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On Shareholders Derivative Action of China

Fu Zheng

Law School, GuangXi University, Nanning, China

zhengfu1220@126.com

Abstract: The new "China Company Law" for the first time introduced and established shareholder derivative action. This essay aims to expand the system and clarify the composition and structure of shareholder derivative action. And at last show the importance of it.

Keywords: Derivative Action, Shareholders, Right

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1. INTRODUCTION

The "China Company Law", which came into force on January 1, 2006 after been passed by the eighteenth meeting of Tenth National People's Congress on the October 27, 2005 , for the first time introduced and established shareholder derivative action. This essay aims to expand the system and clarify the composition and structure of shareholder derivative action.

2. PRODUCTION AND THE DEVELOPMENT OF THE DERIVATIVE ACTION

Shareholder derivative action is based on the UK equity, which was to protect the interest of minority shareholders initially. For a long-term, the "Foss v. Harbottle rule", established by the Foss v. Harbottle case in 1843 confront an awkward circumstance that can't protect the legitimate interests of minority shareholders [1]. When the directors control the company and there is improper behavior that damaged the interests of the company, because of the control, the company could not agree on the prosecution and minority shareholders can not sue in their own name, which will cause the company irreparable harm, the offender can not be legally punished, and such a result is contrary to justice and fairness. In order to solve this problem, in 1864 the East Pando Lead Co. V. Mairuiweize case served as an addition to the Foss V. Harbottle rule, which is summarized as: if the director's action constitute fraudulence to the minority shareholders and the directors are in charge of the company, the Foss V. Harbottle rule does not apply. The small shareholders are allowed to represent themselves and other similarly situated minority shareholders filed a shareholder lawsuit. This has been the prototype of shareholder derivative litigation. The rule established hereof was developed and gradually accepted by many civil law countries.

In different historical legal background, the national titles for the shareholder derivative action are different. Common law calls it the shareholder derivative action, also known as second-class litigation. Japanese and South Korea scholars call it representative litigation, while Taiwan scholars called it subrogation litigation [2].

Because the shareholder's suit is not only on behalf of themselves, but also represents the other shareholders who suffered losses, and over the suit, what the shareholders have are the company's right. So it is not only Subrogation but also representative. That it is only called representative litigation or subrogation can not fully demonstrate its features, so the name of derivative action is more reasonable.

3. THE COMMON AND LEGAL CHARACTERISTICS OF SHAREHOLDER DERIVATIVE ACTION

The reason that shareholder will institute a derivative action is because of the company, and this derived right is always full of controversy. However, there are some kinds of different comments.

a) The theory of selfish interest right (also called the theory of creditor's subrogation right). This theory says that the derivative action is actually substantively presented as creditor's subrogation right, and it claims that the shareholders is the subject of the creditor's right since they have their own share and their shareholders rights to dividend. So for the protection of creditor's right's sake, the shareholder can fulfill the company's right to request compensation for damages from the infringers, as well as the other company creditor's rights in broad sense. The derivative action is actually the company fulfilling its right to request which is based on the internal relations with its directors, the commercial law has just changed it into another form without changing its essence. To draw a conclusion, the right to institute a derivative action is absolutely a selfish interest right.

b) The theory of other beneficial rights. It holds the opinion that the shareholder derivative action is based on the company and is under the invasion of inappropriate or legal violating act, but its no-activity fulfills its own right of action. So this action is totally an action that aims to protect the company's rights from being invaded. And this right of action is an other beneficial right.

c) The theory of common benefit. It means that the shareholders exercise their rights in representation of their own and the company's interests [3]. It's a right for shareholder to supervise and correct the company's inapplicable or illegal action, thus it should be a common benefit. The litigation reason does not subject to the shareholders themselves, though they are the members of the company, but to the company as a whole. The successful result, which appears to be the achievement of the companies' interests or avoiding the loss, ensures that the shareholders, creditors and workers could enjoy their respective interests indirectly. Regarding the right of self-benefit shareholders' rights as the creditor's rights doesn't meet the nature of share ownership. Shareholders Derivative Action don't have the condition to subrogation

rights so it's not available to take that theory into considerate [4]. Other beneficial rights desperate the personal interest with company interest. They are too biased, so this theory also can't convince others.

