

Chapter 2

An Overview of Shareholder Litigation

2.1 Introduction

Shareholder litigation is traditionally perceived as being about compensating shareholders for infringements of their rights or for losses they suffered as a result of negligent behaviour by the company and its directors, or by third parties. For a long time now, an additional function of shareholder litigation has been put forward: to deter managerial misconduct.¹ The term ‘shareholder litigation’ comprises all civil actions brought by shareholders against managerial wrongdoings within companies in order to recover economic losses caused by them.² Plaintiffs in shareholder litigation are obviously shareholders of a company. But defendants vary depending on different forms of shareholder litigation; they include companies, majority shareholders, directors, other senior managers in companies and third parties that are involved with the company (suppliers, bankers and other creditors, government agencies...).³ With regards to the causes of actions, as indicated before,

¹See Paul Weitzel, ‘The End of Shareholder Litigation? Allowing Shareholders to Customize Enforcement through Arbitration Provisions in Charters and Bylaws’, *Brigham Young University Law Review* (2013), Issue 1, 65, pp. 67–68; And see Federico Pastre, *How Shareholder Litigations Deter Directors and Officers: U.S. and Italy, a Comparative Analysis* (GRIN Verlag, 2013), pp. 3–4.

²See Patrick M. Garry, Candice Spurlin, Debra A. Owen, William A. Williams and Lindsay J. Efting, ‘The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform’, *South Dakota Law Review*, (2004), Volume 49(2), 275, pp. 276–277.

³For example, in a shareholder derivative action, the nominal defendant is the company where the misconduct occurs. In a shareholder direct action, the defendants are generally the wrongdoers. In an unfair prejudice remedy, the defendants are the members of the company who commit wrongdoings (they can include majority shareholder, directors, or other members).

they are mainly caused by wrongdoings within companies resulting in financial losses.⁴ The following sections will introduce three types of shareholder actions that could be used to claim for damages, including shareholder direct actions, shareholder derivative actions, and shareholder class actions.

2.2 Shareholder Direct Actions

Shareholder direct actions are, in nature, ‘personal claims’ not brought on behalf of companies. It is, in many cases, compared with shareholder derivative actions which are commenced by shareholders on behalf of the company for the losses suffered by the company. Practically, to distinguish derivative actions from direct ones, it depends on the answers to two questions—who suffers the alleged injury? (the company as a whole or the individual shareholder)—and who will receive the recoveries ordered by the court?⁵ Actually, in a derivative action, the company suffers financial losses because of wrongdoings, and the shareholder plaintiff suffers reflective losses in that case. But in a direct action, injuries are done to the shareholder plaintiff individually. One of the fundamental differences between those two actions may be that injuries in a direct action must be a special injury which does not equally affect all shareholders of the company.⁶ Furthermore, an action cannot be a derivative one if the shareholders’ injuries are separate and distinct from that suffered by others.⁷ But in case law, the courts in Delaware and New York hold that an action should still be considered as a direct one if the principal injury is done to the company, but special injuries remain with the individual shareholders.⁸ Fundamentally, close attention should be given to the issue whether a particular

⁴As for financial losses in shareholder litigation, they differ in different type of shareholder litigation. For example, in a shareholder derivative action, the cause of action must be that the company’s interests have been infringed by wrongdoings, and under this circumstance, shareholder plaintiffs may suffer ‘reflective losses’ (the term of ‘reflective loss’ is a concept use in the English company law, which means that reflective losses of an individual shareholder are inseparable from general losses of the company). In a direct action, the cause of action should be that the shareholder plaintiffs suffer a special injury which does not infringe the interests of other members of the company. It is also the main point distinguishing derivative actions from direct actions. And also in the U.S., shareholder class action is a sort of shareholder litigation, in which the shareholder plaintiffs are financially harmed because they pay the inflated prices for their stock. See Patrick M. Garry et al., ‘The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform’, *South Dakota Law Review*, (2004), Volume 49(2), 275, p. 277.

⁵Andreas Cahn and David C Donald, *Comparative Company Law: text and cases on the laws governing corporations in German, the UK and the USA*, (Cambridge University Press, 2010), pp. 602–603.

⁶See American Law Institute (ALI), *Principle of Corporate Governance: Analysis and Recommendations* (American Law Institute Publisher, Minnesota, 1994), Volume 2, pp. 17–22.

⁷*Ibid.*

⁸*Elster v. American Airlines, Inc.*, 34 Del. Ch. 94, 100A.2d 219, 222 (1953); 12b *Fletcher’s Cyclopedia Corps.*, S 5912, p. 431 (Perm. Ed., Rev. Vol. 1984), see American Law Institute (ALI),

right of claim belongs more to the company or to the shareholders.⁹ If it belongs more to the company, it should be a derivative action. Otherwise, it is a direct action.¹⁰

2.3 Shareholder Derivative Actions

Up till now, shareholder derivative actions have been legally confirmed in many jurisdictions (for instance, the UK, the US, China, Japan, Singapore).¹¹ Actually, the derivative action was originated in the UK as an exception to the proper plaintiff principle (the *Foss* Rule¹²) which means that an action brought because of wrongdoings to the company should be pursued by the company itself and the damages should also be awarded to the company. Derivative actions enable (certain) shareholders to redress the company's losses on behalf of the company in the event that the company (the proper plaintiff) is not able to bring a suit by itself.¹³ For instance, when the company is substantially controlled by the wrongdoers. In this case, wrongdoings done to the company can be redressed by shareholders representing the company instead of the company per se, which could be regarded as a fundamental justification for the existence of derivative actions.¹⁴

(Footnote 8 continued)

Principle of Corporate Governance: Analysis and Recommendations (American Law Institute Publisher, Minnesota, 1994), Volume 2, p. 19.

⁹See Joseph Bishop, *The Law of Corporate Officers and Directors: Indemnification and Insurance*, (Clark Boardman Callaghan, 1981), pp. 3–10.

¹⁰Actually, there are overlaps of direct and derivative actions. In many cases, the line between a direct and a derivative action is hazy. For example, while it is generally agreed that actions for declared dividends are direct actions, there have been disagreements as to compelling dividends. In this case, the claim might be direct and individual since 'the right to dividends is an incident of stock ownership, and shareholders were injured directly due to the failure of distribution of dividends'. On the other hand, a derivative action is also justified on the ground that the corporation also suffered losses due to 'punitive excess retain-earnings taxes or the retained earnings will otherwise be used improvidently'. See James D. Cox and Thomas Lee Hazen, *Corporations* (Aspen Publishers, 2nd edition, 2002), p. 421.

¹¹In most of countries in continental Europe, derivative actions are legally allowed (e.g. Germany, Spain, Sweden, Austria, Slovenia, Italy). But Dutch law does not permit derivative actions.

¹²In fact, in the *Foss* rule, two main principles have been identified: one is the majority rule principle and the other one the proper plaintiff principle. The majority rule principle states that the alleged wrongdoing can be ratified by a simple majority of company's members in a general meeting, then the court will not interfere. *Foss v Harbottle* (1843) 67 ER 189.

¹³See Xiaoning Li, *A Comparative Study of Shareholders' Derivative Actions: England, the United States, Germany and China*, (Kluwer, 2007), p. 1.

¹⁴See Xiaoning Li, *A Comparative Study of Shareholders' Derivative Actions: England, the United States, Germany and China*, (Kluwer, 2007), p. 2 and pp. 22–23.

The shareholder plaintiffs' right to sue, in fact, derives from the company's right to commence a lawsuit.¹⁵ Because of the very nature of the derivative action (an exception to the general principle), it can only be applied in limited circumstances. For instance, a derivative action could only be brought for a certain range of causes of actions.¹⁶ And from the procedural perspective, in some jurisdictions like the UK and the US, the court's discretion on allowing a derivative suit is expressed in several procedure requirements specially designed for such litigation.¹⁷ The derivative nature of this litigation also explains the fact that, if the action is for damages, any award will be paid to the company, and not to the shareholders who brought the action on behalf of the company.

2.3.1 *Shareholder Derivative Actions in China*

2.3.1.1 Introduction and Development of Shareholder Derivative Actions

For quite a long time, Chinese companies have been conceived as having what one could call a block-holder model of shareholder structure, where the state or the Communist Party controls the general operation of the company.¹⁸ But since the opening and reform policy initiated in early 1980s, the planned economy has been gradually transformed into a market economy and a large amount of economic entities began to emerge at that time. Given this background, the demand for regulations on corporate governance and relevant issues increased. Hence, the first PRC Company Law was born in 1993 (CL 1993). After more than ten years' development, it had become clear that this law did not succeed in solving disputes

¹⁵Ibid.

¹⁶For example, in the US, the shareholder plaintiff should demonstrate that the company is in the "wrongdoers' control", and the derivative action would have been commenced by directors in good faith. And in the UK, a derivative action could be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company (section 260(3) of UK Companies Act 2006).

¹⁷For example, in the UK, since 1 October 2007, the procedures in respect of all derivative claims have been set out in the Civil Procedure Rules 1998 (CPR) Parts 19.9 to 19.9F, Practice Direction 19C and UK Companies Act 2006 Part 11. Generally, the permission to continue the claim is a two-stage procedure (At the first stage, the shareholder plaintiff should present evidence to demonstrate the case is a *prima facie* one, otherwise, the claim will be dismissed by the court. And at the second stage, the court carries out a comparatively high degree of judicial discretion). See A. M. Gray, 'The statutory derivative claim, an outmoded superfluity', *Company Lawyer*, (2012), Volume 33(10), 295, p. 297.

¹⁸See Flora Xiao Huang, 'shareholder revolt? The statutory derivative action in China', *Comparative Research in Law & Political Economy. Research Paper No. 49/2009*, pp. 4–5 <http://digitalcommons.osgoode.yorku.ca/clpe/157> (accessed on 10 August 2016).

between directors and shareholders, and also failed to meet the demand of balancing the interests of controlling shareholders and minority ones.¹⁹

Given that, the CL 2006 introduced a series of techniques aimed at achieving such balance, including the introduction of shareholder derivative actions.²⁰ These are expected to promote corporate governance, enhance the protection of minority shareholders and build an investor-friendly legal regime in response to the rapid economic growth in China. In fact, prior to the introduction of it in 2006, there were legal practices and judicial discussions regarding derivative actions because conflicts between controlling shareholders and minority ones had begun to become a common issue in corporate governance.²¹ There were several significant cases regarding some forms of ‘derivative actions’ even though the concept was not dealt with in the law at that time. For example, Mr. Shao, a shareholder of Sanjiu Medical & Pharmaceutical Co., Ltd., used it against the director of that company in April 2003, claiming that around 96% of the company’s assets had been inappropriately usurped by the director and controlling shareholders. Mr. Shao required the court to order the wrongdoers to make amends towards the company. Unfortunately, the Shenzhen Intermediate People’s Court dismissed Mr. Shao’s appeal, stating that a derivative action should represent the legal interests of all shareholders of the company, and Mr. Shao must obtain consent from all of them prior to the commencement of such a lawsuit.²² In fact, Li Guoguang, the deputy president of the Supreme People’s Court (SPC) indicated that courts should accept derivative actions in a meeting concerning China’s court adjudication work for civil and commercial affairs on December 11th 2002. However, Mr. Li’s view was not adopted by the court because his speech could only be considered as a reference but not a rule with binding effects.^{23,24}

¹⁹See Xudong Zhao, ‘The aim of the amending of the Company Law 1993’, (in Chinese), (公司法修改的价值取向), *Legal Forum* (法学论坛), 2004(6), 11; see Junhai Liu, ‘The amendment and interpretation of the Company Law 1993’, (in Chinese), (公司法的修改与解释), *The Application of Law* (法律适用), 2005(3), 2, p. 3; Min’an Zhang, *The Balance of Interests in the Company Law 1993*, (Peking University Press, 2003).

²⁰Those new techniques include the introduction of independent directors, the application of a cumulative voting system and the use of shareholder derivative actions.

²¹See Peizhong Gan, ‘The Potential for Shareholder Derivative Actions in China’, (in Chinese), (论股东派生诉讼在中国的有效适用), *The Journal of Peking University (Philosophy and Social Science)*, 2002, 39(5), 17, pp. 18–19; Yunqiu Yan, ‘The Theoretical and Statutory Aspects of Shareholder Derivative Actions’ (in Chinese) (公司利益相关者派生诉讼的理论逻辑与制度构建), *Studies in Law and Business*, 2006, 22(6), 24, pp. 26–27.

²²See Guojie Xu, ‘The first derivative lawsuit was refused by the court due to the absent of consent from all company’s shareholders’, (in Chinese), *China Securities Journal* (中国证券报), (April 22nd 2003).

²³*Ibid.*

²⁴Except for *Sanjiu* case, before 2006, there were several significant cases regarding the similar issue, which could also be regarded as milestones in the development of shareholder derivative actions. For example, *Li Kai v. Lianhua Weijing* (May 2004); *Xie Guangxue, Yao Jun et al. v. Pan Shiyi* (August 2004, and the disputed value of the case is amounted to 1.05 Billion RMB); *Daqing Lianyi Case* (2004). These casea are not officially published, but articles discussing them could be

After 2003, several rules concerning derivative actions were issued by High People's Courts. For instance, Shanghai High People's Court promulgated its *Opinion on Some Issues in Trials for Legal Actions Related to Company Dispute (No 1)*, where the legality of derivative actions was confirmed by a Chinese court for the first time.²⁵ On top of that, Jiangsu High People's Court issued its *Opinion on Some Issues in Trials for Legal Actions Applied with Company Law (Provisional Rules)*,²⁶ which set up rules for shareholder representative actions (股东代表诉讼) largely equivalent to the common law definition of shareholder derivative actions.^{27,28}

On the national level, the SPC in 2003 published the first draft of *Regulations on Some Issues Concerning Trials for Company Disputes (consultation paper)*, which includes five articles concerning derivative actions.²⁹ Article 43 of it provides causes of derivative actions.³⁰ Article 44 stipulates two preconditions for a commencement of a derivative claim, including the 'contemporaneous ownership requirement'³¹ and the 'threshold requirement'. Article 45 is about the status of

(Footnote 24 continued)

found. See, for example, (*Li Kai v. Lianhua Weijing*) <http://finance.sina.com.cn/y/20040731/1844916842.shtml>; (in Chinese, accessed on 16 July, 2016); <http://www.cctv.com/news/financial/inland/20040729/101495.shtml> (in Chinese, accessed on November 16th, 2014); For the case (*Xie Guangxue, Yao Jun et al. v. Pan Shiyi*), see, for example, <http://www.china.com.cn/chinese/law/660372.htm> (in Chinese, accessed on 16 July 2016); <http://news.163.com/05/0519/02/1K35GSLN0001122D.html> (in Chinese, accessed on 16 July 2016).

²⁵Article 5(1) of it states that the court cannot refuse a derivative claim on the ground that the plaintiffs are ineligible.

²⁶Article 17 of it provides that the court should accept derivative actions. And defendants in such claims are wrongdoers, while the company should be listed as 'a third person' in the litigation. PRC Civil Procedure Law (CCPL) indicated that 'a third person' is a party whose interests will be affected by the result of a case. See article 56 of the CCPL.

²⁷See Flora Xiao Huang, 'shareholder revolt? The statutory derivative action in China', *Comparative Research in Law & Political Economy. Research Paper No. 49/2009*, p. 9 <http://digitalcommons.osgoode.yorku.ca/clpe/157> (accessed on 10 August 2016).

²⁸In addition, Zhejiang High People's Court in 2002 (Understandings on Several Difficult Issues Regarding the Application of the Company Law) and Beijing People's High Court in 2004 (The Guiding Opinions of Beijing High People's Court on Several Issues on Adjudicating Corporate Disputes Cases) respectively issued similar judicial opinions concerning the use of shareholder derivative actions.

²⁹'Regulations on Some Issues Concerning Trials for Company Disputes' (关于审理公司纠纷案件若干问题的规定), articles 43–47 (in Chinese).

³⁰Shareholder could launch a court proceeding if a director, supervisor or senior officer breaches his or her obligation of loyalty to the company, or if controlling shareholders abuse their position, which cause losses to the company.

³¹The 'contemporaneous ownership requirement' means that qualified shareholder plaintiffs should hold continuously the company's shares when the misconducts infringing the company's interest occur. And the 'threshold requirement' means that a complaint shareholder should hold at least 10% of a limited liability company's total shares or 1% of a joint stock limited company.

other parties in a derivative lawsuit.³² And article 47 indicates that under certain circumstances the court could order the shareholder plaintiffs to post security for costs.³³ Although this draft by the SPC was only a consultation paper and had no binding effects on judicial practice, it did demonstrate the efforts to unify the rules on shareholder derivative actions.³⁴

In 2006, the new Companies Legislation formally granted minority shareholders the right to protect the company's interests (and shareholders' interests as well) by initiating shareholder derivative actions. Neither the statutory provisions concerning derivative actions in the CL 2006 nor those rules in the subsequent judicial interpretations of it by the SPC³⁵ have offered practical guidance (for instance, the problem in the 'demand requirements', see the following sections in this regard), which might be partly responsible for the comparatively unsuccessful functioning of derivative actions after 2006.³⁶ The following sections will attempt to investigate the practical difficulties when derivative actions are used.³⁷

2.3.1.2 Anatomy of Derivative Actions Under the PRC Company Law 2014³⁸

2.3.1.2.1 General Statutory Provisions

For a better explanation of the legal framework of derivative action in China, the overall rules for them can be summarized in four steps. First of all, there should be an actual wrongdoing to the company, which causes damage. Second,

³²For example, the status of other shareholders who also file an action and the status of the injured company.

³³For example, if the derivative claim was suspected to be a strike suit, a financial deposit by the shareholder plaintiff would be necessary.

³⁴See Xiaoning Li, *A comparative study of shareholders' derivative actions: England, the United States, Germany and China*, (Kluwer, 2007), p. 272.

³⁵There are three judicial interpretations on CL 2006 in total, which were issued in 2006, 2008, 2010.

