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ARTICLE

LEGAL PROTECTION FOR MINORITY SHAREHOLDERS IN CHINA

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In view of the increasingly severe exploitation of minority shareholders and the existence of double agency costs in China, it is necessary to provide strong protection for minority shareholders in China in order to build an investor-friendly system. By enabling minority shareholders to prevent misconducts of majority shareholders and managers, legal system has made significant progress in the past twenty years. Nevertheless, many defects still exist. The first enactment of the PRC Company Law was passed in 1992 with primary goal to serve reform of state-owned enterprises and therefore protection for minority shareholders was excluded by the scope of these reforms. The revision of the Company Law in 2005 was regarded as historical progress of Chinese company law in respect of providing protection for minority shareholders as many rights are conferred on shareholders and more measures were adopted to restrain the power of directors and controlling shareholders. However, this paper identifies that these various rights and protective mechanisms have certain deficiencies, which means that the interests of minority shareholders suppose to be guaranteed would be inevitably affected. Without improvements and clarifications of the existing legal protection in the future, interests of shareholders and company as a whole will be obstructed ultimately and development of capital markets will be significantly impeded.

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INTRODUCTION

"The ability of an individual shareholder complain of irregularities in the conduct of corporate affairs has long been a source of controversy,"[1] and thus it is essential to explore legal mechanisms which have been promulgated to enable minority shareholders to prevent misconducts of majority shareholders and managers. This is particularly relevant given that there are currently two agency costs in China: vertical agency cost between minority shareholders and managers, and horizontal agency cost between controlling shareholders and minority shareholders.[2] Law plays a key role in reducing these agency costs and protecting the interests of minority shareholders.

Consequently, this paper aims to investigate legal protection for Chinese minority shareholders. First, it will introduce the source of legal protection provided for minority shareholders. Among the laws and regulations discussed

[1] R. J. Smith, *Minority Shareholders and Corporate Irregularities*, (1) The Modern. L. Rev. 147, 160 (1978).

[2] For the details of these double agency costs, see Shaowei Lin, *Double Agency Costs in China: A Legal Perspective*, 9 The Asian Bus. L. 124, 133 (2012).

herein, this paper will focus on company law, which provides a general layer of protection for minority shareholders. Second, this paper will briefly examine the historical developments of legal protection for minority shareholders prior to the *Company Law of the People's Republic of China* (2006). Third, this paper will discuss the improvements to the methods adopted in company law. Finally, the attendant defects will be identified in depth. It is argued that these legal mechanisms should be improved or clarified in the future in order to provide a more solid form of protection for minority shareholders in China.

I. THE SOURCES OF LEGAL PROTECTION FOR MINORITY SHAREHOLDERS

There are three main legal sources of protection that are available for minority shareholders. The first and most important one is statutory law including the Company Law and the Securities Law. The Company Law basically deals with corporate governance issues and provides protection for shareholders in general. The Securities Law, however, focuses principally on stock companies or listed companies by stipulating provisions for disclosure of information, market transparency and listing qualifications, etc. The two laws were adopted and passed by the Standing Committee of the National People's Congress (SCNPC), which has an enhanced degree of legal force than other regulations. Anything that contradicts these laws in judicial decisions or administrative regulations is treated as invalid.

The second source of minority shareholder protection is judicial decision-making. Judicial interpretations issued by the Supreme People's Court (SPC) can generally be divided into two components. The first one is the explanation of a specific law such as the *Decisions on Issues Regarding Application of the PRC Company Law*. In practice, judicial explanations are treated as statutory legislation that is binding on all courts in China.[3] It is

[3] The power of legal interpretation of the SPC was granted by several regulations as follows: *Decisions on Issues Regarding Interpretation of Law* (1955), *Law of the PRC on Organization of the People's Court* (1979), *Resolution of the SCNPC Providing an Improved Interpretation of the Law* (1981), *Provisions of the Supreme People's Court on the of Judicial Interpretation Work* (1997).

recognized that some provisions in law are ambiguous. However, it is impractical to revise them once the defects are found since the amendment of those provisions by formal legislative process would take a long time. Therefore, solving these problems by issuing judicial explanations has been widely recognized as a straightforward and convenient way to proceed. The second component is guiding cases. On 26 November 2010, the SPC made a significant change to the Chinese legal system by adopting a rule creating a procedure to recognize a batch of "guiding cases." Although the new rule only states that courts at all levels should "refer to" guiding cases issued by the SPC, it is expected that these cases should be followed, otherwise there may be serious consequences. Therefore, although these guiding cases are not officially construed as binding precedents as they do in the Western sense, they may evolve to similar effectiveness.[4]

The third source of legal protection for shareholders can be found in administrative regulations. While there are numerous administrative regulations governing various matters in China, regulations on legal protection for minority shareholders are dominantly issued by the China Securities Regulatory Committee (CSRC). Regulations issued by the CSRC play a key role in constraining controlling shareholders and managers of listed companies because the Company Law and the Securities Law are ineffective and insufficient to offer redresses for minority shareholders. The Company Law (1993) was enacted primarily to regulate state-owned enterprises (SOEs) which accounted for the majority of corporations in China at that time. The Company Law (1993) basically provided little protection for minority shareholders because the principal purpose of the law was in favor of majority shareholders. Furthermore, there were few provisions policing conducts of controlling shareholders and directors in listed companies since the securities market was newly established. The Securities Law was first enacted in 1999, which means most of the regulations pertaining to listed companies were largely provided by the CSRC from 1992 to 1999. Even after the enactment of the Securities Law, the CSRC still plays a key role in

[4] The SPC had published eight guiding cases, at http://cgc.law.stanford.edu/guiding-cases (last visited Jul. 9, 2012)

regulating various forms of management and majority shareholder misconducts.[5]

II. DEVELOPMENTS OF LEGAL PROTECTION FOR MINORITY SHAREHOLDERS PRIOR TO THE COMPANY LAW (2006)

At the beginning of the 1990s, the main purpose of commercial law was regarded to reform and serve SOEs. From this perspective, the first enactment of the Company Law in 1993 was passed to provide a legal basis for SOEs reform, and therefore only a few provisions were designed for protection of minority shareholders. However, with the rapid development of the capital market in China and increasing occurrences of exploitation of shareholders, interests of minority shareholders received increasing attention in China. The attention to minority shareholders was strengthened by the argument that legal protection of minority shareholders indicated success of a capital market because the country with inadequate protection for minority shareholders would be less attractive to investors and would have significantly smaller debt and equity markets.[6] The research conducted by Johnson et al. also revealed that there was a link between legal protection for minority shareholders and conditions of a financial market with the argument that legal mechanisms to constrain controlling shareholders and reduce "tunneling" activities were vital in furthering capital market development.[7] Acknowledging

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[5] The primary regulations issued by the CSRC are as follows: *Detailed Rules for Implementation Regulations on Information Disclosure by Companies Offering Public Stocks* (1993), *Provisional Measures on Prohibition of Securities Fraud* (1993), *Guidelines on Articles of Association of Listed Companies* (1997), *Rules for the General Assemble of Shareholders of Listed Companies* (2000), *Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies* (2001), *Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders* (2004).

[6] See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny ("LLSV"), *Law and Finance*, Working Paper 5661, National Bureau of Economic Research 1993); La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, Working Paper 5879, National Bureau of Economic Research 1997; La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership around the World*, Working Paper 6625, National Bureau of Economic Research 1998.

[7] Johnson Simon, Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *Tunneling*, 90(2) Am. Econ. Rev. 22, 27 (2000).

the insufficient protection provided by the Company Law (1993), CSRC issued many regulations and guidelines to prevent majority shareholders and managers from exploiting interests of minority shareholders and companies and to discipline those who violate these regulations and rules. Nonetheless, it is argued that these regulations and guidelines are unsystematic and only provide limited and low-level protection.[8] In addition, it seems that the reluctance of courts to accept civil cases involving protection for minority shareholders exacerbated the situation, although it changed several years later.

A. Company Law (1993)

The enactment of the Company Law (1993) was regarded as a milestone of Chinese economic reform for the reason that, prior to the date of its enactment, China ostensibly did not need a company law since it was deemed as a law under capitalism. Someone even suggested that the name of the Company Law should be State-Owned Enterprise Law because that law was intended to serve the formation and management of SOEs.[9] Fortunately, the name was not changed although the basic structure and the main contents of the law were indeed primarily related to regulations of SOEs. The Company Law remained unchanged until the substantial revision in 2005.[10]

Shareholders were given some basic and general rights under the Company Law (1993). Article 4 stated that shareholders "have the right to enjoy the benefits of the assets of the company, make major decisions, choose managers etc., in accordance with the amount of capital they have invested in the company."[11] In particular, shareholders were given the right to attend and vote at the shareholders' general meeting,[12] examine the financial reports and

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[8] Xiaoning Li, *A Comparative Study of Shareholders' Derivative Actions: England, the US, Germany and China*, Kluwer Law International (London), at 269 (2007).