The fact that the derivation lawsuit wins often benefits the company to obtain or avoids loss, so do indirectly the company shareholders, the creditor and the staff.

The derivation lawsuit is the one of public right, if shareholders take the lawsuit without self-benefit (Commercial Law of Japan). The shareholder derivation lawsuit comes from the common civil procedure, but is not equal to it. The law features are:

a) The replacement of shareholder derivation lawsuit. The production of shareholder derivation lawsuit needs the harm of corporation power as a foundation [5]. The plaintiff shareholder and the violation company benefit's defendant do not have the direct relations. The defendant's behavior has harmed company's interests, so the shareholder's interests would be damaged indirectly. However, the shareholders can charge by their own name only when the corporation is negligent in the lawsuit. Therefore, the shareholders only have the right to sue in form, which is said to be the replacement.

b) The nature of representative action in shareholder derivation lawsuit. The loss in company's interests is usually the loss of beneficial rights in the major shareholders [6]. The injured shareholders have the right to take a suit. The shareholders who raise the suit represent the interests of a vast majority of people. In this sense, legal validity is available to all the injured shareholders, which is featured in representative action.

4. RESTRICTIONS ON PLAINTIFF IN DERIVATIVE ACTION

Plaintiffs of Derivative Action are generally stockholders who are blessed with the right to sue, either in Common Law or Civil Law. Nevertheless, the difference comes from the requirements that Company Law of various countries regulated to the qualification of the plaintiffs. The following aspects can specifically cover this situation.

4.1 Restrictions on quantity and proportion of shareholding.

The restrictions on quantity and proportion of shareholding can fall into two types—Substantive Limits and Procedural Limits—in accordance with the different legal traditions of each country.

Substantive Limits refer to the fact that unless the shareholders can come up to the quantity and proportion of shareholding as regulated, they are not eligible to raise an action, which are mostly adopted by Civil Law countries. For instance, Share Law in Germany and Commercial Law in South Korea.

Procedural Limits, however, does not have special request on proportion of shareholding when a shareholder raises an action on Derivative Action, except a guarantee. And this type is usually employed by Common Law countries.

4.2 Restrictions on time of shareholding

In terms of time limits of shareholding, there exist several forms. One is the form of continued shareholding, which implies that stock owners shall possess the right to shareholding for a certain period of time when initiating an action, so as to avoid suit abuse [7]. This time limit pattern, however, doesn't protect the right to sue of small and medium shareholders; neither does the overall maintenance of company's interests.

5. THE DEFENDANT IN DERICATIVE ACTION

The defendant in a derivative action is a litigant who takes dishonest measures to infringe upon company and should respond in damages [8]. It involves in anybody in any way to damage the company. However, to be on the different sides, countries always make some restraints on it. Thus the rule of judgments of the object and the scope is various; generally there are two main legislative patterns.

One pattern is that the plaintiff chooses defendant, represented by America. In America, the object in derivative action is extensive as same as the scope of those companies which have rights to conduct prosecution. Anyone, no matter who he is, in or out of the company, can become the defendant in derivative action.

The other pattern is that legislation restrains the scope of defendants, represented by Japan and Taiwan, China. Take, for instance, the Japanese Commercial Code the defendant in derivative action is mainly company directors [9], besides includes supervisor, sponsor, liquidator, directors who have rights to vote and accept advantages of company, and man who issues striking price shares in an obviously unfair way; the Corporation Law of Taiwan region institutes a narrower scope-only company directors.