³⁶Actually there are opinions supposing that the use of derivative actions in China was not a success because compared to the large amount of companies, derivative actions were rarely used. See Dan Wang, *Theoretical analysis on shareholders' derivative actions*, (in Chinese), (公司派生诉讼论), China legal publishing house (中国法制出版社), (2012), p. 325; And it was also indicated that the unsuccessful function of shareholder derivative actions are due to the defects on Chinese judicial system and special social background. See Donald C. Clarke and Nicholas C. Howson, 'Pathway to minority shareholder protection: derivative actions in the People's Republic of China', in Dan W. Puchniak, Harald Baum and Michael Ewing-Chow (eds), *The derivative action in Asia: a comparative and functional approach*, (Cambridge University Press, 2012), 243.

³⁷For example, the funding difficulties and the ambiguous procedures.

³⁸The latest version of PRC Company Law is CL 2014, but the rules concerning shareholder derivative actions are the same with those in CL 2006. So in this book, for convenience, when discussing derivative actions in China, the law usually refers to the CL 2014.

shareholders³⁹ cannot commence a derivative action immediately: they should first ask the board of supervisors in writing to file a lawsuit in the court. Third, if the board of supervisors finds itself in the circumstances (for instance, the company's director breaks law and causes losses to the company) as stated in Article 149 of CL 2014,⁴⁰ the aforementioned shareholders may require the board of directors in writing to initiate a lawsuit. And fourth, eligible shareholders could bring a derivative action provided that the board of directors refuses to commence a derivative action or it fails to file such a lawsuit within 30 days after receiving the shareholders' request. In addition to that, in case of emergency, eligible shareholders can initiate a derivative action without any prior request.⁴¹ It should be noted that the 'wrongdoings' mentioned before could have been committed by directors, supervisors⁴² and other senior officers of a company as well as outsiders to the company who infringe the lawful rights and interests of the company.⁴³

2.3.1.2.2 Standing to Sue

In general, who is qualified to commence a derivative action on behalf of a company depends on the type of the company involved in the lawsuit. There are two main types of companies under Chinese law—limited liability companies (LLCs) and joint stock limited companies (JSLC).⁴⁴ In a LLC, all shareholders are eligible to initiate a derivative action, while in a JSLC only those who separately or aggregately hold one percent or more of the total shares in the company for more than 180 consecutive days are entitled to file a derivative lawsuit.⁴⁵ Given that, it can be said that the law imposes stricter requirements for shareholders of JSLCs to launch derivative lawsuits.⁴⁶

³⁹The CL 2014 provides that eligible shareholders in a derivative action only include (a) in a joint stock limited company, shareholders who separately or aggregately hold 1% or more of the total shares of the company; (b) in a limited liability company, all shareholders are eligible to commence a derivative action.

⁴⁰Article 150 provides when performing their duties, directors, supervisors and senior managers should comply with laws, administrative regulations and the company's articles of association. If their illegal behaviors cause losses to the company, they should be held liable for such losses.

⁴¹The emergency case refers to a circumstance that the failure to bring up a derivative action will cause unrecoverable damages to the company.

⁴²Companies must establish a board of supervisors (for small-scaled companies with a small number of shareholders, one or two supervisors without a 'board' form is also allowed under Chinese law). Supervisors must be selected representatives from shareholders and the staffs of the company. No directors and senior officers of the company could be selected as supervisors (article 117 of PRC company law 2014).

⁴³Article 151 of CL 2014 defines the scope of defendants in derivative actions.

⁴⁴The formation and operation of these two types of companies differ. Generally, requirements regarding the formation of a JSLC are more that those when a LLC is established. Issues concerning LLCs are provided in this chapter and Chap. 3 of CL 2014, and Chaps. 4 and 5 present statutory provisions regarding JSLCs.

⁴⁵Article 151 of CL 2014.

⁴⁶See Hui Huang, 'The statutory Derivative Action in China: Critical Analysis and Recommendations for Reform', *Berkeley Business Law Journal* (2007), Volume 4, 227, p. 236.

An important reason can be identified to account for the different standing rules is that the risk of strike suits in the case of a LLC might be lower than that in a JSLC where a third party can purchase shares more easily to become a shareholder just for the purpose of obtaining the standing to sue.⁴⁷ Moreover, disgruntled shareholders can easily leave JSLCs by selling their shares in the stock market while due to the closely-held nature of LLCs, a consent from at least half of all shareholders is required prior to a member selling his shares.⁴⁸ Furthermore, compared to LLCs, the performance of JSLCs is supervised by various regulatory authorities, such as the China Securities Regulatory Commission (CSRC) and relevant stock exchanges.⁴⁹ Therefore, improving corporate governance by derivative actions might be more relevant to LLCs than to JSLCs.⁵⁰ Empirical research has found that from 2006 to 2011, the number of derivative actions brought against directors in LLCs is much higher than that of derivative lawsuits involving JSLCs.⁵¹

2.3.1.2.3 Demand Requirement

Article 151 of CL 2014 sets out the preconditions that should be met prior to the commencement of a derivative lawsuit by providing that:

If a director or senior manager is under the circumstances as mentioned in article 149⁵² of this law.....eligible shareholders may require the board of supervisors or the supervisor of LLCs with no board of supervisors in writing to file a lawsuit in the court. If the supervisor is under the circumstance as stated in article 149 of this Law, qualified shareholders may require the board of directors or the executive director of LLCs with no board of directors in writing to initiate a lawsuit in the court.

.....

If the board of supervisors, or supervisor of a LLC with no board of supervisors, or the board of directors or the executive director refuses to file a lawsuit after it/he receives a written request as mentioned above, or if it/he fails to initiate a lawsuit within 30 days after it receives the request, or if, in an emergency, the failure to lodge a lawsuit immediately will cause unrecoverable damages to the interests of the company, qualified shareholders may, on their own behalf, directly file a lawsuit in the court.⁵³

⁴⁷Limitations on stock transfer in a JSLC are only for directors and senior managers but not for general shareholders. But the stock transfer to an outside person in a LLC needs to get the consent of half of the shareholders (article 71 of CL 2014).

⁴⁸Article 71(2) of CL 2014.

⁴⁹See Hui Huang, 'The statutory Derivative Action in China: Critical Analysis and Recommendations for Reform', *Berkeley Business Law Journal* (2007), Volume 4, 227, p. 236.

⁵⁰See Hui Huang, 'The statutory Derivative Action in China: Critical Analysis and Recommendations for Reform', *Berkeley Bus. LJ* 4 (2007), 227, p. 236.

⁵¹From 2006 to 2011, only two derivative actions sued directors of JSLCs. See Dan Wang, *Theoretical analysis on shareholders' derivative actions*, (in Chinese) (公司派生诉讼论), (China legal publishing house, 2012), p. 325; It should be indicated that the argument that there is a greater need of derivative actions for LLCs than that for JSLCs could not be provided as the only reason to explain the disequilibrium. For other reasons, see *infra* 4.4.

⁵²Article 149 of CL 2014 provides that directors, supervisors and senior managers should make compensation where they violate laws, administrative regulations or the articles of association and the interests of the company are infringed because of violation.

⁵³Article 151 of CL 2014.

According to these statutory requirements, eligible shareholders could lodge a derivative action after making a demand to the board of directors, or otherwise they should demonstrate that any delay in bringing the lawsuit would cause irreparable damage to the company,⁵⁴ which means that the derivative action is the last resort only applied when all internal remedies are exhausted.^{55,56}

However, it is found that these rules might be problematic. According to preconditions provided in article 151, eligible shareholders could commence a derivative action after the demand is refused by the company or the company does not respond to the shareholders' application. The law does not give an answer to the question—if the company refuses the demand in order to prevent a strike suit, whether the shareholder could still bring a derivative lawsuit after the rejection. In light of the statutory provisions, unless the company brings the action by itself, it cannot stop a suit from being brought even though it is a case without merits.⁵⁷ Even though an unmeritorious case can be rejected after the court's investigation, it might waste judicial resources and might hurt the company's reputation. In this regard, it is suggested if a derivative action brought in a court was previously refused by a company, the court should be informed of the reasons of the rejection, be provided with relevant evidence and take them into account.

2.3.1.3 Problems and Recommendations for Reform

2.3.1.3.1 The Issue of Legal Expenses

The functioning of the derivative lawsuit could be largely impacted by litigation costs. Litigation costs of a derivative action may be high given its commercial

⁵⁴See Flora Xiao Huang, 'shareholder revolt? The statutory derivative action in China', *Comparative Research in Law & Political Economy. Research Paper No. 49/2009*, p. 9 <http://digitalcommons.osgoode.yorku.ca/clpe/157> (accessed on 10 August 2016).

⁵⁵Ibid.

⁵⁶Preconditions for the filing of a derivative lawsuit could also be found in other jurisdictions. For instance, the American law similarly provides that prior to the initiation of a derivative action, demand needs to be made on the company (Rule 23.1 of the Federal Rules of Civil Procedure); Normally, a company is allowed to make a decision within 90 days after receiving the shareholder's demand. But if the shareholder can prove that the delay would generate unrecoverable damages to the company, the period could be shorter (Section 7.42 of Model Business Corporation Act. This act does not have mandatory effect but many states have adopted this rule, such as, Connecticut, Iowa, Michigan). The Australian law similarly provides that at least 14 days before an application of a derivative lawsuit is granted by the court, the shareholder applicant must give a written notice to the company of the intention and reasons why the application is made, in order to screen out vexatious or frivolous suits (Section 237(2) of Australian Corporation Act 2001), for the Australian case, see also Hui Huang, 'The statutory Derivative Action in China: Critical Analysis and Recommendations for Reform', *Berkeley Bus. LJ* 4 (2007), 227, p., p. 239. And see P.M. Choo, 'The Statutory Derivative Action in Singapore: a Critical and Comparative Examination' (2001) 13 *Bond L. Rev.* 64, pp. 72–73.

⁵⁷Hui Huang, 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis', *Banking and Finance Law Review*, (2012), Volume 27, 619, p. 639.

nature.^{58,59} Generally, litigation expenses for a derivative lawsuit are composed of at least two parts: the court's charges (including the case acceptance fees paid to the court before the suit and the case application fees incurred during or after the hearing of the case) and the lawyer's fees.⁶⁰ Thus, a rational would-be shareholder plaintiff in a derivative lawsuit would take the success rate of the case, the risk involved and the legal costs into consideration when deciding whether or not to file such a lawsuit.

In addition to that, according to article 29 of *Measures on the Payment of Litigation Costs* (2006), the losing party should be liable for the winning party's litigation costs excluding lawyer's fees.⁶¹ Considering that, the prospective shareholder plaintiff's concern about high litigation costs may be further enhanced. In fact, even if the shareholder plaintiff finally wins the case, the lawyer's fees, which might be a considerable amount of money, should be borne by himself. What could be even worse is that the successful shareholder plaintiff may suffer from substantial financial losses if the defendant goes bankrupt or refuses to pay back the court charges.⁶² Under this circumstance, the winning shareholder plaintiff should plead for an obligatory enforcement of the court's judgment, but the cost of such a pleading should be paid by the shareholder.⁶³

From the perspective of the monetary benefits brought by a successful shareholder lawsuit, it is an essential feature of derivative actions that the recoveries, actually belong to the company rather than the shareholder plaintiff.⁶⁴ But nevertheless it is the plaintiff who faces a substantial financial risk when commencing a derivative claim, which is disproportion to the benefits. Therefore, from the perspective of cost-and-benefit analysis, plaintiffs lack direct incentives to bring a derivative action because they 'have nothing to gain, but much to lose'.⁶⁵ In order to make derivative actions function, funding from other sources must be obtained.

With regards to funding issues of derivative actions, article 35 of the Fourth Judicial Interpretation of the Supreme People's Court on Some Issues Regarding

⁵⁸According to the calculation method under Chinese civil procedure rule, litigation expenses are generally proportionate to the value of the dispute. See article 13 of the Measures on the Payment of Litigation Costs (2006).

⁵⁹Why litigation costs for a derivative action is high is explained in *infra* 3.1.1 (Costs arising).

⁶⁰See *infra* 3.1.1 (costs arising).

⁶¹It could be understood as a partial cost-shifting rule. For further discussions, see *infra* Part II, Chapter I 2 ('the cost-shifting rule').

⁶²See Flora Xiao Huang, 'shareholder revolt? The statutory derivative action in China', *Comparative Research in Law & Political Economy. Research Paper No. 49/2009*, p. 9 <http://digitalcommons.osgoode.yorku.ca/clpe/157> (accessed on 10 August 2016).

⁶³Article 10 of the Measures on the Payment of Litigation Costs (2006).

⁶⁴The shareholder plaintiffs just benefit from the recoveries through an indirect way. For example, the derivative suit may correct wrongdoings of the directors and promote the corporate governance, thus the probable rise of the share value in the stock market is beneficial to all shareholders of the company.

⁶⁵*Wallersteiner v. Moir* (No.2) [1975] QB 373, at 392.

the Application of PRC Company Law, Consultation Paper 2016 stated that the shareholder plaintiffs could be indemnified by the company if the case is won under the court's discretion. The proposal in this consultation paper might be helpful to solve the funding problems confronted with prospective shareholder claimants in derivative lawsuit, but the problem is the consultation paper did not mention under what circumstances the court could order the company to indemnify the claimant.

2.3.1.3.2 Shareholder Derivative Actions or Shareholder Direct Actions

The 2014 CL also grants the shareholders the right to bring a direct lawsuit when his legal right or interest is infringed. Article 22 and article 152 of CL 2014⁶⁶ are both concerned with shareholder direct actions.

2.3.1.3.2.1 Claims for Nullification

Article 22 provides that

The resolution of the shareholders' meeting, shareholders' general meeting or board of directors of a company violating any law or administrative regulation should be invalid.

If the procedure for convening or the method of voting at a shareholders' meeting, shareholders' general meeting or meeting of the board of directors violates any law, administrative regulations or the company's articles of association, a shareholder may, within 60 days as of the day when the resolution is made, request the people's court to revoke it.

If a shareholder brings a lawsuit in accordance with the preceding paragraph, the people's court may, at the request of the company, require that the shareholder provide financial guarantee.

.....

According to article 22, shareholders can commence a lawsuit to nullify and withdraw a void⁶⁷ or voidable resolution⁶⁸ of the shareholders' meeting or that of the board of directors. But whether or not such judicial requests should be based on the fact that interests (including the shareholders' interests and the company's interests) are infringed by the defective resolution is not mentioned in the law. In fact, article 22 only grants shareholders the right to request the court to nullify defective resolutions.⁶⁹ If such defective resolution causes damages to the company or the shareholders, a claim for damages may not be brought under article 22.⁷⁰ Therefore, the function of article 22 is not concerned with redress of damages.

⁶⁶Article 22 of CL 2014 is the same with article 22 of CL 2006 and article 111 of CL 1994. And article 152 of CL 2014 is the same as article 153 of CL 2006.

⁶⁷A void resolution refers that the content of the resolution violates mandatory rules (laws and administrative regulations). And this sort of resolution is invalid from its inception.

⁶⁸A voidable resolution means that the formation procedure of this resolution violates laws administrative regulations or the company's articles of association.

⁶⁹See Xiaoning Li, *A comparative study of shareholders' derivative actions: England, the United States, Germany and China*, (Kluwer, 2007), p. 279.

⁷⁰*Ibid.*

2.3.1.3.2.2 Claims for Compensation (Article 20 and Article 152 of CL 2014)

The shareholder derivative action under article 151 is a lawsuit in which damages are claimed as compensation. Article 152 is also concerned with this issue by stating that

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

Compared to article 151 regarding shareholder derivative actions, actions brought under article 152 could be regarded as a direct lawsuit. There are no procedural preconditions to be met for such a direct lawsuit prior to its commencement. However, several practical problems arise because article 152 is not clear enough. For example, it does not indicate what kinds of infringement of shareholders' interests could generate a cause of a direct action. When a company's interests are harmed and shareholders suffer indirect losses, is it feasible for the shareholder to initiate a direct lawsuit under article 152?⁷¹ In a comparative perspective, it is found that shareholders' reflective losses are usually not regarded as a tenable ground on which a direct lawsuit could be brought. Generally, under this circumstance, a shareholder derivative action must be initiated for the redress of shareholders' reflective losses.⁷² Considering that, the CL 2014 should have made a clear distinction between shareholder derivative actions (article 151) and shareholder direct actions (article 152), indicating on the base of which kinds of infringement a given lawsuit can be commenced. But the law is not that clear on this issue.

The second problem is that article 152 states that a direct suit could only be brought where the shareholder's interests are infringed by the company's directors or senior managers. If a controlling shareholder not holding the position as a director or a senior manager harms the shareholder's interests, a direct suit cannot be initiated under article 152 against the guilty controlling shareholder, which may lead to the result that the shareholder who is the victim of another shareholder cannot redress his loss through the courts.⁷³

2.3.1.3.2.3 Conclusion

Through the comparison between derivative actions and direct actions under CL 2014, dilemmas can be found. As indicated before, when a shareholder's personal interests are infringed by the controlling shareholders, he is not able to bring a lawsuit against the wrongdoers to claim for compensation. CL 2014 only provides in article 20(2) that:

⁷¹See Li Xiaoning, *A comparative study of shareholders' derivative actions: England, the United States, Germany and China*, (Kluwer, 2007), p. 280.

⁷²*Johnson v Gore Wood & Co* [2002] 2 AC 1 at 19.

⁷³Under this condition, it is also not feasible for the harmed shareholder to commence a derivative action because his own interests instead of the company's are infringed by the controlling shareholder.

Where the abuse of shareholders' rights causes any loss to the company or other shareholders, such abusive shareholder shall be liable for compensation in accordance with the law.

It could be found in article 20(2) that it does not explicitly grant the injured shareholder the right to commence an action. A lawsuit cannot be brought under article 20(2) when an infringed minority shareholder is oppressed by a majority one. And also, in this case, a derivative action is not applicable because the loss of the shareholder's personal interests is not a cause of a derivative action.