[9] Many provisions of the Company Law (1993) emphasized the interests of the State. For example, article 4(3) stated that the ownership of state-owned assets in a company shall vest in the country.

[10] The Company Law was revised in 1999, but it was a minor amendment with little significance.

[11] *Company Law of the People's Republic of China* (1993), art. 4.

[12] Id. art. 37, 41, 102, 106.

accounting records,[13] draw dividends,[14] seek remedies when their interests were infringed[15] and enjoy priority in subscription of newly issued shares.[16] However, some of these rights were ambiguous and limited, and therefore it was reasonable to say that these rights were only on the books without any practical application. For example, the priority in subscription for new shares in the Company Law seems to be a strong protection for minority shareholders while actually it lacks any specific means of being applied. There is only one sentence stating that "[the] existing shareholders may have priority in subscription for new shares where a company increases capital."[17] However, it does not provide any procedures for such a shareholder to subscribe. The second example of such ambiguity and limited scope of application is the right of a shareholder to bring lawsuit where a resolution of the shareholders' general meeting or the board of directors infringes his or her lawful rights and interests, while not all shareholders are entitled to enjoy this right. Only shareholders in stock companies are entitled to exercise this right when their interests are violated. Furthermore, remedies available for shareholders who bring this type of lawsuit are limited to an injunction rather than any compensation, which obviously strongly discourages individual shareholders. Another example is that shareholders representing one-fourth or more of the voting rights in a limited liability company or holding more than ten percent of shares in a stock company were able to request an interim shareholders' meeting.[18] However, the nature of remedy for shareholders where his or her request is denied by the board of directors was not addressed in the Company Law.

Besides general rights as above, specific and carefully tailored protection for minority shareholders were barely included in the Company Law (1993). MacNeil examined the legal protection for minority shareholders by employing LLSV's "anti-director rights index" and concluded that minority shareholders protection in China's Company Law (1993) was much weaker

13 Id. art. 32, 110.

14 Id. art. 33.

15 Id. art. 111.

16 Id. art. 33.

17 Id. art. 33

18 Id. art. 43, 104 (3).

than those of other countries.[19] Six protective components are identified in LLSV's index and are calculated by adding 1 point when each of them occurs. MacNeil found out that the total score for China was 2 with a world average of sample countries there of 3 and an average of common law jurisdictions of 4 (see Table 1).

Table 1 Index of Protective Components in China's Company Law (1993)

Protection	Score
Shareholders can mail their vote to the company	0
Shareholders are not required to deposit their share prior to the Annual Shareholders' General Meeting	1
Cumulative voting or proportional representation of minorities in the board of directors is allowed	0
An oppressed minorities mechanism is in place	0
The minimum percentage of capital that is necessary for shareholders to call an extraordinary shareholders' meeting is less than or equal to 10%	1
Shareholders have pre-emptive rights that can only be waived by a shareholder's vote.	0

It is not a surprise that the Company Law (1993) failed to provide specific protective rights to minority shareholders since the primary intention to introduce this law was to reform governance of SOEs and to protect state assets. However, possibilities of directors to abuse their powers were recognized by the drafters of the Company Law (1993) and several modest measures were adopted, such as a supervisory board to supervise acts of the directors[20] and administrative and criminal liabilities they should bear when violating certain laws and regulations.[21] Nevertheless, experience demonstrated that directors were rarely disciplined for their wrongdoings due to the ineffective and impractical mechanisms of enforcement. For example, as Li pointed out, the supervisory board did not perform the supervising function as expected and thus failed to supervise the directors.[22] Furthermore, the restrictions on exploitation of controlling shareholders were barely set up in the law because the majority shareholder in most companies is the State. For

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[19] Iain MacNeil, *Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies,* 2(2) J. Corp. L. Stud. (2002).

[20] See fn. 11, sec. 4.

[21] Id. ch. X

[22] Li, fn. 8 at 280.

example, there was no provision imposing fiduciary duties on the majority shareholders to the company or the minority shareholders, and the law did not provide that controlling shareholders should not enjoy voting rights for transactions that they were involved.

B. Administrative Regulations

The administrative regulations issued by the CSRC took a more robust and progressive approach to protect the interests of minority shareholders. Among many regulations issued by the CSRC, the *Guidelines for the Articles of Association of Listed Companies* (hereinafter, the "Guidelines 1997") and the *Code of Corporate Governance for Listed Companies* (hereinafter, the "Code 2002") are the most fundamental ones, and their provisions seemed to be effective in constraining controlling shareholders and directors.

Prior to the Guidelines 1997, articles of association of many listed companies were chaotic and controlled by the majority shareholders. In order to prevent majority shareholders from using the articles of association to deprive minority shareholders and the company of interests, CSRC issued the Guidelines 1997 which all companies that demand to get listed should comply with or provide reasonable grounds for non-compliance, and failing to do so would result in rejection of its listing application. Under the Guidelines (1997), shareholders enjoy certain rights that did not exist in the Company Law (1993). For example, shareholders with 5% of the voting shares in the company shall have the right to raise proposals to the company.[23] Second, the Guidelines 1997 also addressed problems result from when the board of directors disapprove to convene an interim shareholders' assembly meeting requested by eligible shareholders. The Guidelines 1997 specified that such a meeting should be convened despite of the board of directors' disapproval.[24] Furthermore, the supervisory board has more practical rights to perform its supervising functions. Under the Guidelines 1997, the supervisory board can propose the convening of an interim shareholders' assembly to the board of directors when necessary, and such an assembly shall be convened by the supervisory board directly where the

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[23] *Guidelines for the Articles of Association of Listed Companies* (1997), art. 57.

[24] Id. art. 44, 54.

proposal is disapproved and at the expenses of the company.[25]

The Code 2002[26] made substantial improvements to protection for minority shareholders' and achieved an average level of 3 under the LLSV's index due to the first adoption of cumulative voting right.[27] The Code 2002 provides that listed companies that are owned more than 30% by controlling shareholders shall adopt a cumulative voting system which is expected to provide a strong mechanism for minority shareholders to have a voice in the company by electing their favored directors. Most importantly, two particular measures constraining controlling shareholders are adopted by the Code 2002.

The first measure is fiduciary duties that controlling shareholders owe to minority shareholders. It has been recognized that fiduciary duties should be imposed upon controlling shareholders to the company and minority shareholders for the integrity of the company.[28] The Code 2002 adopted this doctrine for the very first time, providing that controlling shareholders generally owe fiduciary duties to the listed company and other shareholders as the Company Law (1993) and the Securities Law (1998) did not mention it at all.[29] Accordingly, the controlling shareholders shall act in the interests of the company, including minority shareholders, and minority shareholders may bring lawsuits against the controlling shareholders where they breach their fiduciary duties. Unfortunately, detailed rules of the procedures of enforcement and remedies for violations were not contained in the Code 2002, and therefore litigation based on it has rarely been brought in practice.

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[25] Id.

[26] *Code* 2002 issued based on a previous *Guidelines for Corporate Governance* 2000. *Guidelines* 2000 with only 55 articles, however, was not mandatory for listed companies; while *Code* 2002 with 95 articles is mandatory for all listed companies.

[27] A precise explanation of the cumulative voting system is as shown in Chapter III B(2).

[28] See Tenev Stoyan, Chunlin Zhang & Loup Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*, World Bank Report, at 82–83 (2002).

[29] Article 19 of *Code* 2002 states that controlling shareholders owe fiduciary duties to the listed company and other shareholders. The controlling shareholders shall strictly comply with laws and administrative regulations while exercising their rights as investors, and shall be prevented from damaging rights and interests of the listed company and other shareholders. Controlling shareholders shall not take advantage of their position to seek additional benefits.

The second measure is the independence and separateness of the listed companies from the controlling shareholders, which was emphasized by the Code 2002. Separate legal personality is one of the characteristics of a business corporation and thus it sounds normal and natural that the controlling shareholders should be distinct from the listed company. However, this is not the case in China. Many Chinese listed companies are controlled by majority shareholders who intentionally mingle their assets with those of the company, appoint directors without approval of the shareholders' general meeting, and/or misappropriate assets of the company to gain private and personal benefits. Therefore, the Code 2002 prohibits controlling shareholders from interfering with management of the listed company and appointing directors and senior managers without approvals of the shareholders' general meeting. Resolution of election for directors passed by the shareholders' general meeting and resolution of appointment of directors passed by the board of directors will become effective despite of disapproval of controlling shareholders.[30] Furthermore, controlling shareholders should also isolate themselves from the listed company in terms of personnel, assets, business and financial affairs.[31] The purpose of this requirement is to prevent controlling shareholders from engaging in the same or similar business of the listed company and to avoid problems arising out of related party transactions. However, the absence of provisions regarding relieves that can be awarded where the controlling shareholders violate these rules in the Code 2002 seemingly weaken protection it provides.

