Just as China's economy is at a transitional stage,³⁰ China's enterprise system and securities market are also going through transitional changes.³¹ China has been drawing upon foreign experience in developing its own companies and securities regulatory regimes for more than a decade.³² However, much knowledge about foreign law and practice came from the short visits to some foreign countries by China's law makers³³ and the ten-member Company Law Amendment Expert Advisory Group of whom few have a good command of a foreign language. Thus accuracy and completeness of this knowledge is somewhat in doubt. This situation led to confusing provisions in the new *Company Law* and the new *Securities Law*. The concepts of shareholder representative action, derivative action and direct action are examples of such confusion. .

The concept of shareholder representative action is introduced by article 152 of the 2005 *Company Law*. According to this article, when any director, or any senior managerial officer has breached laws, regulations or the articles of association of the company, and thereby caused damage to the company, a shareholder or a group of

²⁸ Ibid art 47.

²⁹ Cao, above n 4, 355.

³⁰ Yujun Zhang, Lijian Xiao, Wuhua Long and Jinsong Tang, *Reform and Development of Chinese Stock Market in a Transitional Period (Zhuangui shiqi Zhongguo Zhengquanshichang Gaige Yu Fazhan)* (2004) 1

³¹ Ibid.

³² The making of the 1993 *Company Law*, the 1998 *Securities Law*, the 2005 *Company Law*, and the 2005 *Securities Law* is strong evidence.

³³ Above n 4, 350.

shareholders holding one per cent or more of the company shares (either separately or jointly) for a consecutive period of 180 days, may in writing request that the supervisor board or the supervisor (in the case of a limited liability company), bring an action against this director, supervisor or senior managerial officer to the court; if any supervisor is involved in such a breach, the aforesaid shareholder(s) may in writing request the board of directors or the executive director (in the case of a limited liability company which has not established a board of directors) to bring such an action before the court.

Article 152 continues to provide that shareholders shall bring a shareholder representative action on their own behalf for the interests of the company.

Westerner lawyers may find it hard to understand how an action brought by shareholders on their own behalf can be called a derivative action. This is because the derivative action in Western countries refers to an action brought by shareholders on behalf of the company for a wrong done to the company where the company is unwilling or unable to bring the action.³⁴ An action under s 152 would be seen as a direct action in Western countries.

However, it is widely believed by Chinese scholars that the shareholder representative action is the same as the derivative action.³⁵ One of the prominent company law scholars of the China Academy of Social Sciences,³⁶ Professor Liu Junhai holds the view that the shareholder derivative action refers to an action which is brought by shareholders on their own behalf when the interests of the company have been infringed by other parties, especially by the controlling shareholder or directors.³⁷ He argues that although the derivative action is focused on shareholders exercising the

³⁴ The *Australian Corporations Act 2001* (Cth) s 236; the Corporate Law Economic Law Reform Program Bill 1998 Explanation Memorandum [4.2].

³⁵ Tiantao Shi, *Corporations Law* (2005) 508; Qing Yan, 'Related Party Transactions of Listed Companies under the Company Law' in Feng Guo and Jian Wang (eds), *On Amending the Company Law* (2000) 266, 304;

³⁶ He joined School of Law of the People's University, one of the leading law schools in China in 2006.

³⁷ Junhai Liu, 'On Shareholders' Right to Bring a Representative Action' in Baoshu Wang (ed), *Commercial Law Essay* (1997) vol 1, 84.

company's rights, the representative action is focused on the shareholders' status as the representative of the company in the action, and both actions really mean the same thing.³⁸ Professor Yan Qing notes that the term derivative action is used in common law countries, whilst in civil law countries this action is called representative suit.³⁹ Professor Shi Tiantao has said that the shareholder derivative action is also called the shareholder representative action.⁴⁰ In a book edited by one of the ten experts of the Company Law Amendment Experts Advisory Group, Professor Jiang Ping, it is also held that the derivative action is also called the shareholder representative action.⁴¹ Even the State Council drafters held the same view.⁴² There had been frequent calls in China for the adoption of the concept of the derivative action in the process of amending the 1993 PRC *Company Law*.⁴³

To some degree there was therefore a misunderstanding in China of derivative actions. Most of the literature mentioned above describes the shareholder representative action as one action brought on behalf of shareholders.⁴⁴ Few people advocate that the derivative action must be brought on behalf of the company.⁴⁵ It seems that the draftsmen of the LAC were reluctant to use the term derivative action. Instead, they use the concept of shareholder representative action in the legislation.⁴⁶ However, they did not say whether the shareholder representative action is different from the derivative action. Some legal academics continue to hold the view that the derivative action is the same as the shareholder representative action.⁴⁷

³⁸ Ibid 85.