CL 2014, subsequent judicial interpretations and consultation paper do not clearly mention the distinctions between derivative actions and direct actions.⁷⁴ It is very vague under what circumstances a derivative action or a direct action could be brought. As indicated in the last section, the American case law draws the distinctions between derivative actions and direct ones mainly based on the 'special injury' test,⁷⁵ meaning that a claim could be commenced without showing an injury or breach of duty to the corporation should be treated as a direct lawsuit.⁷⁶ Furthermore, the American Law Institute (ALI) also points out that an action cannot be a direct one if all of the shareholders are equally affected by the infringement.⁷⁷ Sometimes, both the company and the individual shareholder suffer an injury at the same time and it is not easy to distinguish one from the other. Under this condition, an additional 'special duty' test could be used—to whom the defendant owes the duties?⁷⁸ For instance, when the defendants are directors or senior managers of the company, it is particularly important to identify the party to whom the defendants owed the relevant duty, because they own duties to both the company as an entity and to the shareholders as individuals.⁷⁹ In this regard, Chap. 6 of the CL 2014 is concerned with the duties of directors and senior managers owed to the company,

⁷⁴Three judicial interpretations and one consultation paper on CL were issued in 2006 (available in <http://vip.chinalawinfo.com/newlaw2002/slc/slc.asp?db=chl&gid=219133>), 2008 (available in <http://vip.chinalawinfo.com/newlaw2002/slc/slc.asp?db=chl&gid=219131>), 2010 (available in <http://vip.chinalawinfo.com/newlaw2002/slc/slc.asp?db=chl&gid=219132>) and 2016 (consultation paper) (http://www.legaldaily.com.cn/index_article/content/2016-04/12/content_6583564.htm?node=5955) respectively (in Chinese, accessed on 16 August 2016).

⁷⁵This test provides if a shareholder alleges a 'special injury', he is entitled to state a direct action. A special injury was alleged if the wrong was inflicted only upon that shareholder or where the shareholder complained of a wrong affecting a particular right. See *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Delaware 2004), 1038.

⁷⁶American Law Institute (ALI), *Principles of Corporate Governance: Analysis and Recommendations*, (American Law Institute Publishers, 1994), S6.11.

⁷⁷*Ibid.*

⁷⁸Stephen M. Bainbridge, *Corporation Law and Economics*, (Foundation Press, New York, 2002) p. 363.

⁷⁹*Ibid.*

and other shareholders.⁸⁰ However, the law elaborates the duties owed to the company by the controlling shareholders, the directors and the senior managers,⁸¹ while their duties owed to the shareholders are rarely touched upon. It is only briefly mentioned that the directors and senior managers of a company are not allowed to harm the shareholder's interests by violating the law, administrative regulations or the articles of association of the company, which is vague. In view of that, it is suggested that the law needs to indicate what kinds of director's duties owed to the shareholders in a clear way rather than stating a general term. Furthermore, it should be noted that certain misconducts can breach duties owed to the company as well as those owed to individual shareholders.⁸² For instance, inside trading can violate both a duty owed to the company as an entity and a separate duty owed to the shareholder who is selling their securities.⁸³

2.3.1.3.3 The Practical Development of Derivative Actions (2006–2016) in the Chinese Context

In addition to the already indicated difficulties, for instance concerning funding, there are other reasons why the practice of derivative actions is up till now not a great success in China. The unique Chinese judicial system and social background also account for the 'failure' of derivative actions.⁸⁴ For instance, the lack of judicial independence means that the courts are hardly shielded from the influences of the local government and the Communist Party, making it difficult for the court to independently judge derivative actions involving SOEs or significant enterprises.⁸⁵ In addition to that, the general resistance of courts to mass litigation may also contribute to the failure of derivative actions. For instance, the SPC issued instructions to lower courts to strictly limit the acceptance of the private securities claims in order to prevent the potential turmoil brought by a mass lawsuit where a group of injured people may join and the result of which may affect the general

⁸⁰Article 146–152 of the CL 2014.

⁸¹For instance, article 148 provides that the directors and the senior managers are not allowed to misappropriate the company's funds.

⁸²American Law Institute (ALI), *Principles of Corporate Governance: Analysis and Recommendations*, (American Law Institute Publishers, 1994), §7.01(c).

⁸³*Ibid.*

⁸⁴See Donald C. Clarke and Nicholas C. Howson, 'Pathway to minority shareholder protection: derivative actions in the People's Republic of China', in Dan W. Puchniak, Harald Baum and Michael Ewing-Chow (eds), *The derivative action in Asia: a comparative and functional approach*, (Cambridge University Press, 2012), 243.

⁸⁵If a derivative action involved a highly profitable enterprise in a given region, the court might be reluctant to side with shareholder plaintiffs. Because the local government may attach much importance to the tax turned by this enterprise, and may interfere any negative decision on the enterprise by the court. See *infra* 4.4.3 ('typical characteristics and deficiencies in Chinese judicial system').

public in a given area.^{86,87} Additionally, the court may not be willing to hear the derivative lawsuit even when it has not been explicitly prohibited by these legal documents. In theory, a derivative action could be filed by an individual shareholder, however, in fact, the result of a derivative lawsuit may influence the interests of a large number of shareholders even if they are not nominal plaintiffs.⁸⁸ Since in China, including in the courts, a lot of importance is attached to ‘the harmonious society’, this may be why the Chinese courts were not active in hearing corporate and securities cases.⁸⁹

2.3.1.4 Summary

In China the introduction of derivative actions was as such a milestone in corporate governance and shareholder protection. Nevertheless, as the comparative overview in this section has made clear, having statutory rules on derivative actions as such is of course no guarantee of their effectiveness as a governance mechanism. We criticised several statutory rules regarding derivative actions in China. For example, the demand requirements in article 151 of the CL 2014. It provides that eligible

⁸⁶Supreme People’s court’s notice on temporarily not accepting securities cases involving civil suits for damages, (‘最高人民法院于涉证券民事赔偿案件暂不予受理的通知’), issued on September 21st, 2001, available at www.law-lib.com/law/law_view.asp?id=16373 (accessed on 10 August 2016); Also see Supreme People’s court’s notice on issues relating to the acceptance of civil cases in tort arising out of false representations in securities markets, (‘最高人民法院关于受理证券市场因虚假陈述引发的民事纠纷案件有关问题的通知’), issued on January 15th, 2002, available at www.law-lib.com/law/law_view.asp?id=16956 (accessed on 10 August 2016); And see Supreme People’s court’s several provisions on the adjudication of civil suits for damages arising out of false representations in securities markets, (‘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’), issued on January 9th, 2003, available at www.law-lib.com/law/law_view.asp?id=42438 (accessed on 10 August 2016); One judicial document issued in May 2007 has to be mentioned is that it guided the courts internally to broaden the scope of permissible claims to include market manipulation and inside trading, however, other procedure hurdles established by the aforementioned documents still apply, see Peixin Luo, Difficulties over whether to eliminate or keep the precondition procedure, (‘前置程序去留困境’), *Caijing* (Finance), 19(2007), 28.

⁸⁷The concept of ‘harmonious society’ (和谐社会) is highly valued in Chinese society. Thus, a lawsuit with lots of participants is, normally, thought to have the potential for turmoil. See Supreme People’s Court, *Notice of the Supreme People’s Court on Issuing Some Opinions of the Supreme People’s Court about Providing Judicial Protection for the Construction of Socialist Harmonious Society*, (in Chinese), (最高人民法院于为构建社会主义和谐社会提供司法保障的若干意见), (2007-01-15).

⁸⁸Donald C. Clarke and Nicholas C. Howson, ‘Pathway to minority shareholder protection: derivative actions in the People’s Republic of China’, in Dan W. Puchniak, Harald Baum and Michael Ewing-Chow (eds), *The derivative action in Asia: a comparative and functional approach*, (Cambridge University Press, 2012), 243, pp. 279–280.

⁸⁹See Xin Tang, ‘Protecting Minority Shareholders in China: A Task for Both Legislation and Enforcement’, in Hideki Kanda, Kon-sik Kim, and Curtis Milhaupt (eds.), *Transforming Corporate Governance in East Asia* (New York: Routledge, 2008), pp. 141–167.

shareholders may commence a derivative action after the demand is refused by the company or the company does not respond to the shareholders' application. But the law does not indicate whether the shareholder could still bring a derivative lawsuit after the company's rejection. According to article 151, unless the company brings the action by itself, it cannot stop a suit from being brought even though it is a case without merits. Another problem is the unclear criteria in China to distinguish between direct actions and derivative actions. Rules about shareholder direct actions are mainly incorporated in article 20 and article 152 of the CL 2014. The former one is about the injunctive relief (in particular to nullify a resolution of a shareholders' meeting) while the latter one is dealing with claims for damages (i.e. a shareholder's interests are infringed and causes monetary losses to him). Article 152 only provides that if the shareholder's interests were infringed by the board of directors or senior managers, a direct action against the wrongdoers could be commenced by the victim. The problem is if a controlling shareholder, who does not hold the position of director or senior managers, infringes a minority shareholder's interests, article 152 does not grant the victim the right to sue the wrongdoer directly. In this case, obviously, the victim cannot launch a derivative lawsuit because the individual shareholder but not the company suffers losses. The second problem of article 152 is that it does not indicate what kinds of infringement of shareholders' interests could generate a cause of a direct action. The law does not mention if a shareholder suffers reflective losses, he can initiate a direct or a derivative lawsuit, which might create uncertainty in practice.

As the law stands now, derivative actions cannot really become a success in China. Except for the problems in statutory rules in the CL 2014, the lack of effective funding ways also contributes to the failure of derivative actions. Shareholder plaintiffs (particularly minority ones) need to pay lots of money to sustain an expensive derivative action. But on the other hand, damages created in a successful case belong to the company but not the shareholder plaintiffs. They would only indirectly benefit from remedies through the potential rise in the share price on a *pro rata* basis. However, in light of the shareholder's (except for majority ones) small stakes in the company, in financial terms, an economically rational shareholder may not be incentivized to launch a shareholder derivative claim. In addition to that, a prospective shareholder claimant may have strong incentives to leave the claim for someone else to sue after being aware that the company and other shareholders will free ride on his efforts.⁹⁰ However, the latest Fourth Judicial Interpretation of the Supreme People's Court on Some Issues Regarding the Application of PRC Company Law, Consultation Paper 2016 proposed a model under which the shareholder plaintiffs could be indemnified by the company if the case is won under the court's discretion. But further details such as under what

⁹⁰Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation*, (Oxford University Press, 2007), pp. 222–223.

circumstances such indemnification could be awarded to the shareholder plaintiff are not mentioned in the consultation paper.

Additionally, problems are also caused by the unique judicial system and social background in China. For example, the lack of judicial independence makes it difficult for the court to independently judge a derivative action involving SOEs or significant enterprises. Moreover, there is general resistance of the courts to mass litigation. The court may not be willing to hear derivative action cases as such cases may be likely to break the principle of ‘maintaining the harmonious society’ held by the Chinese society and judicial system. In fact, Chinese courts are not proactive in hearing corporate and securities cases.

2.3.2 *Shareholder Derivative Actions in the United Kingdom*

2.3.2.1 *The Traditional Foss Rule and Its Exceptions*

In the UK, the traditional common law derivative actions were developed from the *Foss v. Harbottle* rule and its exceptions. The main principle of this rule was where a wrong is done to a company, only the company per se was considered to be the proper plaintiff to bring a lawsuit to redress losses (the proper principal rule). An individual shareholder could bring a derivative claim in exceptional situations.⁹¹ In fact, the *Foss* rule received quite a lot of criticism.⁹² The most significant criticism was that this rule scarcely grants minority shareholders any effective mechanisms to protect themselves or the company, and to discipline corporate governance.⁹³ In view of that, the introduction of statutory derivative actions in the UK was suggested. Currently, the rules governing statutory derivative actions are incorporated in Part 11 of the UK Companies Act 2006 (CA 2006), under which a member of a company could commence, under certain conditions, a derivative action against the directors in case of negligence, default, breaches of duties or breaches of trust.⁹⁴ The shareholder plaintiff in the action should, at the time when the conduct being challenged took place, have been a member of the company.⁹⁵

⁹¹For example, the ‘wrong control’ exception, which allows the shareholder to commence a derivative action in the event that the company was controlled by the wrongdoers. For more exceptions to the *Foss* rule, see Xiaoning Li, *A comparative study of shareholders’ derivative actions: England, the United States, Germany and China*, (Kluwer, 2007), pp. 23–27.

⁹²See Gower & Davies, *Principles of Modern Company Law*, (Sweet&Maxwell, 2012), pp. 647–648.

⁹³*Ibid.*

⁹⁴Section 260(3) of CA 2006.

⁹⁵Section 260(4) of CA 2006.

2.3.2.2 The Legal Framework of Statutory Derivative Actions Under the CA 2006

Rules regarding statutory derivative actions in CA 2006 reflects the recommendations of the Law Commission that ‘a new statutory derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action’.^{96,97} In line with this recommendation, statutory derivative actions will only be available in case of negligence, default, breaches of duties or breaches of trust by a director of the company,⁹⁸ even if the director does not benefit from these conducts personally.⁹⁹ On top of that, plaintiffs in a derivative action should demonstrate that the director committing misbehaviours substantially controls the company.¹⁰⁰

2.3.2.2.1 Standing to Sue

CA 2006 indicates who are entitled to commence a derivative claim. Only the members of a company are entitled to launch a derivative claim.¹⁰¹ A former member of the company cannot initiate such an action even if the issued complained of was occurred during his membership.¹⁰² However, it should be noted that there is an important statutory extension of the notion of ‘member’.¹⁰³ Even though a person has not entered into the registration procedure to officially become the company’s member, he could also be considered to hold a valid membership to bring a derivative action if his shares have been transferred or transmitted by operation of law (for instance, through succession).¹⁰⁴ According to section 260 of CA 2006, a member of the company could bring a derivative action where the alleged wrongdoing arose before he enters into the company.¹⁰⁵

2.3.2.2.2 Permission to Continue: A Three-Step Test

Previously, under the regime of common law derivative actions, the criteria used in determining whether a claim can be brought before the court is vague. The commencement of a derivative claim relied on the exceptions to the *Foss* rule. The only important exception of that rule was ‘fraud on the minority’, under which individual shareholders are allowed to bring an action on behalf of the company.¹⁰⁶

⁹⁶See Law Commission, Shareholder Remedies (LC 246), para. 6.15.

⁹⁷The *Foss* rule is not used in practice. See Gower & Davies, Principles of Modern Company Law, (Sweet&Maxwell, 2012), p. 654.

⁹⁸Section 260 (3) of CA 2006.

⁹⁹See Saleem Sheikh, *A guide to the Companies Act 2006*, (Routledge-Cavendish publisher, 2007), p. 1043.

¹⁰⁰For instance, the director controls the decision-making procedure. Ibid.

¹⁰¹Section 260 of the CA 2006.

¹⁰²Ibid.

¹⁰³See Gower & Davies, Principles of Modern Company Law, (Sweet&Maxwell, 2012), p. 655.

¹⁰⁴Section 260(5)(c) of the CA 2006.

¹⁰⁵Section 260(4) of the CA 2006.

¹⁰⁶See Zhong Zhang, *The derivative action and good corporate governance in China: Economic theories and legal rules*, (Lambert Academic Publishing, 2011), p. 114.

‘Fraud on the minority’ contains two elements: fraud and wrongdoers control.¹⁰⁷ It means that a shareholder can bring a derivative action only if the complained wrongdoing should be a fraud and meanwhile the wrongdoers substantially control the company.¹⁰⁸ Moreover, it must be stated that the wrong here is actually done to the company, but not to the individual shareholder. However, unfortunately, those requirements are vague under English common law.¹⁰⁹

In order to make the rules clear, the Law Commission proposed to reform shareholder derivative actions. Generally, it was suggested that the court has the power to decide whether a shareholder could lodge a derivative action by considering:

(1) whether the shareholder is in good faith; (2) whether the action would be in the interest of the company; (3) whether the alleged wrong has been, or may be, approved by the company at a general meeting; (4) whether the general meeting has resolved not to pursue the wrong; (5) the views of an independent organ; and (6) the availability of alternative remedies.¹¹⁰

In addition, it was also suggested that ratification of a wrongdoing by a shareholders’ meeting could bar the commencement of a derivative action, unless this shareholders’ meeting was under the support or the influence of wrongdoers.¹¹¹

In fact, these reform proposals were largely accepted by the CA 2006. Under the current law, a shareholder intending to bring a derivative action has to apply to the court for permission to continue the action.¹¹² The factors which should be taken into consideration by the courts in deciding whether to grant a leave to the action are mainly consistent with those recommendations proposed by the Law Commission.¹¹³ All breaches of directors’ duties generate causes of actions, unless there was an actual authorization or ratification.¹¹⁴ The authorization or ratification is valid only if it is made by a shareholder’s meeting without the influence of directors who allegedly committed misbehaviours and persons that may involve in such misconducts.¹¹⁵

¹⁰⁷Ibid.

¹⁰⁸*Prudential Assurance Co. Ltd. v. Newman Industries Ltd.* (No.2) (the Court of Appeal), [1982] Ch. 204, at 210F-211B.

¹⁰⁹See Xiaoning Li, *A comparative study of shareholders’ derivative actions: England, the United States, Germany and China*, (Kluwer, 2007), p. 19.

¹¹⁰See Law Commission, *Shareholder Remedies* (LC 246), para. 6.75–6.92.

¹¹¹See DTI, *Modern company law for a competitive economy: completing the structure*, (London, DTI, 2000), para. 7.46.

¹¹²Section 260 (1) of the CA 2006.

¹¹³Section 263 of the CA 2006.

¹¹⁴Section 263 (2) of the CA 2006.

¹¹⁵Section 239 (3) & 239 (4) of the CA 2006.