Besides the two important documents foregoing, several other regulations issued by the CSRC are also dealing with particular problems in this field. For example, the Interim Regulations on the Administration of the Issuing and Trading of Stocks (1993) and the Implementation Rules on Information Disclosure by Companies Offering Public Stocks (1993) were issued to improve shareholders' access to company information. Also, the Provisional Measures on Prohibition of Securities Fraud (1993) was issued to target emerging securities fraudulent activities in the capital market. In collaboration with the CSRC, the Ministry of Finance issued the Accounting Standards for

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[30] *Code of Corporate Governance for Listed Companies* (2002), art. 20.

[31] Id. art. 21.

Disclosure of Related Parties and Affiliate Transactions (1997), which sought to enhance the transparency of transactions by disclosing relative information. Although these regulations have been repealed, many rules in these regulations have been incorporated into the Company Law (2006).

C. Judicial Interpretations

The SPC has been playing a key role in legal protection of interests of minority shareholders. On the one hand, the SPC can encourage individual shareholders to bring lawsuits against wrongdoers, but on the other it can also limit these lawsuits by issuing judicial interpretations. Because court should remain neutral and make its decision only based on facts and laws, it may be unusual to see a court encourages or discourages individual shareholders to initiate a lawsuit. However, the case hearing system in China is quite different from that of common law jurisdictions. Case filed with court will not necessarily be tried before the judicial panel since the case will be placed on docket by a designated court division before any panel hearing to decide whether it should be accepted or not. If the case meets all requirements and the division accepts, then based on the nature of the dispute, a civil division or criminal division or another division will hear the case. If the docket division decides not to accept the case, then the court will make a ruling on rejection of the case. If the plaintiff does not agree with the ruling, he/she may appeal it.[32]

According to the *Civil Procedure Law of People's Republic of China*, a Chinese court shall place the case on the docket within seven days if four requirements has been met: (i) The plaintiff must be a citizen, a legal person, or any other organization that has a direct interest in the case; (ii) there must be a definite defendant; (iii) there must be a specific claim or claims, facts, and a cause or causes for the suit; and (iv) the suit must be within the scope of acceptance for civil actions by the court and under the jurisdictions of the court where the suit is accepted.[33] Among these four requirements, the third requirement is the most complex and fraught since sometimes it is quite difficult for a plaintiff to demonstrate cause or causes of action in securities

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[32] *Civil Procedure Law of the People's Republic of China*, art. 112.

[33] Id. art. 108.

litigation. Therefore, the SPC circulated a notice stating that the high courts should not accept civil compensation cases arising from inside trading, security fraud and market manipulation because the causes of action in these types of cases could not be clearly demonstrated.[34] The SPC later explained that several factors were considered in making this decision. First, the absence of judicial consistency would get different results to plaintiff-investors with similar facts and causes of actions. Second, it was expected that the acceptance of civil compensations arising from security would encourage more cases and the caseload of courts might exceed reasonableness, especially given that the exploitation of shareholders in the capital market had been increasing. Third, professional knowledge and expertise of judges in securities area became a concern. At that time, the reality was that many judges were military retired officer during the military reform. They did not have professional legal experience to handle these cases. Fourth, the lack of a standardized rule of evidence was also an obstacle for the acceptance of civil compensation cases involving securities. Last, since a majority of listed companies were SOEs at that time, it was concerned that some small investors might strip state assets away by filing such a case.[35]

However, this notice provoked a debate about China's commitment to the rule of law and the role of the SPC in legal protection of shareholders' rights.[36] Many scholars and investors harshly criticized that the functioning of capital markets would be prejudiced by the refusal to accept civil compensation cases involving securities. Facing this intense pressure, the SPC changed its decision several months later by issuing another notice. The second notice provided that investors could assert claims against anyone for losses caused by false representation made by information disclosure in violation of law.[37] However, there was a prerequisite that had to be fulfilled

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[34] *Notice of the Supreme People's Court on Temporary Refusal to Accept the Civil Compensation Cases Involving Securities* (2001).

[35] News Report at http://finance.sina.com.cn/y/20011011/114918.html (accessed July 10, 2012)

[36] Jiangyu Wang, *Rule of Law and Rule of Officials: Shareholder Litigation and Anti-Dumping Investigation in China*, No. 4, Rule of Law in China Series Policy Brief (2008).

[37] *Notice of the Supreme People's Court on Issues Concerning Acceptance of Civil Compensation Arising from False Statement in Securities Market* (2002), art. 1.

before such a case being filed. A case must be investigated and penalized by the CSRC or its dispatched institutions before being accepted by a court and the investigation result should be used as basis by the investor in filing.[38] The provision actually means shareholders cannot initiate a lawsuit unless it has been investigated by the CSRC and the violator of the information disclosure obligations has been imposed punishments by an administrative decision or/and the criminal law. Although this provision was criticized for its limitations of access to justice, it is no doubt that the SPC did make some progress in protecting minority shareholders with it.

In January 2003, the SPC accelerated the progress by issuing the third judicial interpretation, i.e. *Certain Notice of the Supreme People's Court on Trial of Civil Compensation Cases Arising from False Statement in Securities Market*, which was regarded as the most comprehensive judicial interpretation on misrepresentation and a milestone in the evolution of shareholder rights in China.[39] This judicial document clarified several important concepts, including misrepresentation. Most importantly, it also specified a set of more detailed rules to direct investors filing proceedings against people who make false statements. It is the first judicial interpretation that provides the benefit of clear and concrete legal procedures to shareholders who bring securities litigation to courts. However, the prerequisite provided that no cases of this type should be brought to courts unless administrative sanctions have been decided and imposed. As Hutchens argues, this prerequisite transfers the "right to sue" from shareholders to the government and thus shareholders actually cannot enjoy any meaningful "private" litigation rights.[40] Nevertheless, despite its numerous defects, the provisions were undoubtedly a positive response to the concerns of the legal community and investors.[41]

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[38] Id. art. 2.

[39] Chen Lin, Clement Chun-Yau Shum & Sonia Man-Lai Wong, *The Emergence of Shareholder Protection in China*, in J. R. Barth et al. eds., *China's Emerging Financial Markets*, Springer Press (New York), at 593 (2007).

[40] Walter Hutchens, *Private Securities Litigation in China: Materials Disclosure about China's Legal System*, 24 Penn. J. Int. Eco. L. 599 (2003).

[41] For more details about defects of this judicial interpretation, see Xiao Cheng & Wen Yang, 最高人民法院<关于审理证券市场因虚假陈述引发的民事赔偿案件的若干规定>的几个欠缺 (Several Defects about the SPC Provisions Regarding the Adjudication of Civil Compensation Securities Cases Based upon Misrepresentation), (1) 判解研究 (Case Studies) 58 (2003).

Although restrictions on private litigation rights in securities cases is somehow inevitably due to limited judicial resources and ideological constraints, it is worth to emphasize that the three judicial interpretations issued within such a short period is an indication that the SPC is trying to support investors' rights to claim. It is expected that the SPC will become more positive in providing protection for investors, and the limitations on securities litigation will become relaxed.

III. GENERAL PROTECTION FOR MINORITY SHAREHOLDERS UNDER THE COMPANY LAW (2006)

Since the SPC changed its decision and started to embrace the significance of private securities litigation, acknowledge of insufficiency of legal protection for minority shareholders has been also increased. Along with the continuous issuance of regulations by the CSRC, the support has been growing for a revision of China's company law to strengthen minority shareholders' rights. Widely reported cases concerning exploitation of shareholders in the capital markets also pushed legislators to reform the Company Law. As a key legislation regulating commercial business and capital markets, it was recognized that the Company Law should not fall behind other regulations and interpretations in terms of protection for minority shareholders. Instead, the Company Law legislation should have been in a leading position in providing an investor-friendly environment. Based on this recognition and common view, the Company Law was revised in 2005. The revision was considered as the most comprehensive and significant reform in the legislative history of Chinese company laws. One of the distinctive characteristics of this revision was to meet with the increasing demands for rules that provide better protection for minority shareholders.

