Derivative Action/lawsuit in China: protection of (small) shareholders

Description

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Derivative actions are regarded worldwide as an effective enhancement of corporate governance in terms of protecting shareholders from the misbehaving management of their invested company, and protecting small shareholder from being repressed by controlling shareholders. China adopts this mechanism when overhauling its Company Law in 2006.

Article of 151 of China Company Law (revised just recently for reforming registered capital) provides for the guidelines of derivative action:

> Article 151 Upon occurrence of the circumstances set out in Article 149 to the directors or senior management personnel, the shareholders of a limited liability company, or the shareholder of a company limited by shares who have held, whether individually or in aggregate, 1% or more of the shares of the company for a consecutive period of 180 days or more may request in writing that the supervisory committee or supervisors (where the limited liability company does not have a supervisory committee) initiates a legal proceeding in the people's court. Upon occurrence of the circumstances set out in Article 150 to the supervisors, the aforesaid shareholders may request in writing that the supervisory committee or supervisors (where the limited liability company does not have a supervisory committee) initiates a legal proceeding in the people's court.
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> If the supervisory committee, supervisors (where the limited liability company does not have a supervisory committee), the board of directors, or the executive director refuses to initiate a legal proceeding upon receipt of the aforesaid shareholders' written request, or fails to initiate a legal proceeding within 30 days upon receipt of the aforesaid shareholders' written request, or where in the case of an emergency, the failure to forthwith initiate a legal proceeding will cause the company to suffer irreparable losses, the shareholders set forth above shall have the right to initiate a legal proceeding to the people's court directly in their own name in the interests of the company.
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> If the company incurs losses as a result of others' infringement of the legitimate rights and interests of the company, the shareholders set forth in paragraph 1 above may initiate a legal proceeding in the people's court according to the first two paragraphs of this Article.

Though derivative action is put in law there for more than 8 years, there is a lot of confusion in practice due to the over-general wording or lack of detailed rules in applying this piece of rule in judiciary system.

I will briefly analyze this Article from the perspective of a litigation proceeding.

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I. Who Can Initiate Derivative Action

It seems quite clear from the wording above. In the case of a limited liability company (the organizational form most foreign invested companies take), any shareholder, no matter how much share of equity interests it holds, shall be entitled to launch the derivative action. In the case of a company limited by shares or joint stock company, there are restrictions on percentage or shareholding and time period of holding the shares.

There are even people querying whether previous shareholders can initiate derivative action. While it may be interpreted the other way, I would say that most Chinese courts would only allow the current shareholders meeting the criteria to sue.

In practice, shareholdership is not that straightforward at all, though in most cases the registered shareholders will have the legal rights to take action. I notice a derivative action case tried and judged by a Shanghai court in which the initiating party initiating the derivative lawsuit acquired shareholding in a Sino-foreign equity joint venture company by way of a court judgement but that acquisition had not gone through the approval procedure with local foreign investment authority, not to mention being registered as a shareholding in the joint venture. Now the question is how come the court in charge of the derivative lawsuit would, in the absence of approval by the foreign investment authority, allow this party to launch the derivative action in such as situation. The point is that the shareholdership of the party in the joint venture was not legally confirmed yet. I have serious doubt about the legality of the judgement.

There are other thorny issues in relation to affirming shareholdership in a company. This will for sure take another long post to write about.

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II. Who Are the Defendants

Derivative actions are instituted in most cases against corporate directors and officers. Indeed from theoretic research, some of the countries in the world clearly restrict derivative actions from being employed against parties other than directors of a company while in United States it is said that derivative actions can be used against either controlling shareholders, directors, officers, even employees and third parties.

China Company Law makes it clear that derivative actions can be initiated against directors, supervisors and senior officers who cause losses to the company as result of their performance of corporate duties in violation of laws, regulations and articles of association of the company.

As you can see in the last paragraph of Article 151, there is the word “others” which literally means any and all other people than those mentioned before, namely, the directors, supervisors and senior officers. So it seems clear that China has followed the suit of the United States.

However, from the precedent cases judged in local Shanghai courts, we see contradictiveinterpretation of the word “others”. In a publicly available case judged by Shanghai No. 1 IntermediaryPeople’s Court in April of 2013, the judges find that “others” shall refer to other persons performingcorporate duties within the company, excluding shareholders. Based on that interpretation, the courtrejected the claims by plaintiff.