Regarding the leave granted by the court, the CA 2006 formulates a three-stage test.¹¹⁶ First, the plaintiff must present evidence to demonstrate there is a *prima facie* case. Otherwise, the claim will be dismissed by the court.¹¹⁷ For the second stage, the court carries out a higher degree of judicial scrutiny.¹¹⁸ Permission must be refused by the court at the second stage if the defendant performed his duty in line with section 172 of CA 2006¹¹⁹ to promote the general success of the company.¹²⁰ Or, if the issue in question was ratified or authorized in a proper way,¹²¹ the application by the claimant will not be accepted by the court.¹²² In the event the claim can overcome the first two tests, the court will then take into the six factors listed in section 263 (3) of the CA 2006 into consideration to decide whether the claim should proceed.¹²³

At the first stage, the main question is what kind of standard should be adopted by the court to decide the claim is a *prima facie* one. The CA 2006 does not provide any concrete rules in this respect. While in the case law, a typical example is the *Wishart v. Castlecroft Securities Ltd.*¹²⁴ case, in which the Scottish Court of Session (Inner House) appeared to place a low threshold for the plaintiff by indicating:

The question is not whether the application and supporting evidence disclose a *prima facie* case against the defendant, but whether there is no *prima facie* case disclosed for granting the application for permission. And onus is placed on the claimant to satisfy the court that there is a *prima facie* case: rather, the court is to refuse the application if it is satisfied that there is not a *prima facie* case.¹²⁵

¹¹⁶See Victor Joffe, David Drake, Giles Richardson and Daniel Lightman, *Minority shareholders, law, practice and procedure*, (Oxford University Press, 2011), p. 46.

¹¹⁷Section 261(2) of the CA 2006.

¹¹⁸See A.M. Gray, 'The statutory derivative claim, an outmoded superfluosity', *Company Lawyer*, (2012), Volume 33(10), 295, p. 297.

¹¹⁹Section 172 of CA 2006 explains what constitutes duty to promote the success of the company.

¹²⁰Section 263(2)(a) of the CA 2006.

¹²¹Section 239(3) & 239(4) of the CA 2006.

¹²²Section 263(2)(b) of CA 2006.

¹²³Section 263(3) of CA 2006. The six consideration factors include: (a) whether the member is acting in good faith in seeking to continue the claim; (b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it; (c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be—(i) authorized by the company before it occurs, or (ii) ratified by the company after it occurs; (d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company; (e) whether the company has decided not to pursue the claim; (f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.

¹²⁴*Wishart v. Castlecroft Securities Ltd.* [2010] BCC 161.

¹²⁵*Wishart v. Castlecroft Securities Ltd.* [2010] BCC 161, per Lord Reed Opinion at 31.

In contrast, in *Iesini v. Westrip Holdings Ltd.*,¹²⁶ a stricter standard was used.¹²⁷ Lewison J pointed out that two aspects had to be satisfied simultaneously in order to prove a *prima facie* claim¹²⁸: the company should have a good cause of action; and the cause of action arises from a directors' default or a breach of duty.¹²⁹

In light of that, whether the claimant will overcome the first stage seems to depend largely on the standard employed by the court. In this regard, it is supposed that the English court would be cautious to grant the leave for the claimant because a conservative manner has been applied for long by the English courts.¹³⁰

For the second stage, one of the major concerns is about the ratifiable wrongdoings.¹³¹ It means that a ratifiable wrongdoing that has not actually been ratified will no longer generate a bar to the filing of a derivative action. Even though the court is required to take into account the possibility that the wrongdoing will be ratified by the company, such possibility could not be regarded as a block to the commencement of a derivative action.¹³² Furthermore, not all wrongdoings that have been ratified by the company will definitely constitute a bar to a derivative action.¹³³ Ratification will be invalid if it concerns certain misbehaviours, such as expropriation of the company's property by the majority.¹³⁴

Furthermore, section 239 of the CA 2006 highlights the issues regarding ratification.¹³⁵ To ratify a director's negligence, default, a breach of duty or a breach of trust (causes of a statutory derivative action), the votes of the persons who are personally interested in this ratification should be excluded. Given that, the requirements for achieving a valid ratification become stricter, and it seems that

¹²⁶*Iesini v. Westrip Holdings Ltd.* [2010] BCC 420.

¹²⁷See Victor Joffe QC et al., *Minority shareholders, law, practice and procedure*, (Oxford University Press, 2011), p. 48.

¹²⁸*Iesini v. Westrip Holdings Ltd.* [2010] BCC 420. at 75, 81–83.

¹²⁹*Ibid.*

¹³⁰See Arad Reisberg, 'Corporate law in the UK after recent reforms: the good, the bad, and the ugly', *Current Legal Problems*, (2010), Volume 63(1), 315, p. 349.

¹³¹See Gower & Davies, *Principles of Modern Company Law*, (Sweet&Maxwell, 2012), p. 657.

¹³²*Ibid.*

¹³³There are a few cases to support this point of view. In *Franbar Holdings Ltd v. Patel* [2008] BCC 885, William Trower QC confirmed that the CA 2006 did not alter the common law position that certain wrongs were unratifiable. In *Eastford Ltd v. Gillespie* [2012] BCC 303, Lord Hodge indicated 'I see nothing in the statutory provisions which suggests that Parliament intended to alter the pre-existing rules on ratification by a board of a director's unauthorized acts' (para. 15).

¹³⁴In *Cook v. Deeks* [1916] 1 AC 554, the directors concluded a contract for the interests of themselves instead of for the company, and tried to ratify their misconduct by proposing resolutions in a general meeting of the company (because the majority votes were held by those directors). In the case, the Privy Council indicated that the resolutions, which had been passed by virtue of the votes of the wrongdoers who held a majority of the votes, were not valid. *Cook v. Deeks* [1916] 1 AC 554, at 564.

¹³⁵See Victor Joffe QC et al., *Minority shareholders, law, practice and procedure*, (Oxford University Press, 2011), pp. 27–28.

those directors committing wrongdoings are not able to make use of the ratification procedure any longer.

2.3.2.2.3 Procedural Innovations in Section 262 and 264 of the CA 2006

Section 262, for the first time, innovatively permits a member of a company to apply for permission to continue a claim, which has been brought by the company, as a derivative action under several circumstances.¹³⁶ The cause of this derivative action commenced by the shareholder is identical to that of the previous action brought by the company. Additionally, section 264 permits a member to apply for permission to continue a derivative action brought or continued by another member under certain conditions.¹³⁷

The main purposes of these two innovative procedural devices in the CA 2006 could be summarized as follows

- (i) The goal is to preclude the possibility that a company not having a real intention of achieving a proper resolution brings up an action with a purpose to prevent its members from commencing a derivative action.¹³⁸
- (ii) Another goal is to prevent a member of the company, who is not *bona fide*, from bringing a derivative action just with the purpose to stop another member from initiating the action, or to allow another member of the company to continue the derivative action in some circumstances.¹³⁹ For example, if the member who brought the action is in short of funding to support the court proceeding, another member would be permitted to continue the action.

2.3.2.3 Comments on the Statutory Derivative Actions Under the CA 2006

Before the enactment of the CA 2006 which allows statutory derivative actions, the common law derivative actions actually did not effectively discipline corporate

¹³⁶Section 262(2) provides that the member of a company may apply to the court for permission to continue the action as a derivative on the ground that: (a) the manner in which the company commenced or continued the claim amounts to an abuse of the process of the court; (b) the company has failed to prosecute the claim diligently; and (c) it is appropriate for the member to continue the claim as a derivative claim.

¹³⁷Those conditions provided in section 264 are similar to that in section 262(2). However, as for the first condition, section 264 uses the expression 'the manner in which the proceedings have been commenced or continued by the claimant amounts to an abuse of the process of the court', which has been regarded as a comparatively higher threshold to overcome. See Victor Joffe QC et al., *Minority shareholders, law, practice and procedure*, (Oxford University Press, 2011) p. 61.

¹³⁸See Law Commission, *Shareholder Remedies* (LC 246), para. 6.63. And in para. 6.63, the Law Commission points out that the reason why they do not want individual shareholders to apply to take over current litigation being pursued by their company is that they are not satisfied with the progress being made.

¹³⁹See Victor Joffe QC et al., *Minority shareholders, law, practice and procedure*, (Oxford University Press, 2011), p. 62.

management and protect the interests of the company since it was practically difficult to initiate a derivative action under the common law.¹⁴⁰ The introduction of statutory derivative lawsuits in the CA 2006 was expected to facilitate the commencement of derivative actions and make relevant rules more clear and practical. Unlike the vague cause of a common law derivative actions (fraud on the minority), the CA 2006 lists a clear scope of the causes of an action including the director's negligence and breaches of duties.¹⁴¹ Moreover, the law also facilitates derivative actions by prohibiting the directors from ratifying their own wrongdoings.¹⁴² It is thought that the law provides a delicate balance between promoting corporate governance and shielding director's sound business judgment from liabilities.¹⁴³ Counter-arguments, however, state that the law is in favour of protecting directors in the sense that the filing of a derivative action is still subject to 'tight judicial control at all stages'.¹⁴⁴ Shareholder plaintiffs in a derivative claim may still face the traditional suspicion of the English courts.¹⁴⁵ Thus, it is doubted whether the statutory rules succeed in facilitating derivative claims. To further investigate this issue, we first discuss the first stage in the permission procedure—how could a plaintiff prove a *prima facie* case.

2.3.2.3.1 The Problematic Test of *prima facie* Case at the First Stage

At this step, the shareholder applicant is required to provide evidence to prove the claim is a *prima facie* case.¹⁴⁶ The main difficulty for the individual shareholder, at this stage, is how to collect information to prove misconducts by directors who are more familiar with the operation of the company than the minority shareholders. It is hard to imagine that minority shareholders could access to the company's key documents (for example, accounting books). In consideration of that, it might be difficult for the shareholder plaintiff to overcome this stage in most of cases.

The criteria applied in proving a *prima facie* case is also criticized to be vague.¹⁴⁷ To what extent a case could be considered as a *prima facie* case? It was indicated that to prove a *prima facie* case was merely required to show that this case

¹⁴⁰See Xiaoning Li, *A comparative study of shareholders' derivative actions: England, the United States, Germany and China*, (Kluwer, 2007), p. 33.

¹⁴¹Section 260 of the CA 2006.

¹⁴²Section 239 of the CA 2006 provides that directors are no longer able to vote on their own wrongdoings.

¹⁴³Brenda Hannigan, *Company Law*, (Oxford University Press, 2009), p. 229. David Gibbs, 'Has the statutory claim fulfilled its objectives? A *prima facie* case and the mandatory bar: Part 1', *Company Lawyer*, (2011), 32(2), 41, p. 42.

¹⁴⁴See Arad Reisberg, 'Corporate law in the UK after recent reforms: the good, the bad, and the ugly', *Current Legal Problems*, (2010), Volume 63(1), 315, p. 348.

¹⁴⁵Arad Reisberg, 'Shadows of the past and back to the future: Part 11 of the UK Companies Act 2006 (in) action', *European Company and Financial Law Review*, (2009), Volume 6, Issue 2–3, 219, pp. 224–225.

¹⁴⁶Section 261 of the CA 2006.

¹⁴⁷Julia Tang, 'Shareholder remedies: demise of the derivative claims?', *UCL Journal of Law and Jurisprudence*, (2012), Volume 1, 178, p. 183.

had more than 0 percent of success.¹⁴⁸ On the other hand, another approach suggested that the shareholder applicant must establish a good cause of action to convince the court that there is a serious question that must be dealt with before the court.¹⁴⁹ The unclear standard in the ‘*prima facie*’ test would easily make the first stage develop into a mini-trial.¹⁵⁰ In view of that, a recent trend is that the English courts try to combine the ‘*prima facie*’ test into the second and third parts of the permission stage.¹⁵¹

2.3.2.3.2 The Ratification and Authorization of the Claimed Wrongdoing

The CA 2006 provides that a permission to continue a derivative action should be denied in the event that the challenged act has been authorized or ratified by the company. The new law also stresses that interested directors can no longer vote on their own misconducts, which was allowed in the common law regime.¹⁵² This change in the law aims at vanishing the irrational ratification and authorization by wrongdoers.¹⁵³ In practice, this approach is, however, only workable in small companies.¹⁵⁴ For large public companies, where proxy vote is widely applied, it might be difficult to identify disinterested members.¹⁵⁵ In *Prudential Assurance Co Ltd. v Newman Industries*,¹⁵⁶ Vinelott J, in first instance, proposed that in a large public company the directors who commit misconducts ‘might be able to determine the outcome of a resolution in general meeting in their own favour by the use of proxy votes.’¹⁵⁷ In addition to that, ‘shareholder alliance’ (shareholders influenced

¹⁴⁸This doctrine was derived from *Australian Broadcasting Corporation v Lenah Game Meats Pty Ltd*, [2001] 208 CLR 199 (High Court of Australia), see David Gibbs, ‘Has the statutory claim fulfilled its objectives? A *prima facie* case and the mandatory bar: Part 1’, *Company Lawyer*, (2011), 32(2), 41, p. 44.

¹⁴⁹David Gibbs, ‘Has the statutory claim fulfilled its objectives? A *prima facie* case and the mandatory bar: Part 1’, *Company Lawyer*, (2011), 32(2), 41, p. 44.

¹⁵⁰See Law Commission, *Shareholder remedies*, 1996, Consultation Paper No.142, para. 16.22, available at http://lawcommission.justice.gov.uk/docs/cp142_Shareholder_Remedies_Consultation.pdf (accessed on 10 August 2016).

¹⁵¹In recent cases, the *prima facie* test was bypassed or telescoped because of its defects. For example, in *Mission Capital plc v Sinclair* [2008] BCC 866, the permission procedure was telescoped into one; In *Franbar Holdings Ltd v Patel* case [2008] BCC 885, counsel for the defendants had accepted that ‘it would be appropriate... to deal with the entirety of the application for permission to continue at a single hearing.’ See Julia Tang, ‘Shareholder remedies: demise of the derivative claims?’, *UCL Journal of Law and Jurisprudence*, (2012), Volume 1, 178, pp. 182–183.

¹⁵²Section 239 of the CA 2006.

¹⁵³See J. Paul Sykes, ‘The continuing paradox: a critique of minority shareholder and derivative claims under the Companies Act 2006’, *Civil Justice Quarterly*, (2010), 29(2), 205–234, p. 223.

¹⁵⁴In a strict sense, not all small companies could be able to implement this provision. For example, in some family-run companies, most of the members belong to the same family. Therefore, there is usually no clear distinction between interested members and disinterested ones.

¹⁵⁵See Julia Tang, ‘Shareholder remedies: demise of the derivative claims?’, p. 200.

¹⁵⁶*Prudential Assurance Co Ltd v Newman Industries* [1981] Ch 257.

¹⁵⁷*Prudential Assurance Co Ltd v Newman Industries* [1981] Ch 257, at 324.

by wrongdoers) in large public companies is also difficult to be identified, which makes it not easy to find ‘disinterested members’.¹⁵⁸

2.3.2.3.3 Funding Derivative Actions

For shareholder plaintiffs (especially, minority ones), how to fund a derivative action is a big concern when they decide whether or not to commence such a lawsuit. Traditionally, the indemnity cost order (the company indemnifies the claimant for the costs incurred in the derivative claim)¹⁵⁹ is assumed to be an effective way to financially assist shareholder plaintiffs. It was, for the first time, illustrated in *Wallersteiner v. Moir (No.2)*,¹⁶⁰ in which the Court of Appeal ordered the company to indemnify Mr. Moir his costs incurred and to be incurred in the forthcoming proceeding. The rationale behind the court’s order is that a company should indemnify a plaintiff in a derivative lawsuit because the plaintiff is acting on behalf of the company and the company will directly benefit from a successful suit.¹⁶¹ The eligibility of this indemnity depends on whether the plaintiff is in good faith and whether the action is for the company’s interests.¹⁶² The outcome of the action has no direct impact on the granting of the indemnity. Even if the action is lost, the plaintiff may still be entitled to be indemnified. Generally, the award of an indemnity cost order would be subject to the court’s discretion at the permission stage or, under certain circumstances, at the end of the court proceeding.¹⁶³ This funding technique could also help to discourage frivolous and unmeritorious claims for the reason that at the very beginning there is no a guarantee for an indemnity cost order.

Rule regarding indemnity cost orders were further illustrated in *Smith v. Croft (No.1)*,¹⁶⁴ where Walton J supposed that the rule of the indemnity cost order formulated in *Wallersteiner v. Moir* was somewhat unfair to the defendant. He further proposed that a plaintiff should only be indemnified provided that he was genuinely in need (a mean test).¹⁶⁵ Along with that, Walton J also clarified the standard of the test by indicating that the court should satisfy that an independent board of directors would consider the action under certain circumstances.¹⁶⁶

The common law rules about indemnity cost orders also have reflection in the statutory law. The Civil Procedure Rules (Rules and Directions) provide that the court may order a company to indemnify the plaintiff for the costs incurred in the

¹⁵⁸Pearlie Koh, ‘Directors’ Fiduciary Duties: Unthreading the Joins of Shareholder Ratification’ *Journal of Corporate Law Studies*, (2005), volume 5, 363, p. 389.

¹⁵⁹Civil Procedure Rule 19.9 E.

¹⁶⁰*Wallersteiner v. Moir (No.2)* [1975] QB 373.

¹⁶¹Zhong Zhang, *The derivative action and good corporate governance in China: Economic theories and legal rules*, (Lambert Academic Publishing, 2011), p. 204.

¹⁶²*Ibid.*

¹⁶³*Wallersteiner v. Moir (No.2)* [1975] QB 373, *per* Scarman L.J at 408.

¹⁶⁴*Smith v. Croft (No.1)* [1986] 2 All ER 551.

¹⁶⁵*Smith v. Croft (No.1)* [1986] 2 All ER 551, Walton J at 597.

¹⁶⁶*Ibid.*

derivative action.¹⁶⁷ However, this provision does not specify any further procedures for the parties and the court to follow, not to mention the conditions or tests for awarding an indemnity cost order. Therefore, guidance is only sought from the common law.¹⁶⁸ In this regard, the CA 2006 does not make any improvements to make the rules of the indemnity cost order more clear and detailed.