A. Improvements in Protection for Minority Shareholders

First of all, shareholders are given more rights to protect themselves and are encouraged to participate in management of company. For example, shareholders have the right to examine and view corporate documents such as the stubs of corporate bonds and the minutes of shareholders' general meetings.[42] Besides, directors and senior managers are subject to inquire by the shareholders during the shareholders' general meeting.[43] Furthermore, for the purpose to encourage shareholders to engage in management, the Company Law (2006) provides that in a limited liability company, shareholders representing 10% or more of the voting rights may convene and preside over the shareholders' meeting where the executives and the board of supervisors both fail to do so.[44] In a company limited by shares (i.e. stock company), shareholders who individually or jointly hold more than 3% of the shares of the company may also submit proposals to the shareholders' general meeting.[45] Additionally, shareholders representing more than one-tenth of the voting rights may propose to convene an interim meeting of the board of directors.[46] Last but not least, given the fact that the "one share one vote" doctrine may undermine the willingness of minority shareholders to exercise their rights in the company management, the Company Law (2006) for the first time allows shareholders in a limited liability company not to exercise their voting rights in proportion to their respective capital contributions where the articles of association provides another approach.[47] In a stock company, the cumulative voting system was introduced[48] for minority shareholders to have a louder voice in the election of directors and supervisors at the shareholders' general meeting.[49]

Where interests of minority shareholders get infringed, shareholders can be awarded more types of remedies under the Company Law (2006). First, individual shareholders may bring a derivative action against the wrongdoers for compensatory damages in the interests of the company.[50] Second, a

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[42] *Company Law of the People's Republic of China* (2006), art. 34, 98.

[43] Id. art. 151.

[44] Id. art. 41. For a company limited by shares, there is one additional requirement that shareholders have to hold more than 10% of the company's shares for 90 or more consecutive days. See fn. 11, art. 102.

[45] Id. art. 103.

[46] Id. art. 111.

[47] Id. art. 43.

[48] A precise explanation of the cumulative voting system is discussed in paragraph 4.2.1.2 in this paper.

[49] See fn. 42, art. 106

[50] Id. art. 152.

shareholder may request the company to buy his shares at a reasonable price under certain circumstances.[51] Third, when a company is facing serious difficulties confronted in its operation and management, and its continued existence may cause grievous losses and the difficulties cannot be surmounted by other channels, minority shareholders may file a case to dissolve the company.[52]

Due to the emerging "insider controls" problem and the increasing vertical agency cost, duties of loyalty and diligence are imposed upon directors and senior managers (including supervisors) under the Company Law (2006) while the Company Law (1993) only provided that directors should perform duties faithfully.[53] Article 148 of the Company law (2006) requires directors, supervisors and senior managers to assume the duties of loyalty and diligence to the company,[54] and they will be liable for any breach of duties that thus cause losses of the company or shareholders. For instance, directors are liable for resolutions of the board of directors. Where a resolution of the board violates laws, administrative regulations, or the company's articles of association and thus causes serious losses to the company, the directors who participate in adoption of such a resolution may be liable for compensation to the company.[55] Furthermore, the Company Law (2006) itemized several activities that directors and senior managers should not commit, such as misappropriating the company's funds. All earnings derived by a violation of these rules must be returned to the company.[56]

Emphasis on functions of the supervisory board in a company is another approach resorted to in the Company Law (2006) to constrain directors and senior managers. Supervisory board was being criticized for its inability to perform tasks of holding directors to account, and for its excessive dependence to exercise its monitoring function.[57] The first argument is that the Company Law (1993) did not confer sufficient power to the supervisory board to

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[51] Id. art. 75.

[52] Id. art. 183.

[53] Id. art. 59 (1); fn. 11, art. 123

[54] Id. art. 148.

[55] Id. art. 113.

[56] Id. art. 149.

[57] Li, fn. 8 at 262.

supervise internal management, correct managerial misconducts and discipline wrongdoers. The second argument is that supervisors were not independent enough to exercise their rights. Supervisors elected by shareholders were normally controlled by the majority shareholders and supervisors elected by employees were reluctant to challenge the directors and senior managers in fear of discharges. The Company Law (2006) responds to these criticizing options by conferring more powers and functions to the supervisory board, including the powers to remove directors and senior managers who violate laws, administrative regulations or the articles of association of the company, or the resolutions adopted by the shareholders' meetings.[58] The supervisory board even may take legal proceedings against the directors or senior managers under certain circumstances.[59] Besides the additional supervisory board's functions, independent directors' system is also adopted to reduce vertical agency costs of companies. However, the Company Law (2006) does not provide specific rules regarding responsibilities of independent directors in corporate governance. Instead, it simply states that a listed company should have independent directors and specific measures in this regard will be formulated by the State Council.[60]

The prevalence of horizontal agency costs between controlling shareholders and minority shareholders is also noticed. As a result, certain duties are imposed on the controlling shareholders and *de facto* controllers of a company under the Company Law (2006) to prevent them from taking advantages from the company.[61] Article 21 states that controlling shareholders or *de facto*

[58] See fn. 42, art. 54 (2), 119.

[59] Id. art. 54 (6), 119.

[60] Id. art. 123.

[61] The definition of controlling shareholders and *de facto* controllers are clearly stated in article 217 of the Company Law (2006). A controlling shareholder refers to a shareholder whose capital contribution accounts for more than 50% or of the total capital of a limited liability company, or a shareholder who holds accounts for more than 50% of the total amount of shares in a stock company, or a shareholder, although the amount of his capital contribution or the proportion of the shares he holds is less than 50%, whose voting right enjoyed on the basis of the amount of capital contribution made or the number of shares held are enough to have a vital bearing on the resolutions of a shareholders' meeting or a shareholders' general meeting. A *de facto* controller means a person who is able practically to govern the behavior of a company through investment relations, agreements or other arrangements, although the person is not a shareholder of the company.

controllers of a company should not take advantage of their affiliated relations to damage the interests of the company. A person who violate this rule and causes losses of the company should be liable for compensation.[62] The new Guidelines for the Articles of Association of Listed Companies which have been revised in accordance with the Company Law (2006) and the Securities Law goes further. The Guidelines provide that controlling shareholders and *de facto* controllers of the company owe duties to act *bona fide* to the company and other shareholders. Controlling shareholders should not impair legal rights of the company and other shareholders by profits distribution, assets reorganization, external investments, appropriation of funds, borrowing and loan guarantee, nor should use their controlling status to damage the interests of the company and individual shareholders.[63] It is expected that these legal duties will effectively reduce horizontal agency costs of corporate governance.

B. Deficiencies of the Protection

Notwithstanding protection for minority shareholders have been improved significantly and substantially by the Company Law (2006), these mechanisms do have some drawbacks and some of them even do not have sufficient and effective implementing details. This part will explore defects of the general protection and demonstrates why the derivative action is necessary in China.

1. Rights Conferred on Shareholders. — (1) Right to know. It can be presumed that shareholders can scarcely protect their rights and interests information about the company in which they invests. Therefore, "right to know" is a fundamental and extremely important right which is restated and improved under the Company Law (2006). Article 34 states that shareholders have the right to consult the articles of association, the minutes of the shareholders' meetings, the resolutions of the board of directors and the board of supervisors, and the financial and accounting reports of the company. However, if a shareholder requests to consult accounting books of the company, he will need to submit a written request with an explanation of his purpose. The request may be refused by the company in a written reply where

[62] See fn. 42, art. 21.

[63] *Guidelines for the Articles of Association of Listed Companies* (2006), art. 39.

the company reasonably deems that the request is for an illegitimate purpose that may damage the lawful interests of the company. Shareholders with the refusal from the company can request the court to demand the company to provide such information.[64]

There are no doubts that the right to know provides fundamental protection for minority shareholders by furnishing information such as whether interests of the company, especially interests of minority shareholders, have been damaged. However, in order to prevent abuse of this right, the company can refuse the request on reasonable ground to believe that the subjective purpose behind the request is illegitimate or may harm the interests of the company. Whilst it might seem that this provision strikes the balance between protection of minority shareholders and trade secrets of the company, several problems have been unfolded. The first seemingly obvious issue is who can enjoy the right to know. According to the legislation, the answer should be very straightforward, i.e. the shareholders. However, the next question would be whether former shareholders, dormant partners and shareholders have defective capital subscription should also enjoy the right. Although it is extensively recognized in the legal profession that former shareholders can also exercise the right to know,[65] companies or the courts are very likely to refuse their requests if strictly interpreting the law. The second issue is that there is no prerequisite for shareholders to exercise this right in either a limited liability company or a stock company.[66] In a limited liability company, due to its private nature, it is certain that every shareholder can exercise the right to know and consult the company documents. However, in a stock company, the rules should be adjusted due to its different nature. Because stock companies are companies that offering shares to the public, they should be kept under strict supervisions than a private company, and therefore, the rules applied to it should not be identical. Since shares of a stock company can be purchased by anyone on stock exchange markets, person with malicious purpose can easily become a shareholder holding a small amount of shares and request to consult information of the company, which may damage interests of the company. Although the company can

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[64] See fn. 42, art. 34.

[65] Junhai Liu, 现代公司法 (Modern Corporation Law), Law Press (Beijing), at 242 (2008).

