MASTER-THESIS

"Derivative Action in the United Kingdom, United States and China: from A Perspective of Jurisprudence and History"

Verfasserin

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angestrebter akademischer Grad
Master of Laws (LL.M.)

Wien, 2015

Universitätslehrgang: European and Asian Legal Studies
Studienkennzahl lt. Studienblatt: A 992 396
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Abstract

Abgeleitete Aktionärsklagen (derivative actions) kennen sowohl die Länder des Common Law als auch die des Civil Law, allerdings ist die Benennung unterschiedlich: derivative suit (USA), Aktionärsklage (Deutschland) und PaiSheng SuSong (PRC). Grundlage der abgeleiteten Aktionärsklage ist das selbständige Klagerecht (Aktivlegitimation) eines Unternehmens. Die Klage ist insoweit abgeleitet (derivativ) als der Aktionär im Namen des Unternehmens tätig wird und Ansprüche im Namen des Unternehmens erhebt. De-facto-Kläger ist das Unternehmen, sodass Entschädigungen etc. dem Unternehmen (und nicht dem Aktionär) zukommen. Ein Vergleich verschiedener Jurisdiktionen zeigt eine Vielzahl von Zugängen und Regelungen im Bereich dieser Thematik und bietet wichtige Informationen für effiziente und umfassende zukünftige Gesetzgebung im Rahmen der Derivative Action. Die rechtsvergleichende Untersuchung soll Grundlagen zum weiteren Ausbau gesellschaftsrechtlicher Bestimmungen zum Nutzen von Unternehmen und Minderheitsaktionär bieten.

Der erste Teil der Arbeit versucht einen Überblick über das Gebiet der abgeleiteten Aktionärsklage zu geben, der zweite Teil versucht die rechttheoretischen Überlegungen auf denen die abgeleitete Aktionärsklage fußt zu erklären. Einige wesentliche rechtstheoretische Aspekte werden vertieft diskutiert, zum Beispiel: die Theorie der unternehmerischen Rechtspersönlichkeit, Corporate Governance, die sog. „Business Judgement Rule“, die Organfunktion. Die Trennung zwischen Eigentümer und Unternehmensführung ist ein charakteristisches Merkmal der Entwicklung des Gesellschaftsrechts die die Notwendigkeit der abgeleiteten Aktionärsklage bedingt. Im dritten Teil wird der historische Hintergrund dieses Rechtsinstituts untersucht, z.B. die Ursprünge der abgeleiteten Aktionärsklage und die Entwicklung der gesetzlichen Grundlagen, um ein klareres Bild dieses Instruments im Rahmen eines kontextuellen Überblicks zu gewinnen. Gemeinsam mit der komparativen Analyse diesbezüglicher

Ansätze im Vereinigten Königreich, den USA und in China soll diese Untersuchung Anhaltspunkte zu Weiterentwicklung und Reform der abgeleiteten Aktionärsklage bieten, die zur Effizienzsteigerung dieses Instruments beitragen sollen.

Introduction

The derivative action does exist both in civil and common law jurisdictions though named with disparity, that is derivative suit (United States), Aktionärsklage (Germany) and PaiSheng SuSong (PRC). When rights of the company are damaged by its own directors or senior managers while the company refuse to sue those directors or managers in the name of the company. The basic position in English law is that the court will not intervene in the application of shareholder derivative actions.[1] In Germany, it was not until 2005, Law for Corporate Integrity and the Reform of Shareholder actions that introduced derivative action into company law (German Law on Stock Corporations), and unlike the United Kingdom and the United States, universal banks have long been strong. They run mutual funds and investment banks, and their representatives sit on company boards. The Chinese shareholder derivative action mechanism was framed by the Company Law and the CSRC's regulations which, at the same time, aimed to keep a balance between protecting shareholders and preventing strike actions.[2] The statutes merely built a rough legal framework of shareholder derivative action in China, many vital aspects were missing, and this mechanism still should be explained and clarified.[3]

The company's independent right to sue is the basis of a derivative action. The meaning of derivative is that the shareholder brings an action on behalf of the company and claims in the interest of the company. The plaintiff, de facto, is the company, meaning