The author considers the production of procedural regime is for calling company insiders to account. If the scope of defendants is enlarged, it will lead to the indiscriminating use of prosecution. Company owns juridical personality; if the law endows company and directors rights of prosecution simultaneously, lawsuit resources will waste and the prosecution would be disordered. As for the situation of outsiders damaging company, if the company doesn't conduct the outsider prosecution, it infringes the rule that administrator should be responsible for the company, so directors can conduct derivative action to solve this problem. Thus in the two patterns above, the second one is better.

6. THE SCOPE OF OBJECT OF DERICATIVE ACTION

The first kind of legislation takes the Japanese Commercial Code and Company Law in Taiwan of China as the representative, any director of the company who bears the entire debt burden may become the object of derivative action [10].

The second legislative cases represented the United States. The object of American derivative action is very broad, which is equivalent to the litigation scope the company itself has the right to make [11]. All major shareholders, directors, managers, employees and the third party for the prohibition of misconduct, revocation and restore are all included.

Some scholars have proposed the main targets of derivative litigation including the following five items: a) the directors, supervisors, managers, the liquidation group, sponsors and other executives will be responsible for the company who breach their duty of care a good administrator and fiduciary duties; b) controlling shareholders or major shareholders will assume the responsibility who violates the integrity of its obligations to the company; c) the third person will undertake the responsibility to the company for debt fails to carry on; d) the administrative organ shoulders administration tort responsibility to the company; and e) other legal responsibility. The five basic items cover the full range of which should be paid attention to [12].

7. PRE-PROCEDURES OF DERICATIVE ACTION

Shareholders are eligible to be the plaintiff of Derivative Action, which do not mean that they can raise an action as soon as their interests are damaged by the company. One of the ideas of Company Law is that the company shall have independent personality. It is the company that calls to account of tortfeasors if it suffers the damage. Only if the company is negligent in safeguarding their interests or refuses to safeguard, shareholders are allowed to initiate a suit, that is to say, shareholders must request company to take action first. This behavior that plaintiff shareholders request company to take measures is the pre-procedure of Derivative Action. Many countries and regions have regulated this system, which include:

7.1 Demand

Shareholders are obligate for requesting company to raise an action to the tortfeasors before submitting the Derivative Action to a court. On the other hand, the requests that shareholders put forward to companies are different, due to the different regulations of Company Law between Common Law and Civil Law. Plaintiff shareholders are able to raise a Derivative Action after companies or authorities concerned refused to accept the requests, or after the expiration of waiting period [13].

7.2 Guarantee on litigation expense of defendant

As for the lawsuit raised by shareholders, the Company Law of some states in the U.S. provides that the plaintiffs, especially those small shareholders who own low proportion or insufficient shareholding, should be offered appropriate number of guarantee as the defendant requested, so that the plaintiff can pay back the money that the defendant spent on this lawsuit. As is

regulated in Article 267 of Japanese Commercial Law [14], if the defendant is able to prove the ill will of the plaintiff, the court may respond to it and order the plaintiff to give guarantee. Article 214 item 2 of Company Law in Taiwan region [15], the court shall give plaintiff shareholder considerable guarantees as requested by the defendant, when they raise a derivative action. Guarantee on litigation expense of defendant aims at avoiding suit abuse, preventing the appearance of unnecessary and meaningless lawsuit and reducing the possibility to win by a neck.

8. CONCLUSION

The Derivative Action System attaches great importance to maintain the general interests of company and eventually safeguard the interests of shareholders, small shareholders in particular. This system suffers an effective means of remedy to shareholders, which will help massive shareholder, especially small shareholders, to maintain the interests of both company and shareholders rather than their personal interests, and supervise the company's management so that no managers is able to abuse their authority to damage the interests of company and shareholders. Since shareholder representative action came into being, it is found from countries' practice that the system has positive impact on maintaining rights of both companies and shareholders, on strengthening the supervision of top managerial activities and on guaranteeing the healthy operation of the company.

Derivative Action System has been a common choice for current Common Law and Civil Law in protecting the interests of minor shareholders. Article 152 of Company Law in China, carried out in Jan.1. 2006 regulated this derivative action system, offering the right to sue for shareholders.

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