[66] Generally, a limited liability company is a private company and a stock company is comparable to a public company.

refuse his request with reasonable ground that may harm the interests of the company, it is unrealistic for the company to discover the true motivation of each request and to screen background of each applicant. Hence, certain restrictions should be placed. For instance, shareholders of a stock company cannot enjoy the right know without holding a certain percent shares of the company.

Another concerned issue is how to evaluate the existence of an "illegitimate purpose." Given that the company can refuse to meet the request on ground of illegitimate purpose, it is essential to give a clear definition of such a purpose. However, such a definition is absent from the current company law. Additionally, it is ambiguous that who should bear the burden of proof. Article 34 provides clearly the company should state reasons why the request is refused. However, it remains unclear that whether it is the shareholder who should show the reasonableness of the request. Another question up in the air is whether the shareholders can consult the original accounting books, such as the company's invoices. It is argued that shareholders do not have right to examine the original accounting books and reports because the Company Law does not states so. However, it is too difficult for shareholders to inspect the accuracy of accounting books without comparing to original records. Therefore, it should be clarified in the future revisions.

Furthermore, some scholars suggested that even the foregoing issues do not affect the right of companies and minority shareholders, it is questionable that the right to know will be a practical tool for minority shareholders due to their lack of professional knowledge.[67] A company can simply refuse or ignore a request on the ground that the applicant-shareholder does not have any accounting background. This concern was revealed in *Long Jinwen v. Zhonghua Accountant Firm* (ZAF).[68] Facing such an allegation, the shareholder

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[67] Rui Jiang, 浅谈股东知情权 (On Shareholders' Right to the Knowledge of Company's Management), (4) 商业经济 (Commercial Economy), at 123–24 (2007).

[68] In this case, Long purchased 1,000 shares from Jinlun Company after impressed by the annual report audited by ZAF. However, he later discovered that there were eight mistakes in the annual report, which would cause him severe losses instead of making any profits based on his earlier evaluation. Therefore, Long submitted a request to consult more extensive information and filed a claim against Jinlun for compensation. His request was refused by Jinlun since Long did have accounting knowledge, and thus was incapable to review its annual report. Although Long finally won the case in the court, the potential problem that a company may ignore a shareholder's request to consult information about the company by alleging the shareholder lacks of the accounting knowledge, was revealed.

may lose courage and doubt whether his argument will be supported by evidence.

Last but not least, even though shareholders do not come across any difficulty in consulting accounting reports of the company, information provided may be inaccurate and misleading since accountant firms may be in concert with the company to produce false documents and reports to keep some important clients. It is not uncommon in China as many listed companies were reported requiring accounting firms to forge documents to mislead their investors.[69] Hence, it is unlikely for the shareholders to discover about the true information of the company while the effectiveness of this right to constrain directors and senior managers will also be offset. As Cheng argues, the strongest weapon for a minority shareholder to protect himself is to sue wrongdoers if the company collaborates with the accountant firm to deceive investors.[70]

(2) Cumulative voting system. One of the strongest protections for minority shareholders is the right to participate in management of the company by electing directors and supervisors. Under the traditional "one-share, one-vote" doctrine,[71] majority shareholders can definitely control the company by electing their favorite directors and it is highly unlikely for minority shareholders to elect their directors because they represent minor shares of the company. However, the situation might be changed after the system of cumulative voting introduced to the current company law.[72] This

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[69] A typical case is *Kelong Dianqi Ltd.* (Kelong), at http://biz.cn.yahoo.com/t/kltop.html (last visited Jul. 10, 2012).

[70] Wei-qi Cheng, *Protection of Minority Shareholders after the New Company Law: 26 Case Studies*, 52(4) Int. J. L. Mana. 283, 308 (2010).

[71] The "one share, one vote" doctrine is still the general principle under the Company Law 2006. Article 43 states that shareholders shall exercise their voting rights at the shareholders' meetings in proportion to their respective capital contributions, except where provided for by the company's articles of association. Article 44 further explains, "in addition to what is provided for in this law, the modes and voting procedures of the shareholders' meetings shall be stipulated by the company's articles of association."

[72] Article 106 of the Company Law (2006) states, "for election of directors or supervisors by the shareholders' general meeting, the system of cumulative voting may be practiced in accordance with the provisions of the company's articles of association or the resolution adopted by the shareholders' general meeting. For purpose of this law, the system of cumulative voting means that for election of the directors or supervisors by the shareholders' general meeting, the number of voting rights allocated to each share is equal to the number of directors or supervisors to be elected and such voting rights held by the shareholders may be pooled."

system will give all shareholders opportunity to have a voice in corporate governance and protect their interests to some extent. It is widely accepted that this voting system has several advantages. It encourages minority shareholders to participate in management of the company and contribute their perspectives to maximize the company's interests.[73] It is a true reflection of the inherent concept of "check and balance" in corporate governance to prevent directors from abusing powers.[74] It can reduce interests of conflict and moral risks and minimize the risk of investments.[75] In a word, the system of cumulative voting can effectively protect minority shareholders and improve the structure of corporate governance.

Although the adoption of cumulative voting system received a warm welcome, some doubts have been raised about the design of this rule and its functions. First of all, this voting system is not mandatory and it is ultimately decided by the company's articles of association. In another word, shareholders that come in after the company is incorporated will not be able to use this voting system if it is not stipulated in the company's articles of association. Although it is true that the articles of association can provide the system of cumulative voting by a later amendment, it will be impractical to be achieved since the requirements for an amendment of the articles of association are much higher and minority shareholders alone can hardly meet requirements.[76] Second, success of this system depends on the agreements between minority shareholders. The cumulative voting system requires minority shareholders to vote unanimously. However, it is hard to ask minority shareholders to align with each other and vote for the same directors or supervisors, especially in a stock company where minority shareholders normally have diverse interests. Third, minority shareholders may be reluctant to vote and elect their directors because they may believe that their votes are of little influence under the special ownership structure in China. As

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[73] Liu, fn. 65 at 284.

[74] Junwu Wang, 我国股份有限公司累计投票制度法律理论与实务问题研究 (Study on the Legal Theory and Practical Problems on the Cumulative Voting System in China), 27(5) 贵州大学学报 (Journal of Guizhou University) 30, 34 (2009).

[75] Liu, fn. 65 at 244.

[76] According to article 44 of the Company Law (2006), resolution made at a shareholders' meeting on amendment to the company's articles of association shall be subject to the adoption of shareholders representing 2/3 or more of the voting rights.

is well known, China is one of the few countries with many SOEs. Therefore, many listed companies are solely or patricianly controlled by the government. Additionally, many institutional investors prefer to hold shares of these SOEs because of their economic privileges. Hence, even in a case where minority shareholders vote for the same director or supervisor, it is highly likely that their efforts turn to be in vain. The directors who are preferred by minority shareholders and successfully get elected are still subject to the removal by the controlling shareholders through legitimate reduction of directors or other legal channels. In practice, there is evidence to show that shareholders' general meeting is often simply a "rubber stamp" for the controlling shareholders' wishes in China and thus the attendance and voting level of minority shareholders are considerably low.[77] As a result, the cumulative voting system cannot be expected to be a practical means of monitoring management of a company.

(3) Restriction and proxy voting system. In terms of the voting rights, there are some other systems under the Company Law (2006) that provide protection for minority shareholders besides the cumulative voting system. The current company law provides two more instruments to improve corporate governance of companies. The first one is a restriction of shareholders' voting rights in matter that they are involved and subject to a resolution adopted by the shareholders' meetings.[78] The other is the proxy voting system, which creates a friendly environment for shareholders to participate in management of the company.[79] The restriction on voting

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[77] Jinzhu Yang, *Shareholder Meetings and Voting Rights in China: Some Empirical Evidence*, 18(1) Int'l Co. & Com. L. Rev. 4–16 (2007).

[78] Article 16 of the Company Law (2006) states that where a company intends to invest in other entities, the matter shall, in accordance with the provisions of the company's articles of association, be subject to a resolution adopted by the board of directors or the shareholders' meeting or the shareholders' general meeting; and where norms for the gross amount of investments or guarantees and for the amount of a single investment or guarantee are specified in the company's articles of association, such norm should not be exceeded. Where a company intends to provide a guarantee for its shareholders or its actual controller, the matter shall be subject to a resolution adopted by its shareholders' meeting or the shareholders' general meeting.