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[1] Aharon Barak, A Comparative Look at Protection of the Shareholders' Interest Variations on the Derivative Suit, 20 Int'l & Comp. L.Q. 22, 26(1971)
[2] Xiao Huang, Derivative Actions in China: Law and Practice, 6 Cambridge Student L. Rev. 246, 258(2010)
[3] Hui Huang, The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform, 4 Berkeley Bus. L.J. 227, 235(2007)

the recovery from the action shall be attribute to the company rather than the shareholder. The initiation of a derivative action is restricted to certain situations where the company has itself refused or failed to take measures, such as, the Chinese Company Law stipulates where any director, senior management person, controlling shareholders or even third parties of a company violates laws, administrative regulations or even the company's articles of association during the performance of duties, he/she shall be liable for compensation if any damage is done to the company. Meanwhile, the shareholder is obliged to either require a demand on the relevant authorized organ to take over the action or show that such a demand has been futile.

The shareholder derivative action has been deeming to be a controversial and thorny mechanism. Practical experience and empirical studies have led courts and commentators to conclude that in the United States, shareholder litigation were more likely to be abused as strike suits' for their mere nuisance and settlement value than other fields of civil litigation.[4] Stephen M. Bainbridge argues that derivative action have few positive effects but imposes costly restriction to the managerial rights.[5] The compensation that the company acquired from the derivative action were not enough to cover the damages it suffered. Tim Oliver Brandi held that it might be unnecessary to abolish the derivative suit if aspects of procedural law that create incentives for litigation abuse are reformed.[6] Alan J. Meese noticed that some principal-agent theorists have suggested that derivative suits be abolished.[7]

The debate upon the shareholder derivative action with regard to its value and indispensableness is still continuing. It was long been perceived as a remedy for minority shareholders and remains to be discussed in-depth in recent economic circumstances. The separation between ownership and managerial rights of modern

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[4] Id. at 357 , See also Blue Chips Stamps v. Manor Drug Stores, 421 U.S. 723, 741-43 (1975)
[5] Stephen M. Bainbridge, Corporation Law And Economics §1.2, 5(2002)
[6] Supra note 4, at 367-68
[7] Alan J. Meese, The Team Production Theory of Corporate Law: A Critical Assessment, 43 Wm. & Mary L. Rev. 1629, 1682(2002)

listed companies or multi-national companies gives rise to far-reaching missions to derivative litigation supporting sustainable development of the world economy. In essence, the derivative action mechanism is a delicate balance between shareholders and managerial authority in the economic background that separation between ownership and managerial rights. The increasing complexity of business and financial transactions and the judiciary's attempts to handle these problems demonstrate the inadequacy of traditional theories of fiduciary obligation as measures of majority shareholder responsibility owed to the minority.

The first part endeavors to reveal an overview on the derivative action. The second part aims to explain the jurisprudence of which the derivative action is rooted in. Some vital aspects of jurisprudence with regard to derivative action will be properly discussed, for instance: the theory of corporate legal personality; corporate governance; business judgement rule; the institutional function. The separation between ownership and managerial rights is a hallmark in the evolution of corporate law which justify the imperative of derivative action. In the third part, by exploring the legal history, inter alia, the origin and the statutory legislation on derivative action attempt to render a clearer perspective to this mechanism in a contextual review. Along with comparative analyses of the United Kingdom, the United States, and China, this exploration may serve feasible inspiration for future application or reform of derivative action which will make this mechanism practicable in a more effective manner

Chapter I An Overview of Derivative Action

At the starting point, it is vital to remember that the derivative action is created from court of equity[8] and was styled as an invention of equity to supply sufficient and efficient legal redress to compensate the company for directors' breaches of fiduciary duty.[9] To put it simple, in order to realize a company's cause of action, a shareholder

[8] H. Henn, Handbook of the Law of Corporations and Other Business Enterprises §358, 749(2nd ed. 1970)

[9] Max R. Parrish, A Look at the Derivative Suit, 24 Ark. L. Rev. 89, 89(1970-1971); See also Mr.

initiated a derivative action for the interest of the company and in this action, the company is a necessary party.[10] Attitudes towards the status of derivative action have long been opposite, for instance, one judge in the United States severely criticized its negative effects. Because the managers were afraid of being accounted for the loss of the company, they would spent time which otherwise be used for business management to consider about their responsibility. Thus the derivative action did no good to promote commerce.[11] while another judge spoke highly of this mechanism.[12] The existence of derivative action mechanism does render shareholders with a remedy for, and protection against, company and director's wrongdoing. Commonly, the complainant is seeking to realize a claim or right of the company which the company has failed or refused to execute against members of its management or supervisory board. These actions are deemed to be in the societal interest, since they help to improve sound company management while protecting minority stockholders at the same time. The derivative action, wherein shareholders act as private attorneys general, has long been used to police corporate misconduct.[13] The derivative action addresses problems directly related to corporate governance, and besides, it can allege that some mechanism in the corporation failed in permitting the wrong to occur in the first instance.[14] The action would thereby provide with a chance to examine how the company has been managed or, more accurately, mismanaged.[15]