2.3.2.4 Summary

As to the development of the English company law, the replacement of the ambiguous standing requirements in the *Foss* rule by provisions in Part 11 of the CA 2006 was a step forward. It was expected that the reform of derivative actions in 2006 could introduce new statutory derivative actions with ‘modern, flexible and accessible criteria’. However, as analysed before, problems still exist in the existing statutory derivative action regime. For example, the interpretation of several technical terms at the permission stage remains controversial.¹⁶⁹ Moreover, funding difficulties with derivative claims still remain as burdens for shareholder plaintiffs. Unfortunately, the CA 2006 has not made significant progress in tackling with this issue.

2.3.3 Shareholder Derivative Actions in the United States

2.3.3.1 Introduction and Development of Shareholder Derivative Actions in the US

In the US, the law regulating derivative actions is incorporated in both state law and federal law. Although rules about derivative actions vary from state to state, several principles are generally accepted. The following sections will try to discuss these general principles and state law (e.g. Delaware law) on derivative actions will be investigated also. To give a comprehensive overview of derivative actions, analysis

¹⁶⁷Rule 19.9 (E) of CPR, available at <http://www.justice.gov.uk/courts/procedure-rules/civil/rules/part19#19.9E> (accessed on 16 August 2016). This rule indicates that the costs could be indemnified by the company include fees incurred in the permission application or in the course of the derivative claim or both of them.

¹⁶⁸Recent cases suggest that the English courts, actually, hold a pragmatic attitude towards indemnity costs orders. In *Kiani v Cooper* [2010] BCC 463, Proudman J made a limited indemnity costs order in favour of the applicant, and further proposed that the applicant should undertake part of the litigation risk. *Kiani v Cooper* [2010] BCC 463, Proudman J at 49. See Zhong Zhang, *The derivative action and good corporate governance in China: Economic theories and legal rules*, (Lambert Academic Publishing, 2011), pp. 84–85.

¹⁶⁹For instance, how to prove a *prima facie* case.

on the rules incorporated in the Model Business Corporation Act (MBCA)¹⁷⁰ and principles suggested in the American Law Institute's Principles of Corporate Governance: Analysis and recommendations (the ALI Principles)¹⁷¹ will also be examined.¹⁷²

In the course of the development of derivative actions, it could be observed that at the beginning, a lenient approach was applied.¹⁷³ However, it did not mean that any shareholder is qualified to bring a derivative action without limits. In fact, the exhaustion of internal remedies had already been considered as an important principle during that period.¹⁷⁴ Prior to launching a derivative lawsuit, the shareholder plaintiff should request the board of directors to correct the alleged wrongdoings.¹⁷⁵ Now it has been established in MBCA and state rules that the shareholder plaintiff is obliged to make a demand on the board of directors before a derivative claim is initiated.¹⁷⁶

The lenient approach did not continue to dominate in the later development of derivative actions because it gave rise to strike suits.¹⁷⁷ New York became the first state to adopt the 'security-for-expenses' statute, which was enacted to deter strike suits. This rule requires a shareholder or shareholders who do not possess the statutorily required minimum interest in the corporation to post security for expenses, when prosecuting a derivative action.¹⁷⁸ However, this rule did not have the expected effects in the following years. The plaintiffs could easily circumvent it

¹⁷⁰The Model Business Company Act (MBCA) is a model set of law prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association and is followed by twenty-four states. It was created due to variation in how states defined companies after World War II in 1950. The variation and uncertainty resulted in many lawsuits in which a promoter was sued personally for obligations ostensibly incurred in the name of the nascent company. The widespread adoption of the MBCA brought some clarity to such confusion and other corporate law issues. Most states are now guided by the Revised Model Business Company Act (RMBCA), a revised version of the MBCA.

¹⁷¹American Law Institute, *Principle of Corporate Governance: Analysis and recommendations*, St. Paul, Minnesota: American Law Institute Publishers (1994).

¹⁷²Although MBCA and ALI's Principles are not law and have no binding effects, they reveal basic principles and rules of corporate law.

¹⁷³George D. Hornstein, 'The Shareholder's Derivative Suit in the United States', *Journal of Business Law*, (1967), 282–289.

¹⁷⁴In *Dodge v. Woolsey* 18 How. (59 U.S.) 331 (1855), the shareholder plaintiff requested the board of directors to prevent the alleged corporate wrongdoings prior to the filing of the lawsuit. See Xiaoning Li, *A Comparative study of shareholders' derivative actions* (Kluwer, 2007), p. 91.

¹⁷⁵*Dodge v. Woolsey* 18 How. (59 U.S.) 331, 341–344 (1855).

¹⁷⁶Section 7.42 of MBCA and Section 327.4.3 of Delaware General Corporation Law.

¹⁷⁷'Strike suits' refer to claims which were brought without substantial merits in law or in fact, but simply for the benefits from a settlement. See A.J. Boyle, *Minority Shareholders' Remedies*, (Cambridge University Press, Cambridge, 2002), p. 41.

¹⁷⁸Ralph C. Ferrara, Kevin T. Abikoff and Laura Leedy Gansler, *Shareholder derivative litigation: besieging the board*, (Law Journal Seminars-Press, 2013), Section 4.06.

by pleading a federal cause of action.¹⁷⁹ And also, plaintiffs may urge other shareholders to join in the suit in order to satisfy the percentage threshold.¹⁸⁰ Consequently, by the late 1960s there was a revival of derivative actions.¹⁸¹ Between 1956 and 1966 the number of reported derivative actions increased dramatically compared to the previous decade.¹⁸²

During the mid-1970s, in the wake of economic development, the balance between the protection of minority shareholders and the power of corporate management was reconsidered.¹⁸³ As the ‘security-for-expenses’ statute gradually lost its effects in preventing strike suits, a new strategy to prevent the abuse of derivative actions came into play. A special litigation committee consisting of disinterested directors could investigate a plaintiff’s claim and recommend whether the litigation should be brought.¹⁸⁴ It should be stressed that those disinterested directors should not be the defendants of the lawsuit. If all of the directors were named as defendants, the board might appoint outside directors who had no personal financial interest in the challenged transactions to the committee.¹⁸⁵ This strategy was first applied by the Federal District Court of New York in *Gall v. Exxon Corp.*,¹⁸⁶ and later by the Federal Supreme Court in *Burks v. Lasker*¹⁸⁷ and the New York Court of Appeals in *Auerbach v. Bennett*.¹⁸⁸ At present, the ‘special litigation committee’ approach is still being used by many US courts, at state level as well as federal level.

2.3.3.2 The Legal Framework of Derivative Actions in the US

2.3.3.2.1 A Direct Action or a Derivative Action

To determine whether an action is direct or derivative, two questions should be answered: who suffered the alleged injury (the company as a whole or the suing shareholder individually); who would receive the remedies?¹⁸⁹ With regards to

¹⁷⁹American Law Institute (ALI), *Principles of Corporate Governance: Analysis and recommendations*, (American Law Institute Publishers, 1994), S7.04(c), comment at 91.

¹⁸⁰*Ibid.*

¹⁸¹John C. Coffee and Donald E. Schwartz, ‘The Survival of the Derivative Suit: an Evaluation and a Proposal for Legislative Reform’, *Columbia Law Review*, Volume 81(2), 261, pp. 261–262.

¹⁸²Daniel J. Dykstra, ‘The Revival of the Derivative Suit’, *University of Pennsylvania Law Review*, (1967), Volume 116, 74, pp. 74–75.

¹⁸³Xiaoning Li, *A Comparative study of shareholders’ derivative actions: England, the United States, Germany and China*, (Kluwer, 2007), p. 94.

¹⁸⁴Robert C. Clark, *Corporate Law* (Little, Brown, The United States, 1986), p. 645.

¹⁸⁵*Ibid.*

¹⁸⁶418 F Supp 508 (United States District Court, SDNY, D.C.N.Y. 1976).

¹⁸⁷*Burks v. Lasker* 441 U.S. 471 (1979).

¹⁸⁸*Auerbach v. Bennett* 47 N.Y.2d 619.

¹⁸⁹Andreas Cahn and David C Donald, *Comparative Company Law: text and cases on the laws governing corporations in German, the UK and the USA* (Cambridge University Press, Cambridge, New York, 2010), pp. 602–603.

these two questions, the Delaware Supreme Court used a ‘special injury’ test, providing if a shareholder alleged a ‘special injury’, he could bring a direct action.¹⁹⁰ A ‘special injury’ is manifested if the wrong is inflicted only upon the shareholder rather than the company as a whole.¹⁹¹ But the Delaware Supreme Court disregards the ‘special injury’ test and attempts to consider all facts of the complaint because, in some cases, the alleged wrongdoing would be very complicated and just using one simple standard to test it is not sufficient enough.¹⁹²

Sometimes both the company and the individual shareholder suffer an injury at the same time and it is not easy to distinguish one from another. Under this circumstance, an additional criterion should be introduced: to whom the defendant owes the duties?¹⁹³ When the wrongdoers are directors or senior managers of the company, it is particularly important to identify the party to whom the wrongdoers owe the relevant duties since they owe duties to both the company as an entity and each shareholder individually. In consideration of that, if the directors or managers violate such kind of duty, the shareholders may bring a direct action to redress their own injuries, and they can also commence a derivative action on behalf of the company to seek recoveries.¹⁹⁴ For instance, insider trading violates a director’s fiduciary duty owed to the company and a separate duty owed to the shareholder who is selling securities.¹⁹⁵

2.3.3.2.2 Substantial Limitations on the Filing of a Derivative Action

Except for the procedural requirements, the business judgment rule shielding the internal business activities from external interference is a significant substantial restriction on the commencement of a derivative lawsuit. Although the statutory rules do not explicitly indicate that the business judgment rule should be functioned as an exception to the cause of a derivative action, the courts, in fact, hold it as a basic doctrine to avoid judicial interference with the business issues within a company.¹⁹⁶ If the directors and senior officers, performing in good faith and for the company’s interests, still cause losses to the company by their business judgments, they should be exempted from being charged.

¹⁹⁰Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Delaware 2004), at 1038.

¹⁹¹Ibid.

¹⁹²Edward P. Welch, Andrew J. Turezyn and Robert S. Saunders, *Folk on the Delaware General Corporation Law*, (Aspen publishers, 2010), p. 919.

¹⁹³American Law Institute (ALI), *Principles of Corporate Governance: Analysis and recommendations*, (American Law Institute Publishers, 1994), S7.01(c).

¹⁹⁴American Law Institute (ALI), *Principles of Corporate Governance: Analysis and recommendations*, (American Law Institute Publishers, 1994), S7.01(c).

¹⁹⁵Ibid.

¹⁹⁶For example, in *Aronson v. Lewis*, the Delaware court held that ‘it is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company’. *Aronson v. Lewis*, 473 A.2d 805, at 812 (Delaware 1984); The same rule could also be found in *Smith v. Van Gorkom*, 488 A.2d 858, at 872 (Delaware 1985); *Brehm v. Eisner*, 746 A.2d 244, at 264 (Delaware 2000).

2.3.3.2.3 Procedural Requirements on Plaintiffs to Initiate Derivative Actions

2.3.3.2.3.1 The Qualification of Shareholder Plaintiffs

2.3.3.2.3.1.1 The Contemporaneous Ownership Rule

The contemporaneous ownership rule requires that the shareholder plaintiff in a derivative action should be holding shares when the complained transaction is happening, or shareholders entitling to launch a derivative lawsuit should be the ones whose shares were devolved by operation of law (for instance, through succession).¹⁹⁷ The rule is designed to prevent abuse of derivative actions and in particular to avoid the purchasing of shares just in order to maintain a derivative action attacking a transaction that occurred prior to the purchase of the share.¹⁹⁸ However, this rule also creates a dilemma. If a person bought the shares after the misconduct had been committed but before the misconduct was disclosed, does he meet the requirement of contemporaneous ownership rule and is he entitled to commence a derivative action? In practice, this condition is not rare in publicly-held companies for the reason of information asymmetry in capital market.¹⁹⁹ On this issue, the ALI's principles recommends to grant the standing to persons who acquired their shares before the material facts are disclosed to the public.²⁰⁰

When implementing the contemporaneous ownership rule, some states adopt liberal approaches. For instance, Pennsylvania allows a non-contemporaneous shareholder to initiate a derivative action in order to correct serious wrongdoings.²⁰¹ California adopts several exceptions to the application of the contemporaneous ownership rule, such as, a strong *prima facie* case, absence of similar action elsewhere, acquisition of shares before the disclosure of the misconducts.²⁰²

2.3.3.2.3.1.2 The Continuous Ownership Rule

The continuous ownership rule requires the shareholder plaintiff to hold shares in the corporation continuously till the delivery of judgment.²⁰³ Once the plaintiff, for whatever reason, ceases to be a shareholder, he would lose the standing to continue a derivative action.²⁰⁴ This rule is designed to prevent speculative suits and to ensure that the derivative action is brought with merits. However, it may cause problems in certain circumstances such as merger and acquisition. Thus, several states have developed exceptions to this rule. For instance, under Delaware law there are two exceptions to the continuous ownership rule. First, if a merger is

¹⁹⁷Section 327 of Delaware General Corporation Law.

¹⁹⁸*Lewis v. Anderson*, 477 A.2d 1040, at 1046 (Delaware 1984).

¹⁹⁹Stephen M. Bainbridge, *Corporation Law and Economics*, (Foundation Press, New York, 2002), p. 374.

²⁰⁰American Law Institute (ALI), *Principles of Corporate Governance: Analysis and recommendations*, (American Law Institute Publishers, 1994), S7.02(a)(1).

²⁰¹Section 1782(b) of the Pennsylvania Business Corporation Law (PBCL).

²⁰²Section 800 of the California Corporation Code 1977 (CCC).

²⁰³American Law Institute (ALI), *Principles of Corporate Governance: Analysis and recommendations*, (American Law Institute Publishers, 1994), S7.02(a)(2).

²⁰⁴*Lewis v. Anderson*, 477 A.2d 1040, at 1049 (Delaware 1984).

conducted merely to deprive shareholders of standing to bring a derivative action. Second, if the merger is in reality merely a reorganization which does not affect the plaintiff's ownership in the company.²⁰⁵

2.3.3.2.3.2 The Demand Requirement

2.3.3.2.3.2.1 Demand on the Board Requirement

The demand on the board requirement means that a shareholder does not have the right to initiate a derivative action without making a demand on the board first unless he can demonstrate that such a demand is futile. The demand requirement grants the board an opportunity to consider the disputes before the shareholders bring them to the court.²⁰⁶ The rationale of this requirement is largely based on an important principle of company law that the power to manage corporate business, including the power to make a litigation decision, is granted to the board of directors rather than individual shareholders.²⁰⁷ After receiving a demand, the board of the company may respond in three ways: refusing the demand; accepting the demand and allow the litigation to proceed; resolving the matter internally without judicial interference.²⁰⁸

2.3.3.2.3.2.2 Demand Refused Cases

In a demand refused case, the board usually states that the law was not violated and the cause of the derivative action could not be established on tenable grounds. For instance, the exception of business judgment rule. In a vast majority of cases, shareholders may allege that the board made the 'refusal decision' is 'personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgement on behalf of the company, or that their refusal to sue reflects bad faith or breach of trust in some other way'.²⁰⁹ Since whether or not to pursue a claim could also be considered as the board's business judgment, it can only be challenged before a court on the ground that it is irrational. But the interpretation of 'irrational' is greatly subject to the court's discretion. The court will apply its own standard to decide whether the challenge is rational or not. If the shareholder's challenge is successful, the derivative action would then be permitted to proceed.

It needs to be indicated that in the challenge the burden of proof belongs to the shareholder plaintiffs. Normally, they should prove that the directors who made the refusal decision were not independent or disinterested. However, in some states,

²⁰⁵Edward P. Welch, Andrew J. Turezyn and Robert S. Saunders, *Folk on the Delaware General Corporation Law*, (Aspen publishers, 2010), p. 928.

²⁰⁶Blair L. Lockwood and Karen L. Barsch, 'United States', in Dennis Campbell and Sheila Buckley (eds), *Protecting Minority Shareholders*, (Kluwer, 1996), 656, pp. 667–669.

²⁰⁷Xiaoning Li, *A Comparative study of shareholders' derivative actions: England, the United States, Germany and China* (Kluwer, 2007), p. 161.

²⁰⁸Stephen M. Bainbridge, *Corporation Law and Economics*, (Foundation Press, New York, 2002), p. 394.

²⁰⁹Robert C. Clark, *Corporate Law* (Little, Brown, The United States, 1986), p. 644.

(for example Delaware) the inside documents are not available to general shareholders and it is difficult for them to acquire necessary evidence.²¹⁰ For the reason of that, the Delaware law has made effort to facilitate the access to certain corporate books and records for shareholders.²¹¹ New Jersey law allocates the burden of proof to the company's board by requiring it to prove that it was disinterested and independent and the refusal decision was made in good faith and with due care.²¹²

2.3.3.2.3.2.3 Demand Accepted Cases

When a demand is accepted by the board, there will be two possibilities. The first one is the board accepts the demand and prosecutes the action. The other one is that the board intends to solve the issue internally without resorting to the court. In the former situation, the board would notify the shareholders that it plans to take some measures on the demand. Normally, investigations on the complained issues may be conducted by the company thereafter. Then, the company may either go ahead with the lawsuit or make a settlement.²¹³ It should be noted that the parties who attempt to make a settlement must comply with the judicial approval requirement listed in FRCP 23.1 or its relevant state counterparts.²¹⁴ While in the latter case, the company resolves the complained issues through a settlement, and the judicial approval requirement in FRCP 23.1 or its relevant state counterparts does not apply.²¹⁵ One question that might be raised in this regard is when the board accepts the demand and then a settlement is made without resorting to the court, what could the shareholders do if they are not satisfied with the settlement? Generally, shareholders, under this circumstance, are entitled to commence a derivative action on the same ground.²¹⁶

2.3.3.2.3.2.4 Demand Excused Cases

In some cases, the shareholders could commence a derivative action without making a demand on the board.²¹⁷ A typical example in this regard is when the demand is excused as futile, the shareholder could initiate a derivative claim directly.²¹⁸

²¹⁰Deborah A. DeMott, *Shareholder Derivative Actions: Law and Practice*, (Thomson West Press, 2003), Section 5.11.