³⁹ Yan, above n 35.

⁴⁰ Shi, above n 35.

⁴¹ Ping Jiang and Guoguang Li (eds), *The New Company Law Training Textbook* (2005) 327.

⁴² Kangtai Cao et al (eds), *A Research Report on New Company Law Amendments*, China Legal System (2005) 159.

⁴³ Ibid.

⁴⁴ Wanhua Du, 'Opinions on Interpretation of the Company Law' in Feng Guo and Jian Wang (eds), *On Amending the Company Law* (2000) 505; Xuebing Zhang, 'Ten Suggestions for the Amendments to the Company Law' in Feng Guo and Jian Wang (eds) *On Amending the Company Law* (2000) 509; Ling Lin and Dong Hong, 'Legal Entity and Business Results: A Practical analysis of Listed Hi-Tech Companies' in Feng Guo and Jian Wang (eds) *On Amending the Company Law* (2000) 202.

⁴⁵ Shi, above n 35; Cao et al, above n 42.

⁴⁶ An, above n 6, 218.

⁴⁷ Jiang and Li, above n 41.

What is clear among most of the people, who think that the derivative action is the same as the shareholder representative action, is that both terms refer to an action based on the right to sue which belongs to the company. What is confusing is that they believe that shareholders should sue on behalf of themselves, rather than on behalf of the company.⁴⁸

There were two major reasons for the approval by Chinese legislators' preferred use of the term shareholder representative action. First, if the *Company Law* allowed shareholders to bring an action on behalf of the company when the interests of the company have been infringed, and the company is unable or fails to bring such an action against the wrongdoer, there would be a conflict with the current PRC legal representative system.⁴⁹ China introduced a system of director in charge from the former USSR in the *General Principles of Civil Law* in 1986. Under this Law and the Law on Industrial Enterprises Owned by the Whole People 1988, the director of a factory was the legal representative of that factory.⁵⁰ The legal representative refers to a person who represents the company when dealing with outsiders. This concept is officially defined as 'the person who signs on behalf of the enterprise'.⁵¹

The functions of a legal representative include representing the company to appear in the courts. Under the 1993 *Company Law*, the Chairman of the board of directors is the legal representative.⁵² During the process of drafting the 2005 *Company Law*, the Supreme People's Court argued that if shareholders were allowed to bring an action on their own behalf when the interests of the company were infringed, these shareholders would be representing the company in the court and thus would become a legal representative of the company. Therefore, this would be in conflict with the legal representative provisions found in the previous legislation.

⁴⁸ Xu, above n 3, 138

⁴⁹ Author's interview with one member of the Company Law Amendment Experts Advisory Group on 4 December 2005 in Beijing (interviewee asked for anonymity).

⁵⁰ Ibid.

⁵¹ The State Administration for Industry and Commerce, *Amendments to Implementing Rules Concerning Registration and Administration of Enterprise Legal Persons of 1996*, art 27.

⁵² Arts 45, 113.

Furthermore, if shareholders were allowed to bring an action on behalf of the company, were they the plaintiffs or the agents of the plaintiff? To avoid the ambiguities in the legal status of such shareholders before the courts, the Supreme Peoples' Court objected to allowing shareholders to bring an action on behalf of the company against the wrongdoer. This argument was reflected in the language of article 152.⁵³

In China, the concept of the derivative action has been widely used by academics. As they have acknowledged that this concept came from the Anglo-American legal system,⁵⁴ the meaning of this concept was misunderstood and misused. The views of the Chinese academics later misled the legislators.