By means of retrieval the existing legislations, a noteworthy phenomenon is that there is an expansion of derivative action statutes in company law which confirm the right of shareholder to ascertain benefit of the company in various jurisdictions. A number of key jurisdictions, including the United Kingdom in 2006, Germany and Hongkong in

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Justice Robert H. Jackson in Koster v. (American) Lumbermens Mutual Casualty Co., 330 U.S. 518, 522 (1947)

[10] Vanderboom v. Sexton, 294 F. Supp. 1178, 1184 (W.D. Ark. 1969) quoting from Price v. Gurney, 324 U.S. 100 (1945)

[11] Felzen v Andreas, 134 E3d 873, 877 (7th Cir. 1998)

[12] Cohen v Beneficial Industrial Loan Corp, 337 U.S. 541, 548 (1949)

[13] Bruce Dickstein, Corporate Governance and the Shareholders' Derivative Action: Rules and Remedies for Implementing the Monitoring Model, 3 Cardozo L. Rev. 627, 636(1981 – 1982)

[14] Id. at 637

[15] Id.

2005, the People's Republic of China in 2006, Macau in 1999, Japan in 1993, Australia in 2000, and Italy in 1998, have currently stipulated either statutory or codified derivative actions with the hope of transplanting the 'Holy Grail' into their corporate governance regimes.[16] Canada introduced derivative action mechanism at around 1970s and the provisions currently in Sections 238-40 and 242 of the Canada Business Corporations Act, R.S.C. 1985. Singapore and New Zealand introduced this statutory mechanism in 1993.[17] Australia, spent almost a decade of trade-off and debate, in Oct. 2010, adopted the statutory derivative action.[18]

The derivative action, which is deemed to originate from England and flourish in the United State, is now a widely adopted mechanism protecting minority shareholder when the board of directors are de facto paralyzed to pursue the interest of the corporate. During the evolution process of derivative action, the English mechanism was considered separately with that in the United States. Nowadays, in Asia's dominant economies such as China, Japan, Taiwan, South Korea, Singapore, and etc., the derivative action has become a widely existed feature in these countries' company law.[19] The concept of derivative action is hardly to be accurately defined due to the complexity of legal context. However, generalizing the elemental features is normally achievable. There are approximately five elements in a derivative action:

(1) the company suffers the damage;

(2) the wrongdoer usually owes a fiduciary duty to the company;

(3) the company has failed to fulfil its interest;

(4) the shareholder represents the company to sue for the purpose of enforcing the company's right;

(5) compensation renders forthright to the company.

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[16] Harald Baum & Dan W. Puchniak, The Derivative Action: An Economic, Historical and Practice Oriented Approach, in the Derivative Action in Asia: A Comparative and Functional Approach 4,2, (Dan W. Puchniak et al. eds., 2012)

[17] Companies Act, 1993, Pt. IX, (N.Z.); Companies Act §§216A-B., (Sing.)

[18] Corporations Act, 2001, Pt. 2F.IA (Austl.)

[19] Supra note 17, at 64-67

The recent statutory enactments in the United Kingdom, Germany and China resemble certain aspects of U.S. shareholder derivative law, and these statutes also suggest that shareholder derivative action has become a means by which countries intend to protect minority shareholders including investors, whether through a perception of optimized corporate governance by authorizing such actions or through simple imitation of the availability of such actions.

Chapter II Jurisprudence underlies Shareholder Derivative Action

2.1 Theory of Corporate Legal Personality and Derivative Action

2.1.1 Historical Background of Corporate Legal Personality

The concept of legal person shall be restricted as a judicial concept in the realm of legal science and originated from Roman law. According to the theory, a legal subject who was a true man may not necessarily be a true company.[20] The concept of legal person represents a body of both rights and duties, to whom subjective rights legally endowed.[21] The following statement can be a proper explanation of legal personality theory in terms of its existence as a social unit with a real personality.