[79] Article 107 of the Company Law (2006) states, a shareholder may entrust a proxy to attend a shareholders' general meeting. The proxy shall present the shareholder's power of attorney to the company, and shall exercise the voting rights within the scope of authorization.

precluding shareholders from voting for matters they involved, which is designed to resolve conflicts of interests between the company and its controlling shareholders, and the company's interests should be prioritized when such conflict occurs. It is argued that the best protection for interests of minority shareholders is to restrict or invalidate voting rights of the controlling shareholders.[80] Indeed, if the majority shareholders can vote without any restriction, the interests of minority shareholders or even the company will be under potential expropriation, according to the fundamental presumption of rational-economic man (*homo economicus*). The presumption reveals that any person who is rational will act in a self-interested way to maximize his own benefits. This presumption justifies the introduction of the voting restriction and it has been relied upon in the revision of Chinese company law.

Another reform of voting rights that aims to protect minority shareholders is the proxy voting system. Along with the exponential development of capital markets in China, investments are getting more diversified. As a result, shareholders may need to put additional time to learn about and follow up each company he invests in and personally attend each general meeting of shareholders to exercise his voting rights. Ideally, shareholders should be able to do so and his interests would be protected adequately, but in the real business, it is very impractical. This is one of the reasons why the system of proxy voting was designed and adopted under Chinese company law. Second, according to the Company Law or company's articles of association, some resolutions have to be adopted by a certain number of attending shareholders or percentage of representing voting rights to become effective.[81] This means some of the resolutions cannot be made without adequate number of attending shareholders, where proxy may be an efficient solution to the problem. Last but not least, proxy voting provides a platform for every shareholder to express himself and to vote when he cannot personally attend

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[80] Meihuan He, 公众公司及其股权证券 (Public Company and Equity Securities), Peking University Press (Beijing), at 828 (1999).

[81] For example, article 44 stipulates that "resolutions made at the shareholders' meeting on the increase or reduction of the registered capital, or on the merger, division, dissolution, or transformation of the company shall be subject to adoption by the shareholders representing 2/3 or more of the voting rights.

the shareholders' general meetings.[82]

Meanwhile, there are some arguments over effectiveness of these two methods under current company law. Three issues have been brought up regarding the voting restriction. First, the scope of application of the restrictions is too narrow. The Company Law (2006) suspends a shareholder's voting rights only where the company intends to provide a guarantee to him.[83] Other related-party transactions are not mentioned under the current law. Therefore, it is obvious that the scope of applicable transactions is extremely narrow, which needs to be extended. The second issue is the definition of voting restriction is ambiguous. Under the current company law, only the shareholders dominated by the actual controller are subject to the restriction. However, it remains unclear if these mentioned shareholders should be excluded from voting when they represent other shareholders as well. Additionally, it is ambiguous whether the proxy should be subject to the voting restriction if he is a related party to the voting matters while his principal-shareholder is not. Another loophole is the legal consequences of the violation of this rule need improvements. The law should identify the means that can be resorted to by minority shareholders to protect their rights where the voting restriction is not being followed. The law stipulates that shareholders can take a legal proceeding to the court and request rescission of a violating resolution where the resolution in its content or its voting formula is against laws, administrative regulations or the articles of association of the company.[84] Apparently, the law provides that shareholders can request the court to rescind the resolution, but it is unclear whether shareholders related

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[82] Xinsheng Wang, 论股东表决权代理征集制度 (Study on Chinese Proxy Voting System), (9) 法制与社会 (Legal System and Society) 130–32 (2008).

[83] See fn. 42, art. 16.

[84] Article 22 of the Company Law (2006) states that the resolution adopted by the shareholders' meeting or shareholders' general meeting or the board of directors of a company, which in content violates laws or administrative regulations, shall be invalid. Where the procedure for convening the shareholders' meetings, or the shareholders' general meeting, or board of directors, or the voting formulas are against laws, administrative regulations or the articles of association of a company, or the content of the resolution adopted is against the company's articles of association, the shareholders may, within sixty (60) days from the date that the resolution is adopted, request the court to rescind the resolution. Where shareholders take legal proceedings in accordance with the provisions of the preceding paragraph, the court may, upon request of the company, demand the shareholders to provide appropriate guarantees.

to the voting matters are still qualified to be plaintiffs. Further, it is argued that legal consequences of violation here is not reasonably severe, which may result in insufficient deterrence.[85] As to the system of proxy voting, the company law only spares one basic provision providing a shareholder may entrust a proxy to attend a shareholders' general meeting without any detailed implementing rules.[86] Second, it can be hard for a shareholder to find a reliable proxy, especially when the shareholder lives far away from the headquarter of the company. Third, there is no specific restriction imposed on the proxy's exercising of the voting rights under the law. Under the theory of agency, the agent should act for the interests of and instructions from his principal. Therefore, under the Company Law, some mechanism should be provided to make sure the proxy would vote based upon the true intents of his principal. Nevertheless, the law does not contain such provisions and therefore several questions are still up in air. For instance, is it necessary for the principal-shareholder to state clearly in the power of attorney whether he would vote for or against a certain resolution? What if the proxy votes against the true intents of his principal-shareholder? These questions need to be answered eventually to provide more effective protection to minority shareholders.

(4) Derivative actions.[87] After intense discussion, derivative action was first introduced to China, which pleased many scholars. Krause and Qin described this introduction as a milestone in Chinese company law reform.[88] Frinerman and Guo shared the same point of view, commenting that the adoption of derivative action will significantly improve company law, and predicting that it will contribute to good corporate governance.[89] There is no

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[85] Jinhua Song & Zhonglin Xu, 论我国股东表决权排除制度的完善——从中小股东利益保护的角度 (Improvement of Voting Restrictions in China — A Perspective from the Protection of Minority Shareholders), 519(10) 商场现代化 (Market Modernization) 279–80 (2007).

[86] See fn. 42, art. 107.

[87] For further details of derivative actions in China, see Shaowei Lin, *Derivative Actions in China: One Step Forward, Two Steps Back*, 23(6) Int'l Co. & Com. L. Rev. 197–205 (2012).

[88] Nils Krause & Chuan Qin, *An Overview of China's New Company Law*, 28(10) The Co. L. 316 (2007).

[89] James V. Feinerman, *New Hope for Corporate Governance in China?*, 191 The China Q. 590–612 (2007); Craig Anderson & Bingna Guo, *Corporate Governance under the New Company Law (Part 2): Shareholder Lawsuits and Enforcement*, 20(4) China L. & Prac. 15–22 (2006).

doubt that this adoption is a huge step in further protection of minority shareholders and also reflects that legislators would like to strike a balance of rights and interests between the controlling shareholders and minority shareholders. It is expected that this legal framework will not only constrain the speculative conducts of managers, but also improve the corporate governance structure and maintain an investor-friendly legal environment.[90] To that extent, the introduction of derivative action made significant progress of Chinese company law. However, like other Chinese laws, this new statutory procedure that was transplanted from other countries is a mixture of different jurisdictions, which has many drawbacks under a rigorous examine.

First of all, it is argued that requirements of standing for shareholders to bring derivative actions are too high, especially when it requires the shareholders holding at least 1% of the company's shares. It is highly unlikely for a shareholder alone to meet the requirements and bring a litigation considering most minority shareholders hold far less shares and 1% may equal to CNY 0.3 million, which is still a huge amount for many Chinese investors.[91] Additionally, the threshold of duration of shareholding for at least 180 consecutive days is also a hurdle precluding minority shareholders from commencing a derivative action. These requirements are made to prevent investors from purchasing shares with malicious intent to bring lawsuits. Nevertheless, this requirement seems to be an obstacle for individual shareholders since their average shareholding period is shorter than 180 days.[92]

Second, according to Article 152, the shareholders of a company should request, in writing, either the board of directors or the board of supervisors to bring a lawsuit to the court. Where the board of supervisors or the board of directors refuses to take legal proceedings, or fails to take legal proceedings within 30 days from the date it receives such a request, the shareholders can have the right to bring a derivative action to the court. However, this rule still needs further improvements due to several loopholes. First, the content of the

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[90] Rui Dai, *Analysis on Several Problems of the Shareholder's Derivative Suit*, 21(2) 长春理工大学学报·社会科学版 [Journal of Changchun University of Science and Technology (Social Sciences Edition)] 60–63 (2008).

[91] Fidy Xiangxing Hong and S.H. Goo, *Derivative Actions in China: Problems and Prospects*, (4) China Bus. L. J. 376–395 (2009).

[92] Fang Ma, *The Deficiencies of Derivative Actions in China*, 31(5) The Co. L. (2010).

written request is not specified in the current provision. In the United States, detailed information, such as the factual basis for the claim and the damage caused to the company, should be described in the shareholders' written request which is very important for the company to make the decision.[93]

Third, it is argued that the 30-day response time is not reasonable because the company may need more time to consider the request, especially where the claims are complex. Although it is difficult to specify a fixed period of time for accommodating every case, it is proposed that the court should have discretions to extend the respond time upon request of the board of directors or the board of supervisors of the company. Third, it remains unclear that when the alleged wrongdoer is a third party, to whom the shareholders should make their request. This remaining issue should be clarified in the future judicial interpretation with a specific rule states that such a request should be made to the board of directors considering the key role it plays in the company.