Although the term derivative action is not written into the Act, it is clearly used in the Explanatory Memorandum (EM) to the CLERP Bill 1998. Paragraph 1.2 of the EM states that 'a statutory form of business judgment rule is to intend to protect the authority of directors in the exercises of their duties and to clarify their liability. The introduction of a statutory derivative action is based on the Canadian model⁵⁵ and it provides a new avenue of enforcement and action by shareholders where previously there has been a gap.' A derivative action is defined in the EM as an action 'to enable shareholders or directors of a company to bring an action on behalf of the company, for a wrong done to the company where the company is unwilling or unable to do so'.⁵⁶

Under article 153 of China's 2005 *Company Law*, if the misconduct of directors or senior managerial personnel of the company has infringed the interests of a shareholder, the shareholder may bring an action against them to the court. This is called direct action.⁵⁷ The legislative drafters explained that the direct action is an

⁵³ Author's interview with one of the ten members of the Company Law Experts Advisory Group on 4 December 2005 in Beijing (interviewee asked to be kept anonymous).

⁵⁴ Yan, above n 35, 304; Shi, above n 35, 509.

⁵⁵ Ian Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales Law Journal* 149, 174.

⁵⁶ The CLERP Bill 1998 EM, [4.2]

⁵⁷ Above n 46, 219.

action brought by shareholders when their personal interests were infringed.⁵⁸ Article 153 article originated from article 111 of the 1993 *Company Law*. There are four major differences between the shareholder representative action and the direct action: (i) the shareholder's right to bring a representative action comes from the right belonging to the company while in a direct action the shareholder's right to sue belongs to himself/herself; (ii) in the shareholder representative action, the wrongdoer is the defendant, including not only director or supervisors, but also a third party; in the direct action, directors, supervisors or senior managerial personnel are the defendants; (iii) the shareholder representative action deals with the infringement of the interest of the company while the direct action deals with the infringement of a shareholder's personal interest; (iv) the proceeds of the shareholder representative action belong to the company and the interests of all shareholders are indirectly protected, while the proceeds of the direct action belong to the individual shareholders who have sued.

The concept of the shareholder representative action is very confusing for another reason. Such representatives can be easily mixed up with the representatives in joint actions which are regulated under article 53 of the *PRC Civil Procedure Law*. Article 53 provides that if the subject matters in an action are the same or of the same kind, these actions are joint actions; and the people's court may merge these cases with the agreement of all parties. It also provides that if there are too many parties, all the parties may elect representatives in the litigation.

The joint action in China is slightly different from the class action which exists in Australia and other common law countries. The applicants in the joint action have the same dispute and the judgment binds every applicant; while in the class action, the judgment applies to the same kind of litigants no matter they agree with the judgment or not. Nonetheless, both the joint action and the class action are brought on behalf of the individuals who brought the actions. Thus they both are direct actions.

⁵⁸ Ibid.

***C The Shareholder Representative Actions under the 1993 Company Law and the
2005 Company Law***

As analysed above, shareholder representative actions are also called derivative actions in China.⁵⁹ The 1993 *Company Law* was silent on whether shareholders could bring representative actions. Its article 63 only provided that directors, supervisors and managers who had breached the provisions of laws, administrative regulations or the articles of association of the company, and thus had caused damage to the company, should bear liability to pay compensation. This article could be seen as the basis for bringing shareholder representative actions. However, the 1993 *Company Law* did not contain further provisions on what could and should be done if directors, supervisors or managers did not bear liabilities themselves for their wrongs, and the company did nothing when its interests were infringed. Consequently, old article 63 was merely a symbolic declaration without any real legal effect.

As mentioned earlier, China borrowed the concept of the derivative action from Anglo-American company law.⁶⁰ It was seen as a mechanism for directly protecting the interests of the company and indirectly protecting the interests of the minority shareholders.⁶¹ The 2005 *Company Law* has formally adopted the concept of the shareholder representative action. Although Chinese lawmakers have tried to mirror the derivative action mechanism that is used in Anglo-American company law, the shareholder representative action nevertheless has been tailored to suit the needs of China's legal environment. Under the Chinese law, the shareholder representative action has been mixed up with the direct action.

To get a clearer picture of the shareholders representative action mechanism, it is necessary to visit the relevant provisions in the 2005 *Company Law* in detail. Article 150 is about direct actions. Article 152 provides procedures for shareholder representative actions. Article 153 goes on to provide for shareholders' direct actions. It states that when directors or senior managerial personnel have breached laws,

⁵⁹ Cao et al, above 42.