²¹¹Section 220 of DGCL.

²¹²*In re PSE & G Shareholder Litigation*, 173 N.J. 258, 286, (2002).

²¹³Arthur R. Pinto and Douglas M. Branson, *Understanding Corporate Law* (LexisNexis 3rd edition, 2009), p. 479.

²¹⁴Stephen M. Bainbridge, *Corporation Law and Economics*, (Foundation Press, New York, 2002), p. 394.

²¹⁵*Ibid.*

²¹⁶*Ibid.*

²¹⁷There are several circumstances under which the case could be regarded as 'demand excused'. For instance, among others, the company is threatened with irreparable harm; the company has taken an extraordinarily long period of time and make no responses.

²¹⁸Arthur R. Pinto and Douglas M. Branson, *Understanding Corporate Law* (LexisNexis 3rd edition, 2009). p. 480.

A demand could be futile if the shareholder plaintiff supposes that a fair hearing by the board of the company would not be given upon the demand. For instance, if a majority of directors were involved in the alleged wrongdoing and a sound litigation decision could hardly be made, it would be futile for the shareholder plaintiff to make a demand on the board.

In state law, a widely-accepted doctrine is the Delaware Supreme Court's opinion in *Aronson v. Lewis*,²¹⁹ stating that in deciding whether a demand on the board is futile, two issues should be considered: whether the directors were disinterested and independent; and whether the challenged transaction was a product of a valid exercise of business judgment.²²⁰

The *Aronson* test seems to provide a fairly liberal standard and most of the state law as well as the Federal Rules of Civil Procedure adopt this principle by requiring that a shareholder plaintiff pleading demand futility must plead with particularized facts to prove that the *Aronson* standards have been met.²²¹ For example, if the plaintiff only indicated the facts that the directors were nominated or elected by the defendant, or the majority of the board approved of the challenged transaction, it would not be sufficient to render a demand futility.²²² This requirement to plead with particularized facts indeed imposes a significant burden on the plaintiff because normally the plaintiff is not allowed discovery at this stage.²²³

In the mid-1970s, after a drastic increase in the number of derivative lawsuits, an independent body within company boards (the special litigation committee) was established to make the litigation decision for the company. Generally, a special litigation committee is comprised of two or three directors who were not named as defendants in the litigation.²²⁴ If all of the directors were named as defendants, the board might appoint outside directors who had no personal financial interest in the challenged transactions to the committee.²²⁵ If the special litigation committee decides that the commencement of a derivative action is not in the company's best interest, its decision may have a binding effect.²²⁶

According to the business judgment rule, a litigation decision made by the company or the special litigation committee is considered as business judgment which could be exempted from judicial review. Therefore, such a decision made by the special litigation committee, in nature, bars any derivative action initiated by

²¹⁹*Aronson v. Lewis*, 473 A.2d 805 (Delaware 1984).

²²⁰*Aronson v. Lewis*, 473 A.2d 805, at 814 (Delaware 1984).

²²¹Ralph C. Ferrara, Kevin T. Abikoff and Laura Leedy Gansler, *Shareholder derivative litigation: besieging the board*, (Law Journal Seminars-Press, 2013), Section 6.02.

²²²*Aronson v. Lewis*, 473 A.2d 805, at 814–815 (Delaware 1984).

²²³See Carol B. Swanson, 'Juggling Shareholder Rights and Strike Suits in Derivative Litigation: the ALI Drops the Ball', *Minnesota Law Review*, (1993), Volume 77, 1339, pp. 1376–1377.

²²⁴Robert C. Clark, *Corporate Law* (Little, Brown, 1986) p. 645.

²²⁵*Ibid.*

²²⁶The 'binding effect' will be discussed below.

shareholders.²²⁷ With regards to this issue, it is argued that the decision made by the special litigation committee should not have a binding effect because of the ‘structural bias’ problem.²²⁸ The members of a special litigation committee are normally appointed by the board and have a close relationship with the directors, which makes it difficult for the committee to maintain independence when making litigation decision. They tend to perceive their role ‘as that of a buffer by which to shelter and protect management from hostile and litigious shareholders’.²²⁹ The ‘structural bias’ problem could be proved by the fact that a substantial number of decisions made by the special litigation committee are not to initiate a derivative claim.²³⁰

From the practical perspective, several questions in relation to the ‘structural bias’ problem could also be raised, such as, to what extent should the court defer to the ‘not to sue’ decision made by the special litigation committee; how would the business judgment rule be applied when the court reviews the committee’s decision? If the court adopts a strict approach to review the merits of the case, it may deprive the special litigation committee of the power to decide corporate issues, which is, to a certain degree, not in line with the business judgment rule. On the other hand, if the courts simply stick to the business judgment rule and completely defer to the committee’s decision, the ‘structural bias’ problem cannot be solved. Regarding this issue, there are generally three approaches adopted by state courts.

The first approach entirely adheres to the business judgment rule, which is a loose standard. For example, the New York Court of Appeals in *Auerbach v. Bennett*²³¹ in 1979 (this was a demand-excused case) allowed only minimal review of the committee’s decision.²³² In this case, the court held that the business judgment rule would protect the special litigation committee’s decision from being reviewed by the court.²³³ Only if the plaintiff can demonstrate that the members of the committee were not truly independent and disinterested or that they did not act in good faith or in the company’s best interest, the decision by the committee could be reviewed by the court.²³⁴ In fact, the *Auerbach* approach has been criticized for

²²⁷ John C. Coffee and Donald E. Schwartz, ‘The Survival of the Derivative Suit: an Evaluation and a Proposal for Legislative Reform’, *Columbia Law Review*, (1981), Volume 81, 261, pp. 262–263.

²²⁸ Xiaoning Li, *A Comparative study of shareholders’ derivative actions: England, the United States, Germany and China*, (Kluwer, 2007), p. 169.

²²⁹ John C. Coffee and Donald E. Schwartz, ‘The survival of the derivative suit: an evaluation and a proposal for legislative reform’, *Columbia Law Review*, (1981), Volume 81(2), 261, p. 283.

²³⁰ Ralph C. Ferrara, Kevin T. Abikoff and Laura Leedy Gansler, *Shareholder Derivative Litigation: Besieging the Board*, (Law Journal Seminars-Press, 2013), Section 8.01.

²³¹ *Auerbach v. Bennett*, 47 N.Y.2d 619 (N.Y. 1979).

²³² *Auerbach v. Bennett*, 47 N.Y.2d 619, at 621 (N.Y. 1979).

²³³ *Ibid.*

²³⁴ *Auerbach v. Bennett*, 47 N.Y.2d 619, at 623–624 (N.Y. 1979).

over-deferring to the special litigation committee's decision.²³⁵ It is argued that the courts should employ greater scrutiny to eliminate the 'structural bias' problem.²³⁶

In contrast to the New York approach, the Iowa Supreme Court took a strict approach when reviewing a committee's decision. In *Miller v. Register & Tribune Syndicate, Inc.*,²³⁷ the court held that under no circumstances should the special litigation committee's decision not to sue be deferred to.²³⁸ In the court's point of view, where the majority of the board is incapable of making a litigation decision, it has no authority to delegate such power to a special litigation committee.²³⁹ However, like the New York loose approach, the Iowa approach is also criticized for the reason that it imposes a heavy burden on the court and may waste judicial resources.²⁴⁰

In practice, most states take a position between New York and Iowa. For instance, Delaware adopts a standard indicating that the committee's decision should be deferred to a certain degree, but judicial review should also be conducted when necessary.²⁴¹ The Delaware standard is well illustrated by the *Zapata corporation v. Maldonado*²⁴² case, in which a two-step test was used to review the committee's decision. At the first stage, the court should 'inquire into the independence and good faith of the committee and the bases supporting its conclusions'.²⁴³ In this step, the company should prove that the committee's decision was made independently, with good faith and after reasonable investigation.²⁴⁴ If the court finds that the committee did not meet the above-mentioned requirements, the decision by the committee should be dismissed.²⁴⁵ If the court is satisfied with all the procedural requirements, the case may proceed to the next step.²⁴⁶ At the second stage, the court could, at its discretion, decide whether or not to dismiss the suit.²⁴⁷ In this step, special consideration to matters of law and public policy should be taken by the court.²⁴⁸ Like the two approaches mentioned before, the Delaware approach has also been criticized for granting too much flexibility to the court.²⁴⁹

²³⁵Ralph C. Ferrara et al., *Shareholder Derivative Litigation: Besieging the Board*, (Law Journal Seminars-Press, 2013), Section 8.02.

²³⁶*Ibid.*

²³⁷*Miller v. Register & Tribune Syndicate, Inc.* 336 N.W.2d 709 (Iowa 1983).

²³⁸*Miller v. Register & Tribune Syndicate, Inc.* 336 N.W.2d 709, at 714 (Iowa 1983).

²³⁹*Ibid.*

²⁴⁰Kenneth B. Davis, 'Structural bias, special litigation committee, and the vagaries of director independence', 90 *Iowa Law Review*, (2005), Volume 90, 1035, p. 1041.

²⁴¹*Ibid.*

²⁴²*Zapata corporation v. Maldonado* 430 A.2d 779 (Delaware 1981).

²⁴³*Zapata corporation v. Maldonado* 430 A.2d 779, at 788 (Delaware 1981).

²⁴⁴*Ibid.*

²⁴⁵*Ibid.*

²⁴⁶*Zapata corporation v. Maldonado* 430 A.2d 779, at 789 (Delaware 1981).

²⁴⁷*Zapata corporation v. Maldonado* 430 A.2d 779, at 789 (Delaware 1981).

²⁴⁸*Ibid.*

²⁴⁹Kenneth B. Davis, 'Structural bias, special litigation committee, and the vagaries of director independence', 90 *Iowa Law Review*, (2005), Volume 90, 1035, p. 1045.

2.3.3.2.4 Settlements

The federal rule (FRCP 23.1) provides that derivative actions should not be dismissed or compromised without the approval of the court and that notice of a proposed settlement or dismissal must be given to the shareholders in the manner the court directs.²⁵⁰ Normally, the proponents of a settlement have the burden of convincing the court that the settlement is in the best interests of the company and its shareholders, when the court's hearing is held.²⁵¹

In fact, due to many reasons, a majority of cases are terminated with settlements rather than judgment in the US.²⁵² For instance, the plaintiff's attorney would be strongly inclined to settle rather than go to trial because the first option is less risky for him.²⁵³ For the defendants, they also prefer to reach a settlement rather than to wait for the trial for the reason that most of them are directors or senior officers of a company who are afraid of potential harm to their career and reputation in case of losing. Additionally, if a significant public company loses at trial, people would easily lose confidence in the company and it may negatively affect the share price in the stock market.

In consideration of the reasons indicated before, the settlement is of great importance in a derivative action. It is necessary for the court to hold judicial control over it to a certain degree. However, the standard of such judicial control should be moderate. If the judicial control is too far-reaching, it would essentially deprive litigation parties of the freedom to reach a settlement or compromise. On the other hand, if it is just a procedural device not touching the substantial issues involved in the settlement, it would, like before, not be possible to avoid suspect settlements.²⁵⁴

2.3.3.3 Summary

In the US, both state law and federal law have rules regarding shareholder derivative actions. Although state law concerning derivative lawsuit varies, several principles are generally accepted. For instance, settlement agreements concluded by parties in a derivative lawsuit should be approved by the court in order to prevent suspect agreement and protect the company's interests. With regards to 'standing to sue', shareholders should adhere to 'contemporaneous ownership rule' and

²⁵⁰Section 23.1 of the Federal Rule of Civil Procedure (FRCP).

²⁵¹Robert C. Clark, *Corporate Law* (Little Brown, 1986), p. 657.

²⁵²Robert C. Clark, *Corporate Law* (Little Brown, 1986), p. 652.

²⁵³Through a settlement, the lawyer will get an amount of money for sure. But in a court's trial, the attorney will not be paid in case of losing through a contingency fee arrangement which is widely applied in the US.

²⁵⁴In earlier times, it was not the case that settlements had to be approved by the court. Consequently, many suspect settlements not in the company's best interests occurred. To ensure the company's interests, the judicial control by the courts is introduced in order to eliminate such settlements.

‘continuous ownership rule’ at the same time, meaning that shareholders entitled to initiate a derivative action should hold shares at the time of the complained issue is happening and should hold shares continuously until the judgment is delivered. Demand requirements before a derivative lawsuit is commenced under the U.S. law is also important procedural rules that potential shareholder claimants should notice. For instance, under certain circumstances, demand is not needed if the potential shareholder claimant could prove that the board is not independent and disinterested in the challenged issue.

2.4 Shareholder Class Actions

A particular type of shareholder class action is the litigation brought by shareholders against their company, alleging that the company misrepresents its profitability²⁵⁵ and the shareholders thus purchase stocks at an inflated price.²⁵⁶ When the true profitability of the company is revealed, the stock price plummets.²⁵⁷ In other words, plaintiffs in shareholder class actions (also named ‘securities fraud actions’) sue the company and its officers on behalf of investors who have paid too much for their shares caused by the corporation’s misrepresentation.^{258,259} On top of compensating injured investors and deterring future fraud, shareholder class actions also attempt to improve the functioning of the financial markets.²⁶⁰ However, shareholder class actions are commonly perceived as ‘lawyers-driven’ in nature, meaning that those actions are essentially initiated and controlled by plaintiffs’ lawyers.²⁶¹

²⁵⁵See Patrick M Garry et al., ‘The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform’, *South Dakota Law Review*, (2004), Volume 49(2), 275, pp. 276–277.

²⁵⁶*Ibid.*

²⁵⁷*Ibid.*

²⁵⁸See Adam C. Pritchard, ‘Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers’, *Virginia Law Review*, (1999), Volume 85, 925, p. 928.

²⁵⁹In shareholder class actions, the corporation’s misstatements can take various forms, including fraudulent filings with the Securities and Exchange Commission, public statements by corporate officers, or press releases issued by the corporation. See Patrick M Garry et al., ‘The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform’, *South Dakota Law Review*, (2004), Volume 49(2), 275, pp. 278–279.

²⁶⁰‘Fraud on market’ could jeopardize the stock transaction in free market, and further has negative effect on the whole market system and damage the investors’ confidence. The mechanism of shareholder class actions could, in this regard, prevent the fraud behaviour and moreover protect the interests of investors.

²⁶¹See Patrick M Garry et al., ‘The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform’, *South Dakota Law Review*, (2004), Volume 49(2), 275, pp. 283–285; and see Jill E. Fisch, ‘Class Action Reform: Lessons From Securities Litigation’, *Arizona Law Review*, (1997), Volume 39, 533, pp. 533–534.

2.4.1 *Class Actions in China*

2.4.1.1 A General Overview

The Chinese law allows collective actions (共同诉讼) and representative actions (代表人诉讼). Relevant statutory rules are mainly incorporated in article 53–55 of the Civil Procedure Law (CPL).²⁶² In general, there are basically two types of collective lawsuits: (A) essential collective litigation (必要的共同诉讼)²⁶³; (B) ordinary collective litigation (普通的共同诉讼). The ordinary group litigation can be further divided into two sub-catalogues: (A) representative collective litigation in which the number of litigants is fixed at the time the case is filed (人数确定的代表人诉讼); (B) representative collective litigation in which the number of litigants is not fixed at the time the case is filed (人数不确定的代表人诉讼).

2.4.1.2 Rules Concerning Essential Collective Litigation

Under the CPL, essential collective litigation is a claim where participating parties (two or more persons) are involved in the same disputed matter and thus may not be separated.²⁶⁴ Generally, only certain types of collective actions could be considered as essential collective actions, while others not identified in statutory laws are within the category of ordinary collective litigation.²⁶⁵ Essential collective litigation is, in nature, inseparable, meaning that persons having the same disputed issue

²⁶²The PRC Civil Procedure Law was enacted in 1991. Amendments to the CPR came out in 2007 and 2012 respectively. Provisions with regards to collective actions and representative actions are not changed by these two amendments.

²⁶³In fact, the essential group litigation could also be a representative lawsuit. The act of the representative in the litigation should be valid for the party he represents (except for a few particular acts, e.g. modification or waiver of the claim). See article 53 of the CPL. According to the ‘inseparable’ nature of essential group actions, group members who do not agree with the result of the representative selection should join in the whole procedure personally. See article 60 of the Opinions of the Supreme People’s Court on Some Issues Concerning the Application of the Civil Procedure Law of the PRC (最高人民法院关于适用中华人民共和国民事诉讼法若干问题的意见).

²⁶⁴See Xiaoming Xi (ed), Annotations to the Provisions in the New Civil Procedure Law (新民事诉讼法条文释义), (3rd edition, Beijing: People’s Court Press 2010).