2. Measures to Constrain Directors and Shareholders. — (1) The supervisory board ("SB"). It was adopted in the early version of Chinese Company Law to supervise the internal management of companies, however, it was regarded as a complete failure due to its dysfunction in practice. The revised company law acknowledged the problem and under the new law, SB may exercise more rights, including: (i) to put forward proposals for removal of the directors or senior managers who violates laws, the company's article of association, or the resolutions adopted by the shareholders' meeting; (ii) to propose, convene and preside over shareholders' interim meeting as provided for by the law when the board of directors fails to perform the duty of convening; (iii) to put for the motions at the shareholders' meeting; and (iv) to take legal proceedings against directors and senior managers.[94]

Although SB was given more rights to strengthen its supervising function, its inefficiency is still criticized on several grounds.

First, SB's rights are still not strong enough for it to play the role under the Company Law. SB system was transplanted from Germany with

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[93] *Federal Rules of Civil Procedure*, Rule 23.1.

[94] Article 54 of Company Law (2006) states that the board of supervisors shall exercise the following functions and powers: (i) to examine the financial affairs of the company; (ii) to demand directors or senior mangers rectify when their acts damage the interests of the company; and (iii) to convene and preside over interim shareholders' meetings.

fundamental alterations. In Germany, a SB enjoys much stronger powers, including appointing and removing directors. Additionally, important business decisions are subject to advice or/and consent of the SB.[95] However, SBs in China have no right to appoint or remove directors, nor the authority to control the process of business decision-making in the company. Absence of the right and power will inevitably impair a SB's deterrence and make it impossible for a SB to act as a supervisory organ.

Second, the composition of the SB further undermines its function. According to the Company Law (2006), a SB should be composed by three types of supervisors: (i) representatives of the shareholders, (ii) representatives of the staff and workers of the company, and (iii) the external supervisors.[96] It seems such a composition of supervisors will ensure the independence of a SB to supervise the directors, however, the evidence shows to the contrary. Supervisors who are democratically elected by the shareholders normally only represent the preference of the controlling shareholders instead of the minority shareholders. The practical research conducted by Xu and Wang confirmed that among all Chinese listed companies' supervisors that examined in their research, very few of them were representing individual shareholders.[97] Leaders of the dysfunctional labor union are always also the supervisors representing employees.[98] In fear of being fired by the directors, these types

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[95] According to the German Stock Corporation Act, the supervisory board is responsible for appointing and dismissing members of the management board (§84(1)) and representing the corporation in its dealings with such board (§90), including entering into employment agreements with its members (§112). The management board reports to the supervisory board, though the latter is independently entitled to inspect the books, records and properties of the corporation (§111(2)). The supervisory board must consent to certain business decisions of the management board if required by the articles or the supervisory board's rules. The supervisory board may not, however, encumber the management board's ability to manage the corporation with excessive consent requirements. If the supervisory board withholds consent, the management board may nevertheless act if it can obtain a three quarters majority of votes cast at the shareholders meeting. (§111(4)). See Jiangyu Wang, *The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies*, (3) Compliance & Regulatory J. 47–55 (2007).

[96] See fn. 42, art. 52.

[97] X. N. Xu & Y. Wang, *Ownership Structure, Corporate Governance, and Corporate Performance: The Case of Chinese Stock Companies*, Policy Research Working Paper (No. 1794), World Bank (1997).

[98] S. Tenev & C. Zhang (with Loup Brefort), *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets*, World Bank and the International Finance Corporation, Washington D.C. (2002).

of supervisors are little more than puppets of the directors or senior managers and are extremely reluctant to challenge the directors. The external supervisors are expected to be more efficient in exercising their powers and rights since they have fewer conflicts of interests within the company. Indeed, Tam and Hu discovered that performance of external supervisors are more effective than internal supervisors, although generally the latter actually dominant the SB.[99] However, some research shows that many external supervisors are close friends or acquaintances of the senior managers, which significantly limits their role in supervising the board of directors and senior managers.[100] Besides the forgoing arguments, two more factors may also affect the independence of the SB. The first is that the remuneration of the supervisors is decided by the executives of the company. The second is the level of education of the supervisors. Research on education backgrounds among supervisors in companies listed in Shanghai Stock Exchange reveals that the average level of professional knowledge of supervisors is lower than that of the directors.[101]

Overall, it is commonly accepted that the SB is unlikely to be effective in supervising the board of directors and the senior managers. A senior official from the CSRC even candidly admitted that the system of supervisory board failed to provide checks and balances into the managements of companies.[102]

(2) Independent directors. By acknowledging the ineffectiveness of the

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[99] O. K. Tam & H. W. Hu, *Supervisory Boards in Chinese Corporate Governance*, in L. S. Ho & R. Ash eds., *China, Hong Kong and the World Economy: A Study of Globalization*, Macmillan Press (London), at 327–47 (2006).

[100] J. Dahya et al., *The Usefulness of the Supervisory Board Report in China*, 11(4) Corporate Governance 308, 321 (2003).

[101] Shanghai Stock Exchange Research Center (SSE), 中国公司治理报告 (Report of Chinese Corporate Governance), Fudan University Press (Shanghai), at 160 (2003).

[102] Laura M. Cha, the former Vice Chairman of the China Securities Regulatory Commission, said in a speech she gave at the China Business Summit, “It is sometimes argued that the supervisory boards should enjoy more rights and powers to sit on top of the boards of our listed companies. However, experience shows that this system is not effective because it is often unclear whose interest the supervisory board should represent. In many cases, the supervisory boards duplicate the authority of the board without corresponding responsibilities. In fact, the existence of supervisory boards may create an illusion that there are certain checks and balance in the listed company, while in fact, there is none. www.csrc.gov.cn/en/jsp/detail.jsp?infoid=1061948105100&type=CMS.STD (last visited Jul. 10, 2012)

supervisory boards that supervise the acts of the directors and senior managers, independent director system was learned from common law jurisdictions, particularly from the U.S. law, to improve the corporate governance and protect the interests of individual shareholders. The system was first introduced by the Guiding Opinions on the Establishment of Independent Director System in Listed Companies in 2001[103] and later confirmed by the Company Law in 2006 stating that a listed company should have independent directors and the specific measures in this regard should be formulated by the State Council.[104] The detailed rules are known as the Independent Director Guidelines.

The independent director system was designed to supplement the supervising function of the SB and was expected to be more effective than the SB in providing checks and balances into the management of listed companied. However, research indicates that the effects of this system on the corporate governance are disappointing. Ma and Gao conducted empirical research on effectiveness of the independent director system selected by the listed companies on Shanghai Stock Exchange from 2006 to 2008. Their research discovered that independent directors were having very limited effects on constraining the majority shareholders.[105]

Although this research may not necessarily tell the whole story, there is no doubt that to date, the independent director system has not been performed as effective as expected. The outcome may be explained by several reasons as follows.

First of all, it is argued that independent directors are reluctant to challenge decisions made by the board of directors or senior managers.[106] In a survey

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[103] *The Guiding Opinions on the Establishing Independent Director System in Listed Companies* (关于在上市公司建立独立董事制度的指导意见) was issued by the CSRC on Aug. 16, 2001 and revised on Dec. 22, 2006.

[104] See fn. 42, art. 123.

[105] Lianfu Ma & Nan Gao, 股权结构、境外背景独立董事与公司绩效——来自沪市上市公司的证据 (Ownership Structure, Independent Directors with Overseas Background and Corporate Performance — Evidence from Listed Companies in Shanghai Stock Exchange), 33(9) 山西财经大学学报 (Journal of Shanxi Finance and Economics University) 74, 82 (2011).

[106] Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 Del. J. Corp. L. 125, 228 (2006).

conducted by *China Securities Daily*, sixty-five percent of the independent directors admitted they never raised a challenge when attending meetings of the board of directors and all of them did, at least "occasionally," vote for a proposal where they were not based on its content.[107] This problem was brought up by various reasons. First, the independent director's remuneration is not competitive and thus the economic motivation for them to exercise their rights is not strong enough.[108] However, even independent directors can receive much higher annual compensation may lose their independence if their remuneration is decided by senior managers or controlling shareholders. Second, the supervising function of independent directors may be further undermined by the traditional Chinese business culture of *guanxi* (relationship). *Guanxi* means a person would like to compromise his interests to show respect to others, particularly to his friends. In this sense, independent directors would be reluctant to offend their friends, e.g. the CEO or senior managers of the company, even when the latter have committed some misconducts to the company.[109] Third, the absence of legal liability also contributes to the ineffectiveness of this system. The Guidelines did not specify any legal consequences that independent directors may bear if they fail to perform their duties, with one exception that if an independent director fails to attend in person three consecutive meetings of the board of directors, he may be replaced upon request of the board of directors.[110] Without actual legal consequences, independent directors will act little more than "ornamental vases" and it will be hard to encourage them to fulfill their duties.[111]

Limitation to access of company information is another obstacle for independent directors. According to the Independent Director Guidelines, a

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[107] 中国独董调查及制度反思 (Survey and Reflections on China's Independent Directors), 中国证券报 (China Securities Journal), Jul. 28, 2005.