⁶⁰ Ibid.

⁶¹ Ibid.

administrative regulations or the articles of association of the company, and have infringed the interests of shareholders, shareholders may bring an action to the court. As the term direct action has been used in both articles 152 and 153, this may cause some confusion.

D The Shareholders Representative Action under the 2005 Securities Law

Most of the situations where shareholders may bring representative actions are covered by article 152 of the 2005 *Company Law*. However, there are still other situations where shareholder representative actions can be brought, such as those provided under article 47 of the 2005 *Securities Law*. This article aims to prevent the insiders of listed companies from making personal gains. It provides for a special type of shareholder representative actions. It is worth noting that the action under article 47 of the 2005 *Securities Law* must also be brought on behalf of the shareholders, rather than on behalf of the company, although such a right to sue belongs to the company.

E How a Shareholder Representative Action Can Be Brought?

Chinese legislators have tried to balance the right to bring shareholder representative actions and the business efficiency of the company.⁶² On the one hand shareholders are given the right to bring representative actions for the purpose of protecting minority shareholders. On the other hand, some restrictions on the use of this mechanism must be imposed so that the company's resources will not be wasted. Thus article 152 provides that a shareholder representative action can only be brought to the court on the following conditions:

⁶² An, above n 6, 218.

- ***Only certain shareholders may bring a shareholder representative action:***
Under sub-article 1 of article 152, only current shareholders may bring a representative action. Former and future shareholders do not have the right to sue on behalf of the company. As the Chinese *Company Law* only allows limited liability companies and joint stock limited liability companies to be formed,⁶³ shareholders must hold some shares of the company. In Australia, not only a current member, but also a former member, or even an officer of the company can bring a statutory derivative action. According to the study of Ramsay and Saunders, among the 31 cases of statutory derivative actions heard by courts from 13 March 2000 to August 2005, almost all applicants were shareholders; 15 of them were both members and directors and one of them was a director only.⁶⁴

Holding company shares is not enough to be qualified to bring a representative action. Article 152 further requires that the shareholder(s) in a joint stock company which can issue securities to the general public must either separately or jointly hold one per cent or more of the company shares and this shareholding must last for 180 consecutive days before the action can be brought.

Article 45 of the 1993 *Company Law* declares that the chairman of the board of directors is the sole legal representative of the company. In the drafting process of the 2005 Amendments, there had been different opinions on whether the system of sole representative of the legal person should be reformed as this scheme was not in use in other countries.⁶⁵ After examining the counterpart laws of the US, Japan, Korea, Germany and Taiwan, and considering that China had no sound credit and trust system, the majority of the legislators formed the view that it was

⁶³ Art 2.

⁶⁴ Ian Ramsay and Benjamin Saunders, 'Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action' (Centre for Corporate Law and Securities Regulation, 2006) 45: <<http://cclsr.law.unimelb.edu.au/download.cfm?DownloadFile=FB06F6F0-1422-207C-BAEFEA2798DE6D95>> at 26 March 2007.

⁶⁵ An, above n 6, 33.

necessary to maintain the status quo. Meanwhile, the 2005 amendments expand the scope of the people who can act as legal representative.⁶⁶

Under article 13 of the 2005 *Company Law*, the chairman, an executive director or a manager may act as the legal representative of the company in accordance with the provisions of the articles of association of the company. However, it is hard to imagine that cautious Chinese judges will implement this article in hearing cases brought by these individuals or institutions without a clear and official interpretation from the legislature.

- ***Pre-requisites for bringing a shareholders representative action:***

Under article 152(2), there are three pre-requisites: (i) the shareholder must have referred the subject matter to directors, supervisors, the executive director of a company without a board, or the supervisor of a company without the supervisory board, before he/she can bring an action to the court; (ii) the request for dealing with the subject matter must be made in writing; (iii) the action may only be brought after the board of directors, the supervisor board, the executive director of a company without a board of directors, or a supervisor of a company without a supervisory board has refused to bring an action, or has failed to bring an action, or if there is an emergence and non immediate court proceedings will make the company suffer unrecoverable loss.