²⁶⁵The type of cases that could be regarded as essential group litigation are listed in art 43, 46, 47, 50, 52, 55 and 56 of the Opinions and in art 124 to 128 of the Judicial Interpretation of the Supreme People’s Court on Some Issues Regarding the Application of Security Law of the PRC (最高人民法院关于适用中华人民共和国担保法若干问题的解释). For example, litigation arising from joint credit or joint liability; litigation arising from joint succession property. And see Michael Palmer and Chao Xi, ‘Collective and representative actions in China’, National Report to the University of Oxford Centre for Social-Legal Studies and Stanford Law School Joint Project on the Globalization of Class Actions. (2007), p. 3.

should jointly sue or be sued.²⁶⁶ If one or some members of them refuse to join in an essential collective action, the lawsuit cannot be initiated. By contrast, parties in an ordinary collective action have claims concerning disputed matters of the same kind instead of ‘the same disputed matter’. In an essential collective action, aggregated parties have to select one or several representatives through the consent of all members.²⁶⁷ If a member is not satisfied with the selected representative(s), under Chinese rules he still needs to join the action, but as a separate party to the proceedings.²⁶⁸ In addition to that, the inseparability of an essential collective action is also reflected in the provision that there should be just one final outcome of the case (a judgment or a settlement).²⁶⁹

2.4.1.3 Rules Concerning Ordinary Collective Litigation

Unlike essential collective actions, ordinary collective litigation is ‘separable’. Aggregated parties are not treated as an integrated group. Instead, joint parties in an ordinary collective action do not rely on each other, and each group member could commence a claim respectively. Combining their claims together as a collective one is, perhaps, in order to increase judicial efficiency. The CPL suggests that one or several representatives could be selected to represent the whole litigation group. On this issue, if a consensus could not be reached, the representative would be determined by the court through consultation with the group members.²⁷⁰ It should be stressed that under the CPL, the act of the representative in ordinary collective litigation would be valid for all persons he represents (except for a few particular acts, e.g. modification or waiver of the claim).²⁷¹

2.4.1.3.1 The Fixed-Member Representative Collective Litigation

The fixed-member representative collective litigation refers to a lawsuit where all group members have been confirmed when the lawsuit is filed with the court. The number of group member is generally ‘large’ (The *Opinions* provides that

²⁶⁶In fact, essential group litigation could be divided into two categories: the positive essential group litigation and the passive essential group litigation. The former one means that two or more persons joint together to sue a single defendant, while the latter one indicates that two or more defendants are jointly sued by a single plaintiff.

²⁶⁷See article 53 of the CPL, and article 60 of the Opinions of the Supreme People's Court on Some Issues Concerning the Application of the Civil Procedure Law of the PRC (最高人民法院关于适用中华人民共和国民事诉讼法若干问题的意见).

²⁶⁸See article 60 of the Opinions of the Supreme People's Court on Some Issues Concerning the Application of the Civil Procedure Law of the PRC (最高人民法院关于适用中华人民共和国民事诉讼法若干问题的意见).

²⁶⁹In an ordinary group action, the final result (the judgment or the settlement) could vary from one member to another. See Xiaoming Xi (ed), Annotations to the Provisions in the New Civil Procedure Law.

²⁷⁰See article 54 (2) of the CPL.

²⁷¹See article 53 of the CPL.

‘large’ number means ten or more than ten persons).²⁷² In such cases, two to five representatives could be selected to represent the whole group to participate the court proceeding.²⁷³

2.4.1.3.2 The Unfixed-Member Representative Collective Litigation

‘Unfixed-member representative collective litigation’ refers to a lawsuit where not all group members have been confirmed when the lawsuit is filed with the court. The general procedure of an unfixed-member representative collective action is that the court handling the lawsuit issues a notice, specifying the circumstances of the lawsuit and instructing all persons whose interests are similarly affected to come forward and register with the court within a given period (the period should generally not be less than 30 days).²⁷⁴ Potential participants who intend to register with the court should demonstrate that their interests have been similarly affected and they have suffered damage as a result.²⁷⁵ Persons failing to do so can launch independent claims with the same or similar cause of action within (around) 2 years.²⁷⁶ The court’s final decision on an unfixed-member representative collective has binding effect on all registered group members.²⁷⁷ The court’s decision is also valid for those people who do not register with the court but bring similar claims as indicated above.²⁷⁸

2.4.1.4 Rules and Practice Regarding Collective Litigation Arising from Securities Fraud

The main question in this regard is which sort of collective action can be used when a securities fraud action is filed with the court (an essential collective action, a fixed-member representative collective litigation, or an unfixed-member representative collective litigation). To answer this question, we should first give a brief introduction to the development of securities fraud litigation in China.

On 20 September 2001, 363 disgruntled investors in the York point Science & Technology Co (亿安科技) (a Chinese listed company) simultaneously filed lawsuits with Intermediate People’s Courts in Beijing, Shanghai and Guangzhou, alleging large-scaled market manipulation by the company. But unfortunately, courts in Beijing, Shanghai and Guangzhou refused to accept the *York point* case for the reason that on 21 September 2001, the Supreme People’s Court (SPC) issued

²⁷²See article 59 of the CPL Opinions.

²⁷³See article 62 of the CPL Opinions.

²⁷⁴See article 55 of the CPL, and article 63 of the CPL Opinions.

²⁷⁵See article 64 of the CPL Opinion.

²⁷⁶See article 135 of General Principles of the Civil Law of the People’s Republic of China (中华人民共和国民法通则, ‘zhonghua renmin gongheguo minfa tongze’).

²⁷⁷See article 54 (4) of the CPL.

²⁷⁸*Ibid.*

a temporary notice (SPC 2001 notice) to instruct lower courts not to accept private securities lawsuits.²⁷⁹

This temporary bar set by SPC received heavy criticism. It was stated that the court's refusal to private securities fraud cases would fundamentally harm the development of the Chinese stock market and damage investors' confidence.²⁸⁰ In January 2002, the SPC lifted the temporary bar to allow lower courts to accept private securities litigation in which the cause of the case was false statements (SPC 2002 notice).²⁸¹ On top of that, in January 2003, SPC further issued interpretations (SPC 2003 interpretation) to provide specific guidance on the trial of private securities lawsuits.²⁸²

The 2002 Notice ruled out the use of a group action (集团诉讼), which is largely equivalent to the unfixed-member representative collective litigation under Chinese law, to establish a private securities fraud lawsuit arising from false statements.²⁸³ It further provides that injured investors are allowed to sue the company individually or collectively.²⁸⁴ In addition to that, the 2003 interpretation suggests that injured investors could bring a fixed-member representative collective action to redress the losses caused by the company's false statements,²⁸⁵ but the number of the plaintiffs must be ascertained before the commencement of the trial.²⁸⁶ Furthermore, the 2003 interpretation also stipulates that the court may require individual claimants to join other aggrieved investors who choose to sue collectively.²⁸⁷ The court may also choose to combine several collective claims (brought by different groups of victimized investors arising from the same false statement) into one single collective action.²⁸⁸ With regards to representatives in securities fraud actions, the 2003 Interpretation expands the scope of representative's delegation power to a wider extent, including, such as, the power of modification or waiver of the claim that is

²⁷⁹The Supreme People's Court: *Notice of the Supreme People's Court on Refusing to Accept Civil Compensation Cases Involving Securities For the Time Being* (关于涉证券民事赔偿案件暂不予受理的通知).

²⁸⁰See Bin Luo, *Researchs on Securities Class Actions*, (Law Press, China, 2011); and see Ren Zili, *Securities Class Actions: International Experience And China's Way Out*, (Law Press, China, 2008).

²⁸¹The Supreme People's Court: *Notice of the Supreme People's Court on the Relevant Issues concerning the Acceptance of Cases of Disputes over Civil Tort Arising from False Statement in the Securities Market* (关于受理证券市场因虚假陈述引发的民事侵权纠纷案件有关问题的通知) (2002).

²⁸²The Supreme People's Court: *Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market*, (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) (2003).

²⁸³See article 4 of the 2002 Notice.

²⁸⁴See article 4 of the 2002 Notice and article 12 of the 2003 Interpretation.

²⁸⁵See article 13 of the 2003 Interpretation.

²⁸⁶See article 14 of the 2003 Interpretation.

²⁸⁷See article 13 of the 2003 Interpretation.

²⁸⁸*Ibid.*

not authorized by the CPL.²⁸⁹ But the rule in the 2003 interpretation concerning the representative's power contradicts with the articles regarding lawyer's power in civil litigation in the CPL. Considering the hierarchy system of Chinese law, the level of the CPL is higher than that of the 2003 Interpretation, meaning that the power held by representatives in securities fraud litigation should be in line with the provisions under the CPL. In light of that, the power to approve certain issues (for instance, modification or waiver of the claim, admission of the claim of the other party) still remains with all group members rather than the representatives. But in reality, injured investors in securities fraud actions are widely dispersed, making it difficult to gather consent from all of the members to authorize delegation power to the representatives. In consideration of the practical difficulty, it is suggested that the power to determine special issues would better to be remained with litigation representatives instead of the widely-dispersed victimized investors, provided that the representatives always act for the best interests of the group.

2.4.2 *Class Actions in the United Kingdom*

Even though the UK has certain forms of collective litigation, there are no specific shareholder class actions (securities fraud litigation).²⁹⁰

²⁸⁹See article 15 of the 2003 Interpretation and article 53 of the CPL.

²⁹⁰Actually the British law adopts procedures by which claimants with similar claims may group together to bring collective claims against the same defendants (Part 19 of the Civil Procedure Rule UK). Under the Civil Procedure Rules (CPR), two types of collective actions could be brought by claimants. One is a group litigation order (GLO) made by the court, which permits a number of claims concerning common or related issues to be managed collectively (Part 19 of the Civil Procedure Rule UK). Under the GLO mechanism, once it is issued, a register of group claims must be established, and a court which will manage the claims (the management court) has to be specified as well [19.11 (2) (a) and 19.11 (2) (c) of the Civil Procedure Rule, and its Practice Direction 19B (6)]. The other approach is through representative actions. Under this mechanism, a claim where more than one person has the same interests could be begun or continued by representatives selected from this group of persons (Part 19 II of the Civil Procedure Rule). In a representative proceeding, any order of the court is binding on all persons represented in the claim (19.6 of the Civil Procedure Rule). In fact, the mechanism of representative actions is infrequently used in the UK because of narrow interpretations by the courts. Theoretically, the mechanism of representative actions allows a person to take legal action on behalf of persons who had 'common issues' arising from 'the same interest' in a claim against the same defendant. But the 'same interests' requirements has proven to be the most problematic aspect of the rule. Much of its controversy arises from the meaning of 'same interests' (See Rachel Mulheron, *The Class Action in Common Law Legal System, a Comparative Perspective*, Hart Publishing 2004, p. 78). A relatively broad interpretation of representative litigation was given in the House of Lords decision *Duke of Bedford v. Ellis* in 1901. In this case, Lord MacNaughten held that the requirement of 'the same interest' is satisfied if the representative can show a common interest or common grievance and that the relief sought is beneficial to all. However, in a series of later cases, the requirement of common interest was used to give the rule a more restrictive application. And representative proceedings were therefore not available where the sole relief sought involved

2.4.3 *Class Actions in the United States*

2.4.3.1 Rules 23 of the Federal Rules of Civil Procedure

2.4.3.1.1 Rule 23(a)

In the US, all sorts of class actions in the federal courts are governed by Rule 23 of the Federal Rules of Civil Procedure.²⁹¹ Rule 23(a) sets out four preconditions that need to be met before the commencement of a class lawsuit:

- (1) the class is so numerous that joinder of all members is impracticable;
- (2) there are questions of law or fact common to the class;
- (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class; and
- (4) the representative parties will fairly and adequately protect the interests of the class.

(Footnote 290 continued)

damages: these would have to be proved individually (Edward F. Sherman, 'Group Litigation under Foreign Legal Systems: Variations and Alternatives to American Class Actions', *DePaul Law Review* (2003) Volume 52, 401, p. 422). In the framework of representative lawsuits, damages cannot be awarded without reference to the particular loss suffered by members of the class (see Neil Andrews, 'Multi-Party Proceedings in England: Representative and Group Actions', *Duke Journal of Comparative and International Law* (2001) Volume 11, 249, p. 253). These limitations on damages awards were reflected in case laws. For example, in *E.M.I. Records Ltd. v. Riley*, the court indicated that the damages in a representative claim could be awarded only when '(1) the class members' losses can be readily ascertained at the time of the judgment; (2) the class members have waived their rights to individual receipt of damages and wish their compensation to be paid to a body enjoying care of their interests' [*E.M.I. Records Ltd. v. Riley*, 1 W.L.R. 923 (Ch. 1981)]. Given the shortcomings of English representative claims and their practical difficulties, amendments to CPR were made in 2000 to permit the use of GLOs in order to facilitate case management for claims concerning related issues of fact or law. In a GLO, each individual claimant has to start his own proceeding, and parties who want to join in the group must choose to 'opt in' [19.11 (2) (a) of the Civil Procedure Rule, and its Practice Direction 19B (6.2)]. It means that litigants have to choose affirmatively to litigate by entering their names on the group register [19.11 (3) (a) of the Civil Procedure Rule, however, claimants can apply for their claims to be removed from the register, see 19.14 (a) of the CPR]. For the management court, the scope of its power ranges over a wide field. For example, it may vary the GLO issues, it may appoint the solicitor of one or more parties to be the lead solicitor for the claimants or defendants (19.13 of the Civil Procedure Rule). In addition, any judgment or order given on a GLO issue is binding upon other parties on the group register, and the court may give directions as to the extent to which that judgment or order is binding on the parties to any claim which is subsequently entered on the group register [See 19.12 (1) of the Civil Procedure Rule]. Moreover, the management court may give directions for the trial of common issues as well as the trial of individual issues, and the latter ones may be heard from another court whose locality is convenient for the parties [Practice Direction 19B (15.1 and 15.2)]. In October 2015, the US-style class action was introduced into UK by the Consumer Rights Act 2015, making it far easier for groups of consumers to seek compensation from firms that have fixed prices and formed cartels.

²⁹¹ There are several typical categories of class actions in the US. For example, shareholder class actions, consumer class actions.

These four prerequisites are often referred to as *numerosity, commonality, typicality, and adequacy of representation*.^{292,293}

2.4.3.1.2 Rule 23(b)

An additional requirement set in Rule 23(b) is that the action must fall within the categories specifically indicated in Rule 23(b). This rule has three subdivisions, and the first subdivision Rule 23(b)(1) is further broken down into two parts: Rule 23(b)(1)(A) and Rule 23(b)(1)(B). The first part permits a class action when the prosecution of separate actions by class actions would create a risk of creating incompatible standards of conduct generated by individual adjudications. For instance, an action to enjoin state officers from terminating unemployment compensation without a hearing.²⁹⁴

As for the second part [Rule 23(b)(1)(B)], it permits a class lawsuit when individual litigation would impair the ability of class members to protect their rights and interests. For example, when a defendant's fund is too limited to financially afford the claims brought by many individual claimants.²⁹⁵

Rule 23(b)(2) provides that a class may be certified when a party opposing the class has acted (or refused to act) by the same way to a definable group, thus a final injunctive relief or corresponding declaratory relief is appropriate to be delivered to the class as a whole.

The last division of Rule 23 is the most common ground on which to base a class lawsuit. In practice, most class actions claiming monetary compensations are brought under Rule 23(b)(3).²⁹⁶ This rule provides that, in addition to the criterion provided in Rule 23(a), a class action must meet two further requirements set out in this subdivision. First, do the common issues 'predominate' over issues affecting

²⁹²See Robert H. Klonoff, Edward K.M. Bilich and Suzette M. Malveaux, *Class Actions and Other Multi-Party Litigation: Cases and Materials*, (Second Edition, Thomson/West 2006), pp. 68–70. Janet Cooper Alexander, 'An Introduction to Class Action Procedure in the United States', Presented Conference: Debates over Group Litigation in Comparative Perspective, Geneva, Switzerland, (July 21–22, 2000), pp. 4–5.

²⁹³As a matter of fact, these four requirements are key battleground in the grant of class certification. For instance, the 'numerosity' requirement. What should the court take into consideration when assessing whether or not the class meets this requirement? Does it mean that the court only needs to focus on the number? In fact, some courts have emphasized that it is wrong to focus on numbers alone. 'Sometimes, joinder may be impracticable even where the relative size of the potential class is small', *Hernandez v. Alexander*, 152 F.R.D. 192, 194 (D.Nev.1993). It is indicated that the court must look at numbers as well as 'all other relevant factor'. See Robert H. Klonoff, Edward K.M. Bilich and Suzette M. Malveaux, *Class Actions and Other Multi-Party Litigation: Cases and Materials*, (Second Edition, Thomson/West 2006), pp. 78–82.

²⁹⁴*Crow v. California Department of Human Resources*, 325 F. Supp. 1314 (N.D.Cal. 1970).

²⁹⁵See Robert H. Klonoff, Edward K.M. Bilich and Suzette M. Malveaux, *Class Actions and Other Multi-Party Litigation: Cases and Materials*, (Second Edition, Thomson/West 2006), pp. 166–167.

²⁹⁶Janet Cooper Alexander, 'An Introduction to Class Action Procedure in the United States', Presented Conference: Debates over Group Litigation in Comparative Perspective, Geneva, Switzerland, (July 21–22, 2000), pp. 4–5.

only individual members?²⁹⁷ Second, is class treatment of an action ‘superior’ to other alternatives for adjudicating the controversial issue?²⁹⁸

For the first ‘predominate’ requirement, the Advisory Committee pointed out that only where the questions common to the class predominate over the questions affecting individual members, is it possible to achieve the economies that the device of class action pursues.²⁹⁹ It further suggests that the predominance analysis involves a two-stage test:

First, once the threshold determination has been made that common questions predominate sufficiently to support overall class treatment; second, the predominance criterion acts as a guide to the judge in molding and defining the class.It is appropriate to consider simply the degree to which the common questions may be decisive of the issues to be dealt with in the separate phase of the action, in order to judge the efficiency of the arrangement.³⁰⁰

In addition to predominance, Rule 23(b)(3) requires the court to assess whether the class treatment is ‘superior to other available methods for fairly and efficiently adjudicating the controversy’. In determining the superiority, the court needs to consider the factors listed in Rule 23(b)(3)(A)–(D):

- (A) the class members’ interests in individually controlling the prosecution or defense of separate actions;
- (B) the extent and nature of any litigation concerning the controversy already begun by or against class members;
- (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and
- (D) the likely difficulties in managing a class action.

For example, when the individual damages are too small for individual lawsuits to be economically feasible, an aggregated class action is superior to other methods of handling such claims.³⁰¹ However, by contrast, cases involving mass accidents or mass torts (for instance, birth defects caused by prescription drugs, tobacco-related diseases caused by smoking) are not considered suitable for class actions.³⁰²

²⁹⁷John Bronsteen and Owen Fiss, ‘The Class Action Rule’, *Notre Dame Law Review* (2002), Volume 78, 1419, pp. 1423–1424; Robert H. Klonoff, Edward K.M. Bilich and Suzette M. Malveaux, *Class Actions and Other Multi-Party Litigation: Cases and Materials*, (Second Edition, Thomson/West 2006), p. 245.