[108] A recent empirical research based on annual reports from 81 listed companies in 2002 reveals that an independent director's average annual remuneration is less than CNY 30,000.

[109] Chaobin Xie, 独立董事法律制度研究 (A Study of the Independent Director System), Law Press (Beijing), at 320 (2002)

[110] *Guiding Opinions on the Establishing Independent Director System in Listed Companies*, art. IV (5).

[111] Sibao Shen & Jing Jia, *Will the Independent Director Institution Work in China?*, 27 Loy. L.A. Int'l & Comp. L. Rev. 223, 248 (2004).

listed company should provide sufficient materials and working conditions to independent directors.[112] Furthermore, when an independent director exercises his powers, the relevant personnel of the listed company should actively co-operate with him, and may not refuse to do so.[113] However, to exercise these rights mainly relies on the management of the company. In other words, executive directors or senior managers control the access to corporate information and limit independent directors to get access to relevant information. A survey regarding this issue demonstrates by that ninety percent of independent directors, to a great extent, have to reply upon the management of the company to get necessary information. The key point here is that the rights to knowledge of independent directors are almost unenforceable since there are no provisions providing legal consequences where the management of the listed company fails to provide such information. As a result of the absence of legal enforcement, it can be imagined that the effectiveness of independent director system in supervising the controlling shareholders and the senior management is diminished.

(3) Duties of the directors. The Company Law (2006) firstly provides that directors assume the duties of loyalty and diligence to the company and it also itemized that the following conducts should be committed:

(i) misappropriating the funds of the company;

(ii) opening an account in his/her own name or in the name of another person to deposit the funds of the company;

(iii) in violation of the stipulations of the company's articles of association or without the consent of the shareholder's meeting or general meeting, loaning the funds of the company to another person or using the property of the company to provide guarantee for another person;

(iv) in violation of the stipulations of the company's articles of association or without the consent of the shareholders' meeting or general meeting, entering into a contract or conducting transactions with the company;

(v) without consent of the shareholders' meeting or general meeting, taking advantage of his position to seek commercial opportunities, which

[112] See fn. 110, art. VII (2).

[113] Id. art. VII (3).

belong to the company, for himself or for another person, or operating for himself or for another person the same kind of business as that of the company where he is holding a post; (vi) taking into his own possession the commissions from transactions conducted by another person with the company;

(vii) disclosing secrets of the company without authorization; or

(viii) other acts committed in violation of the duty of loyalty to the company.[114]

It is also provided that all earnings derived by the director or senior managers in violation of the preceding paragraph should be returned to the company. It was expected that these duties of directors and senior managers would ensure them to act in compliance with the duties for the interests of the company, and would prevent them from pursuing their own benefits. However, a couple of problems have emerged in the meantime.

First of all, the scope of directors' duties is narrow. It is recognized that the duty of loyalty in China is similar to the fiduciary duty in the United Kingdom since both mainly aim to eliminate the potential conflicts of interests. However, the ambit of the fiduciary duties of directors in the UK is much wider. Three types of duties under UK law are absent from Chinese law. The first type is that directors must exercise their power within the scope of authorization. The second is the good faith requirement, which requires directors to act in good faith for the commercial success of the company. The last is that the directors should use independent judgment during exercising their powers and right.[115] Among these three types of duty, the good faith requirement is regarded as the important tool for preventing management misconducts. Therefore, it is argued that the scope of directors' duties in China should be extended and the good faith requirement should be adopted. One reason is that the duty of loyalty and diligence cannot prevent all types of misconducts that may be committed by the management, and thus the good faith requirement will be a necessary complement based on the research conducted by Eisenberg. The research reveals that the good faith

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[114] See fn. 42, art. 149.

[115] Paul Davies, *Principles of Modern Company Law* (8th Edition), Sweet & Maxwell (London), at 497 (2008).

requirement would cover most of the cases in which the duty of loyalty is inapplicable.[116]

Another defect is that the application standard of the duty of diligence (as known as duty of care) is absent. The Company Law (2006) provides that where a director or senior manager violates the duty of diligence, and thus causes losses to the company, should be liable for compensation.[117] However, the situations of violation of the duty of diligence are not mentioned under the Company Law. As a result, it is difficult for individual shareholders to prove that the director has violated his duty of diligence, and it is also difficult for the directors since there are no clear rules to comply with. The reason for the absence of unambiguousness here may be that the business judgment rule was not adopted when the duty of diligence was transplanted from US law. Therefore, it is argued that duty of diligence cannot be a useful weapon for the shareholders without the business judgment rule.

Finally, shareholders can only bring a derivative action to the court against a director who fails to perform his duties and causes losses to the company. Under the Company Law, shareholders cannot bring lawsuits against the wrongdoers unless the board of directors or supervisors fails or refuses to take legal proceedings.[118] This means that the derivative action is still needed even though the directors' duties *per se* are perfectly designed by the legislators.

(4) Duties of the controlling shareholders. Although the Company Law does not state explicitly that the duties of controlling shareholders to the company and other shareholders, it is widely accepted that the duties were imposed upon the controlling shareholders based on two provisions in the Company Law requiring controlling shareholders not to abuse their rights and should be held liable for damages caused by their violations. Article 20 provides a general rule by stating that the shareholders of a company shall observe laws, administrative regulations and the company's articles of association, exercise the rights of a shareholder according to the law, and

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[116] M. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31(1) Del. J. Corp. L. 27 (2006).

[117] See fn. 42, art. 150.

[118] Id. art. 152.

shall not abuse his right to damage the interests of the company and other shareholders."[119] Article 21 focuses on the controlling shareholders or *de facto* controllers of a company, stating that they should not take advantage of their affiliated relations to damage the interests of the company, and otherwise they would be liable for compensation.[120]

However, it is argued that the duties of controlling shareholders may not effectively constrain their conducts and thus are only "paper tigers."[121] First of all, provisions regarding duties of the controlling shareholders are unsystematic and therefore, it is more like a scattergun approach. As discussed before, there are couples of provisions regarding the duties of the controlling shareholder under the Company Law and some other relative rules can be found occasionally in regulations issued by the CSRC, such as Guidelines for the Articles of Association of Listed Companies. Theses dispersive provisions are obviously not conducive to either the minority shareholders or the controlling shareholders. Second, these provisions are criticized for being too general to claim in practice without details of content or applicable standards.[122] It can be revealed by the fact that to date, there has been no case filed to court claiming the controlling shareholders breach their duties. Third, there are no provisions explicitly stating a shareholder can bring lawsuits against controlling shareholders where they fail to perform their duties and cause damages to other shareholders. This is different from the situation covered under the current Company Law where directors fail to fulfill their duties since the law clearly provides that shareholders, whose interest is damaged when a director violates his duties to shareholders, may bring a lawsuit to the court.[123] This may further prove that the duties of controlling shareholders are potentially ineffective in constraining their conducts. Fourth, remedies for shareholders are very limited. According to the Company Law (2006), the controlling shareholders should be liable for compensating the company or other shareholders for their breach of duties. Therefore, it can be inferred that the only available remedy for the injured

[119] Id. art. 20.
[120] Id. art. 21.
[121] Li, fn. 8 at 256.
[122] Id.
[123] See fn. 42, art. 153.

shareholders is compensatory damages. For a listed company, this seems to be no problem since a shareholder can leave the company by selling out his shares after receiving the compensation. However, for the shareholders of a limited liability company, it is not easy for the injured shareholders to leave the company. For example, they may want to leave the company after its controlling shareholders fail to perform their duties, while the only available remedy is pecuniary compensation. Therefore, it is suggested that a right to exit should be provided to the injured shareholders along with compensatory damages.

CONCLUSION

It cannot be denied that the Company Law (2006) made significant progress in constraining misconducts of majority shareholders and management in several ways. Nevertheless, there still exist many defects and thus, functions of these improvements are inevitably affected in protecting the interests of minority shareholders. In view of the growing severe exploitation of minority shareholders and the deteriorative double agency costs in Chinese companies, it is essential and significant that the interests of minority shareholders should be well protected. Without an investor-friendly legal system, the interests of shareholders and the companies would ultimately be injured and the development of capital markets would be severely impeded. As a consequence, in the future many protection mechanisms, such as derivative actions, should be further improved and clarified to prevent misconducts and to promote the standards of corporate governance in China.