Interesting and maybe ironically, in another case handled by Shanghai No. 2 Intermediary People’s Court (Shanghai has only two intermediary courts) in January of 2013, the judges went so far that they allowed a shareholder of a company to sue a debtor of the said company in a derivative action because the company failed to pursue the liability of that debtor which failure damaged the interests of the company.

Empirically, the majority judicial view is that derivative actions shall encompass not only directors, supervisors or senior officers but also other shareholders (in particular controlling shareholder) that damage the legitimate interests of the company through connected transactions. But whether creditors or other third parties that damage the legitimate interests of the company should fall within the ambit of derivative actions shall remain to be seen until a clear judicial interpretation from China Supreme People’s Court.

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III. Exhaustion of Intra-corporate Remedies

Because companies in Chinese civil laws are regarded as independent legal persons with separate legal personality, derivative actions are often deemed as a threat to the independent legal personality of companies. Thus respect shall be paid thereto by constraining shareholders from abusing derivative actions that may easily overstep boundary of the powers of corporate management.

Article 151 requires that the initiating shareholder shall before launching derivative action in its own name demand the board of directors (or the executive director in absence of a board) or board of supervisors (or the one or two supervisors in absence of a board) firstly to take actions against the wrongdoers. In case that the boards or executive directors or supervisor(s) refuses to take action or fails to launch lawsuit within thirty days of receipt of the written demand from shareholder, then the shareholder can then proceed with the derivative action in its own name. In other words, when the shareholder files the derivative action with court, it shall have to produce evidences proving that it has served written demand to the boards or executive directors or supervisor(s) in the first place and has been failed either by refusal or inaction on the part of the boards or executive directors or supervisor(s).

It seems that the demand rule provided in Article 151 is just procedural without substance allowing no explanation or arguments by the boards or executive directors or supervisor(s), which renders the demand rule sort of meaningless, because the shareholder will always be able to proceed with the derivative action regardless whatever arguments or explanations put forward by the demanded.

It shall be noted that shareholders may dispense with the demand rule and directly initiate derivative action in urgent circumstances where failure to take immediate action will result in irreparable damages to the company. But the law has not gone further to define what urgent circumstance is in practice.

IV. Representation of Company in Derivative Action

This is a serious and complicated issue in the corporate law field.

You may know that every Chinese company has a legal representative that can with his or her signature legally represent and therefore bind the company in business operation and legal proceedings of any kind. You may further know that every Chinese company has a general chop (gong zhang) and other sub-chops (such as contract chop, financial chop). But that is not all about the issue.

In practice, in response to the demand from shareholder, board of supervisors or supervisor may wish to take action against misbehaving management, for instance, the general manager who is also the legal representative, but they will soon find them unable to go far. First of all, in whose name should the board of supervisors institute the lawsuit? In the board's name? The court will for sure tell them that the board of supervisors, as just an internal organ of the company, shall have no legal status to act in its own name. In the company's name? This is more logical, but the court may also reject them on the ground that only the legal representative can represent the company in court proceedings. Sometimes, the company has managed to (for example, with the general chop of the company at hand) file the case against the legal representative, but at some point during the proceeding, the legal representative can withdraw the case because he is the legal representative.

It is reported that a shareholder that wished to sue a third party in accordance with the third paragraph of Article 151 was asked to send its written demand to the legal representative, the board of directors and finally to the board of supervisors in a row as a proof that it had exhausted the intra-corporate remedies. This is totally too much. But it happens here in China, simply because there are no clear guidelines in this regard.

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While the laws in this area are confusing, it is highly recommended that shareholders when setting up their Chinese businesses shall put in place well-written articles of association which shall have clear rules in it dealing with such scenarios.

V. Conclusion

Derivative action in China is still in its infant stage with many other problems not discussed above and it may take many years before it comes mature in terms of its expected role in improving corporate governance in Chinese corporate world.

However, despite that, derivative action is doable now and may well serve good purpose for (minority) shareholders though it may require excellent corporate lawyers with good understanding of Chinese laws and litigation strategy and tactics related to derivative actions.

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