²⁹⁸*Ibid.*

²⁹⁹Notes of Advisory Committee on Rules—1966 Amendment, available at http://www.law.cornell.edu/rules/frcp/rule_23 (accessed on 21 July 2016).

³⁰⁰See James William Moore *et al*, *Moore’s Federal Practice*, para 23.45(2), at 323–333, (third edition, 1997).

³⁰¹Janet Cooper Alexander, ‘An Introduction to Class Action Procedure in the United States’, Presented Conference: Debates over Group Litigation in Comparative Perspective, Geneva, Switzerland, (July 21–22, 2000), p. 5.

³⁰²*Ibid.*

2.4.3.1.3 Rule 23(c) (Class Certification)

This rule directs the court to determine whether the case could be maintained (certified) as a class action. The judge needs to give its permission, as it were, for the case to proceed as a class action. This is called certification. Certification should take place ‘at an early practicable time’ after the case is filed.³⁰³ The ‘early practicable time’ indicated the moment when the court has sufficient information to decide whether or not the case meets the requirements listed in Rule 23(a) and 23(b).³⁰⁴

If the court decides the action could be maintained as a class lawsuit, the certification must be delivered to class members.³⁰⁵ The key factor in the court’s notice is the ‘opt-out’ right for class members. Rule 23(c)(2)(B)(v) provides that in a class action permitted according to Rule 23(b)(3), the members have the right to choose not to take part in the class (to “opt out” of the class). Those who do not opt out will be bound by the effects of the court’s judgement or settlement reached between two parties.

2.4.3.1.4 Rule 23(e) (Class Action Settlements)

This rule provides that no class action could end in settlement unless the court approves the settlement agreement.³⁰⁶ Sometimes, the settlement agreement is reached even before the class is certified.³⁰⁷ Under this circumstance, the settlement agreement still needs to be approved by the court. In addition to applying the criteria listed in Rule 23(e) about the approval of settlement agreement, the court also needs to make sure that the class meets the conditions for certification.³⁰⁸ However, this issue has been debated, for many years, by courts and commentators whether the strict requirements for certifying a class action for litigation purpose need also to be applied in the situation that the certification is sought only for validating a settlement agreement.³⁰⁹ On this issue, the federal law and some state law adopt different approaches. The former one requires that except for the requirement that the court should consider ‘the likely difficulties in managing a class action’, all requirements for certifying a litigation class listed in Rule 23(b)(3) should be applied for the approval of a class settlement agreement.³¹⁰ However,

³⁰³The term ‘At an early practicable time’ takes place of the previous term ‘as soon as practicable’ after the 2003 amendment.

³⁰⁴See Robert H. Klonoff, Edward K.M. Bilich and Suzette M. Malveaux, *Class Actions and Other Multi-Party Litigation: Cases and Materials*, (Second Edition, Thomson/West 2006), p. 311.

³⁰⁵Rule 23(c)(2) of Federal Rules of Civil Procedure.

³⁰⁶Rule 23(e) of Federal Rules of Civil Procedure.

³⁰⁷American Law Institute, *Principles of the Law: Aggregate Litigation*, (American Law Institute Publishers, 2010), pp. 212–213; John Bronsteen and Owen Fiss, ‘The Class Action Rule’, *Notre Dame Law Review* (2002), Volume 78, 1419, p. 1443.

³⁰⁸John Bronsteen and Owen Fiss, ‘The Class Action Rule’, *Notre Dame Law Review* (2002), Volume 78, 1419, p. 1443.

³⁰⁹American Law Institute, *Principles of the Law: Aggregate Litigation*, (American Law Institute Publishers, 2010), p. 213.

³¹⁰*Ibid.*

some state law adopts a relaxed approach where strict requirements for certifying a class action are not used for the approval of settlement agreement.³¹¹

In the court's approval of settlement of a case which is certified according to Rule 23(b)(3), the opt-out rule is also applicable.³¹² In the context of the approval of class action settlement, it is called a second opt-out opportunity. Under this rule, the class members have an opt-out right to leave the class if the content of the settlement agreement does not satisfy them.³¹³ But this rule has not exerted a substantial effect and is only applied as a matter of discretion by the court.³¹⁴ In fact, few courts have ordered such second opt-out right.³¹⁵

2.4.3.1.5 Rule 23(g) and (h) (The Class Counsel and Attorney's Fees in Class Actions)

According to Rule 23(g), the court normally appoints class counsel when the class is certified after considering several relevant factors.³¹⁶ In general, the court must select the counsel who can best represent the interests of the class when there is more than one applicant.³¹⁷ The selection criteria include, among others, counsel's experience in handling class actions and counsel's knowledge of the applicable law.³¹⁸

To fund a class action, a contingency fee arrangement is not commonly used.³¹⁹ Rather, the 'common fund doctrine'³²⁰ is of significant importance in financing class actions, where attorneys in a successful class action could collect reasonable

³¹¹For example, La. Code Civ. Proc. Ann. art. 591(B)(4) (1997), see American Law Institute, *Principles of the Law: Aggregate Litigation*, (American Law Institute Publishers, 2010), pp. 213–216.

³¹²Rule 23(e)(4) of Federal Rules of Civil Procedure.

³¹³The first opt-out right appears in the certifying procedure of a class action, see Rule 23(c)(2)(B)(v) of Federal Rules of Civil Procedure.

³¹⁴American Law Institute, *Principles of the Law: Aggregate Litigation*, (American Law Institute Publishers, 2010), p. 242.

³¹⁵See for instance, *Denney v. Deutsche Bank AG*, 2006 WL 845727, at 12 (2d Cir. Mar. 31, 2006); and see *Hicks v. Morgan Stanley & Co.*, 2005 U.S. Dist. LEXIS 24890, at 17 (S.D.N.Y. Oct. 24, 2005); and see *In re Visa Check/Mastermoney Antitrust Litig.*, 297 F. Supp. 2d 503, 518 (E.D.N.Y. 2003). In all those cases, the second opt-out rights are denied by the courts. For more, see Robert H. Klonoff, Edward K.M. Bilich and Suzette M. Malveaux, *Class Actions and Other Multi-Party Litigation: Cases and Materials*, (Second Edition, Thomson/West 2006), pp. 706–707.

³¹⁶Rule 23(g)(1)(2) of Federal Rules of Civil Procedure.

³¹⁷Rule 23(g)(2) of Federal Rules of Civil Procedure.

³¹⁸The issues must be taken into consideration and may be considered by the court when such a selection is made are incorporated in Rule 23(g)(1)(A) and Rule 23(g)(1)(B) of Federal Rules of Civil Procedure.

³¹⁹Janet Cooper Alexander, 'An Introduction to Class Action Procedure in the United States', Presented Conference: Debates over Group Litigation in Comparative Perspective, Geneva, Switzerland, (July 21–22, 2000), p. 10; and also see Rachael Mulheron, *The Class Action in Common Law Legal Systems: a Comparative Perspective*, (Hart Publishing, 2004), pp. 469–470.

³²⁰The common fund doctrine was endorsed for federal class actions in *Boeing Co. v. Van Gemert*, 444 U.S. 472 (1982).

fees from the entire monetary remedies after the court's discretion.³²¹ If the claim is lost (no common fund is generated), the class counsel get no fees.

2.4.3.2 Securities Fraud Actions in the US

In the US, most shareholder class actions (securities fraud litigation) are substantially based on fraud as provided in section 10 (b) of the Securities Exchange Act of 1934 (15 U.S.C S78j) implemented by Securities Exchange Commission Rule 10b-5. The Private Securities Litigation Reform Act 1995 introduced several procedural rules to combat abuses or practical difficulties in securities class litigation.³²² In order to establish a securities class action under Rule 10b-5, a plaintiff has to prove that a defendant made a misrepresentation of material fact, upon which the plaintiff justifiably relies.³²³ The plaintiffs should suffer financial losses when transacting stocks, which is directly caused by the company's misstatement.³²⁴ Empirical research demonstrates that securities class actions have been widely applied in the US, with a total number of 3641 filings between 1 Jan 1996 and 30 June 2013.³²⁵

2.4.3.3 The Private Securities Litigation Reform Act of 1995 (The PSLRA 1995)

The PSLRA 1995 imposed restrictions on private securities actions by aiming at preventing frivolous securities class actions, which were filed by lawyers desiring high amounts of lawyers' fees.³²⁶ In Congress's views, the biggest winners in

³²¹In practice, the successful lawyer must submit a request to the court to claim reasonable lawyer's fees, which are paid out of the class compensation (the common fund).

³²²See Robert H. Klonoff, Edward K.M. Bilich and Suzette M. Malveaux, *Class Actions and Other Multi-Party Litigation: Cases and Materials*, (Second Edition, Thomson/West 2006), pp. 996–997. See Donna M. Nagy, Richard W. Painter and Margaret V. Sachs, *Securities Litigation and Enforcement: Cases and Materials*, (Thomson/West 2003), pp. 2–11.

³²³Securities Exchange Commission Rule 10b-5.

³²⁴*Ibid.*

³²⁵The Stanford Law School Securities Class Action Clearinghouse in cooperation with Cornerstone Research has identified this figure, available at <http://securities.stanford.edu> (accessed on 11 August 2016).

³²⁶Patrick M. Garry, Candice Spurlin, Debra A. Owen, William A. Williams and Lindsay J. Efting, 'The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform', *South Dakota Law Review*, (2004), Volume 49(2), 275, pp. 281–282; and see Jill E. Fisch, 'Class Action Reform, Qui Tam, and the Role of the Plaintiff', *Law and Contemporary Problems*, (1997), Volume 60, 167, p. 168; and see Susan P. Koniak and George M. Cohen, 'Under Cloak of Settlement', *Virginia Law Review*, (1996), Volume 82, 1051; and see Jonathan R. Macey and Geoffrey P. Miller, 'The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform', *University of Chicago Law Review*, (1991), Volume 58, 1.

securities class actions appear to be plaintiffs' lawyers because they can simply facilitate settlements and collect lawyers' fees.^{327,328} The PSLRA 1995 provides a 'safe harbour' standard, authorizing three independent bases for dismissals of fraud actions involving forward-looking statement.³²⁹ The first ground is based on the Bespeaks Caution Doctrine, requiring that forward-looking statements should be 'identified as a forward-looking statement, and be accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.'³³⁰ The second ground provides that forward-looking statements should be 'immaterial' as a matter of law.³³¹ And the third ground authorizes the dismissal when the plaintiff fails to prove that a forward-looking statement is made 'with actual knowledge' by the defendant.³³²

The PSLRA 1995 brought new procedural requirements in securities fraud actions. For example, the selection of a lead plaintiff.³³³ This procedural change was aimed at preventing 'professional plaintiffs', who own a few shares of stock in a large number of companies just for the purpose of attaching their names to the issues complained, from being lead plaintiffs in securities class actions.³³⁴ Congress worried that class action lawyers would 'hire' professional plaintiffs to be lead plaintiffs, thereby encouraging frivolous litigation just for high lawyers' fees.³³⁵ The PSLRA designed new provisions against 'professional plaintiffs'.³³⁶ The most important rule probably is normally the court will appoint a class member with the highest monetary stake in the case as the lead plaintiff. Another rule is that, during a three-year period, the same lead plaintiffs are not allowed to act in this role in more than 5 class actions.³³⁷ Lead plaintiffs are required to file a sworn certification

³²⁷See Donna M. Nagy, Richard W. Painter and Margaret V. Sachs, *Securities Litigation and Enforcement: Cases and Materials*, (Thomson/West 2003), p. 9.

³²⁸Moreover, Professor John C. Coffee's article states that 'The present structure of securities class actions benefits a trio of interest groups—corporate officials, plaintiff's attorneys, and insurers but not shareholders'. See John C. Coffee, 'Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation', *Columbia Law Review*, (2006), Volume 106(7), 1534, p. 1535.

³²⁹See Section 21(E)(c) of the PSLRA 1995.

³³⁰See Section 21E(c) (1) (A) (i) of the PSLRA 1995.

³³¹See Section 21E(c) (1) (A) (ii) of the PSLRA 1995.

³³²See Section 21E(c) (1) (B) of the PSLRA 1995.

³³³See Section 27 (a) (3) of the PSLRA 1995.

³³⁴See R. Chris Heck, 'Conflict and Aggregation: Appointing Institutional Investors as Sole Lead Plaintiffs Under the PSLRA', *University of Chicago Law Review*, (1999), Volume 66(4), 1199, p. 1202.

³³⁵See the House of Congress Report, *Securities Litigation Reform*, (No. 104-369), (1995), p. 31.

³³⁶See Donna M. Nagy, Richard W. Painter and Margaret V. Sachs, *Securities Litigation and Enforcement: Cases and Materials*, (Thomson/West 2003), p. 398.

³³⁷See Section 27 (a) (3) (B) (vi) of the PSLRA 1995.

stating that—the plaintiff has reviewed the complaint and authorized its filing. The plaintiffs, if necessary, are required to provide testimony at deposition and trial.³³⁸

2.4.3.4 The Problematic Role of Plaintiffs' Lawyers in Securities Class Actions

An important criticism of American securities fraud actions relies on the allegedly problematic role of plaintiffs' lawyers.³³⁹ In practice, it is common that each class member is only compensated with a small fraction of their monetary losses through a settlement or a judgment in favour of him, while plaintiffs' lawyers appear to be the biggest winners in class litigation.³⁴⁰ A survey conducted by the National Economic Research Associates (NERA) in this regard reveals that damages paid to class members just amounted to approximately 5% of their losses.³⁴¹ It was once indicated plaintiffs' lawyers, in practice, face little scrutiny of their performance on behalf of class members because the group of plaintiffs in class actions are, in most cases, 'diffuse and unorganized'.³⁴²

As a matter of fact, the 'lawyers-driven' procedure is not unique to class actions, but could also be found in any sort of litigation on account of the existence of the divergent interests between lawyers and the clients.³⁴³ The concern of 'lawyer-driven' procedure might be further enhanced by the fact that procedures in securities fraud class actions are on average much more complicated than simple civil lawsuits (for instance, contract disputes).³⁴⁴ For this reason, the role of

³³⁸Section 21D (a) (2) (A) (i) to 21D (a) (2) (A) (vi) lists several requirements for the certification of the lead plaintiff.

³³⁹Patrick M. Garry, Candice Spurlin, Debra A. Owen, William A. Williams and Lindsay J. Efting, 'The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform', *South Dakota Law Review*, (2004), Volume 49(2), 275, pp. 276–278; see Jill E. Fisch, 'Class Action Reform, Qui Tam, and the Role of the Plaintiff', *Law and Contemporary Problems*, (1997), Volume 60, 167, pp. 169–170; Susan P. Koniak and George M. Cohen, 'Under Cloak of Settlement', *Virginia Law Review*, (1996), Volume 82, 1051; and see Jonathan R. Macey and Geoffrey P. Miller, 'The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform', *University of Chicago Law Review*, (1991), Volume 58, 1.

³⁴⁰See Patrick M. Garry, Candice Spurlin, Debra A. Owen, William A. Williams and Lindsay J. Efting, 'The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform', *South Dakota Law Review*, (2004), Volume 49(2), 275, pp. 275–276.

³⁴¹See James D. Cox, 'Making Securities Fraud Class Actions Virtuous', *Arizona Law Review*, (1997), Volume 39, 497, p. 501.

³⁴²In theory, the class members own the class action, however, lawyers control and conduct the entire proceeding. The separation of ownership and control would easily lead lawyers to 'monopolize' the whole litigation proceeding. Adam C. Pritchard, 'Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers', *Virginia Law Review*, (1999), Volume 85, 925, p. 928.

³⁴³Further analysis in this regard will be in Sects. 6.2 and 6.3 of this book.

³⁴⁴Simple civil disputes (e.g. contract dispute) are generally not multi-party actions, where complex procedures like 'opt-in', 'register with the court' are not applied.

plaintiffs' lawyers would be more significant in conducting the whole litigation proceeding because general class members are not experts in monitoring complex litigation. In fact, shareholder class actions are criticized for becoming an industry for lawyers specializing in class actions to earn huge lawyers' fees.³⁴⁵

Before the enactment of PSLRA, lots of lawyers 'race to the courthouse' to sue in the wake of the disclosure of unfavourable information or a drop in stock price.³⁴⁶ To facilitate speedy filings of class actions before courts, a common approach for lawyers is to retain a list of potential plaintiffs and their shareholdings,³⁴⁷ and seek help from these 'professional plaintiffs' before the class litigation is initiated.³⁴⁸ In this regard, the 'most adequate plaintiff' provisions in the PSLRA 1995 try to make shareholders in the securities fraud class actions function more actively, by encouraging them to become lead plaintiffs in lawsuits.³⁴⁹ The rationale behind this rule is that a class action where the role of the shareholders is active would be more in line with the shareholders' interest than a class action essentially driven by lawyers.³⁵⁰

³⁴⁵Patrick M. Garry, Candice Spurlin, Debra A. Owen, William A. Williams and Lindsay J. Efting, 'The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform', *South Dakota Law Review*, (2004), Volume 49(2), 275, p. 284.

³⁴⁶Donna M. Nagy, Richard W. Painter and Margaret V. Sachs, *Securities Litigation and Enforcement: Cases and Materials*, (Thomson/West 2003), p. 399.

³⁴⁷See Elliot J. Weiss and John S. Beckerman, 'Let the Money do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions', *Yale Law Journal*, (1995), Volume 104, 2053, p. 2061.

³⁴⁸See Elliot J. Weiss and John S. Beckerman, 'Let the Money do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions', *Yale Law Journal*, (1995), Volume 104, 2053, p. 2060.

³⁴⁹See 27 (a) (3) (B) of the PSLRA 1995. For example, the most adequate plaintiff shall select and retain counsel to represent the class; [27 (a) (3) (B) (v)].

³⁵⁰Janet Cooper Alexander, 'Do the Merits Matter? A Study of Settlements in Securities Class Actions', *Stanford Law Review*, (1991), Volume 43, 497, p. 535.



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