These prerequisites were designed for China's domestic situations. But in practice it is very time-consuming to have a request first dealt with by the company. It is also very hard to prove the urgency of the subject matter, and that the company will suffer unrecoverable loss if an action is not allowed to be brought without meeting the requirement and without the relevant company's institutions and officers first being involved. It is also worth noting that the defendant in the shareholder representative action

⁶⁶ Jian Fu and Jie Yuan, *PRC Company & Securities Laws – A Practical Guide* (2006) 40.

may not only include directors, supervisors or senior managerial personnel, but may also include parties outside the company under article 152(3). This significantly departs from the procedure for statutory derivative actions in Western countries.

In Australia, a derivative action cannot be initiated without leave from the court. The criteria for granting leave seek to reach a balance between the need to provide a real avenue for applicants to seek redress on behalf of the company where it fails to do so and the need to prevent actions proceedings which have little likelihood of success.⁶⁷ This prerequisite is completely different from that of China which uses the company itself as a filter to prevent frivolous actions.

***F Costs Issues in the Australian Derivative Action and the Chinese Shareholder
Representative Action***

Legal costs can operate as a disincentive to litigation and thus courts were given such power in making costs order.⁶⁸ A common problem with both China and Australia is the ambiguity about the costs issue. The Australian court may at any time make any orders it considers appropriate about the costs of the parties involved in the derivative action. This shows that the court's power to make costs orders is broad and discretionary. The purpose for giving the court such discretion is 'aimed at providing an additional safeguard in respect of use of company funds' and reaching a balance between protecting 'a bona fide shareholder against liability for costs indemnifying them out of company funds' and allowing the Court 'a further means of discouraging unmeritorious action'.⁶⁹

Although sometimes the costs problem under the Chinese law is simpler to solve as the Supreme People's Court has the rules on litigation fees, there is still some uncertainty. The 2005 *Company Law* does not have detailed procedures for bringing

⁶⁷ Above n 56, [6.23].

⁶⁸ Ramsay, above n 55, 163.

⁶⁹ Above n 56, [6.69].

the shareholder representative action, let alone the provisions on the remuneration of the costs of the shareholder who brought such action. If a shareholder representative action is brought to a Chinese court and accepted, most probably the court will apply the rules on litigation costs released by the Supreme Peoples' Court. The basic rule on the legal costs is that the loser pays the cost of the winner. In a shareholder representative action, the shareholder plaintiff will be treated the same as any other plaintiff in any other civil cases. If he wins, his legal costs will be first fully remunerated out of the remedies awarded to the company. If the monetary remedies are big enough to cover the shareholder's litigation costs and the loss of the company, it is going to be fine. But if the monetary remedies are not enough to cover the loss of the company, or not enough to pay the shareholder's litigation costs, which will be paid first remains a question. This uncertainty to some degree is a disincentive for the use of the shareholder representative action. If the remedies are not monetary at all, it will certainly deter the use of the shareholder representative action.

V CONCLUSION

Although the shareholder derivative action has been an important corporate governance mechanism in the Anglo-American jurisdiction for some time, it, however, remained largely unknown in China until very recently.⁷⁰ Chinese commentators have vigorously advocated an investor-friendly derivative action mechanism.⁷¹ Insertion of provisions on the shareholder representative action procedure in recent law reforms is a great leap forward in Chinese company law.

However, the shareholder representative action in China is an ambiguous legal term which is based on a misunderstanding of the derivative action procedure in Western countries. It has also been confused with the shareholder direct action. The confusion of the nature of the derivative action with that of the shareholder direct action, the lack of detailed procedures for bringing shareholder representative actions, and the

⁷⁰ Baoshu Wang and Hui Huang, 'China's New Company Law and Securities Law: An Overview and Assessment' (2006) 19 *Australian Journal of Corporate Law* 229, 236.

⁷¹ Jiong Deng, 'Building an Investor-friendly Shareholder Derivative Lawsuit System in China' (2005) 46(2) *Harvard International Law Journal* 347, 385.

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uncertainty in the remuneration of litigation costs will greatly diminish the popularity of shareholder representative actions in China. Thus such a mechanism is certain to be symbolic. It will only assuage the legislators' good intention but be of limited effectiveness in providing the protection of the minority shareholders in China. This is a missed law reform opportunity.