> "The fact of the matter would seem to be that society, or the state as the comprehensive social institution, must be viewed as an entity with a life of its own, to which, in the long run, the interests of individuals are subordinated. . . . Society is, thus, much more than mere mechanical juxtaposition of individuals; it is a finely integrated and delicately balanced system of relationships which give it life, power, and sufficient permanency to play a role in the universal drama."[22]

Besides, there is significant economic advantage in a continue entity. The perpetual succession resolves the dilemma, the entity keeps continuous despite directors and managers change by regular election. A shareholder bear responsibility or duties within

[20] John Dewby, The Historical Background of Corporate Legal Personality, 35 Yale L. J. 655, 656(1925-1926)
[21] Michoud, La Notion de Personnalite Morale (1899) 11 Revue Du Droit Public, 1, at 8
[22] Tnn Social Sciences, (Ogburn and Goldenweiser Ed. 1927), 394-395 (Article by Hankins)

his contribution of capital.[23]

The fiction theory of the company personality was originated from Pope Innocent IV who was born in 1198 and died in 1274. Pope Innocent IV promoted that monasteries were separated from the monks who should otherwise had a legal existence. A monastery who had a soul which was separated from the organization was not liable, according to the fiction theory.[24] The Pope held that the spirit was superior to temporal power. A classic statement of the Fiction Theory was illustrated by Chief Justice Marshall in Dartmouth College v. Woodward that a company was merely an invisible artificial being, a design in law.[25] Whenever we get down to the point in issue, we are still faced with a choice between the fictitious personal of a corporation on the one hand and its factual personality on the other.[26]

Under the concession theory, within the state's jurisdiction, the state is similar to natural person who could be vested or withdraw legal personality. According to this theory, the legal personality of a company could only be created by legislative act.[27] Another theory is the so-called Realist Theory, a corporation is a reality entirely apart from the law. Hence, it has a social or factual personality wholly distinct from the legal personality conferred upon it by the state.[28] The Realist Theory says that a corporate body exists and has a de facto or social personality entirely apart from any act of creation or recognition by the State-let us proceed to a development of these theories and to a comparison of the results which can be obtained from each.[29] Compared with fiction theory, the realist theory seems to be more preferable, which not only take more satisfactory account of the social facts, but much more conducive to a desirable solution of the legal problems involved as well. We have seen that such changes as were made

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[23] Bryant Smith, Legal Personality, 37 Yale L. J. 283, 287(1927-1928)
[24] Supra note 21
, at 665
[25] Trustees of Dartmouth College v. Woodward, 4 Wheat. 518, 636 (1819)
[26] Clyde L. Colson, Corporate Personality, 24 Geo. L. J. 638, 639(1935-1936)
[27] Supra note 24, at 294
[28] Freund, Legal Nature of Corporations §§5, 6
[29] Supra note 22, at 644

in the law have all been away from the logical application of the Fiction Theory toward the adoption of that concept of corporations embodied in the Realist Theory.

2.1.2 Legal Personality and Its Impact to the Development of Company

Justice Marshall held an opinion that a company was an intangible artificial being.[30] The creation of legal personality theory promoted the explosion of company establishment and indeed facilitated commercial activities by separating natural person and legal entity. Legal personality could be interpreted as a conference of legal rights and imposition of obligations. Capital expansion significant benefited economy. One earliest example could traced back to the establishment of the East India Company which was an English joint-stock company formed to pursue trade with the East Indies. The establishment of the East India Company was chartered by the King of the United Kingdom which represented the London Merchants' ambition to trade outer England. The company rose to account for half of the world's trade, particularly trade in basic commodities that included tea, indigo dye, silk, salt, cotton, opium and etc. The company also symbolized the British Empire's beginning of the governance in India.[31]

In order to accumulate as much the requisite funds as possible, the corporate shall seek a wealth of investors. However, the reality was that not all the investor were willing to take an active role in the operation of the entity. A separation between the investors and management did exist. If the investor had to bear unlimited responsibility with little control of the enterprise, he would not invest. The dilemma was resolved through the limitation of risk to the total amount of contribution. By the adoption of separation of ownership and managerial rights, and limited liability, business enterprises were greatly promoted.

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[30] Trs. of Dartmouth Coll. v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819)

[31] M. B. Hooker, The East India Company and the Crown 1773-1858, Malaya Law Review, Vol. 11, 1969, p. 2

2.1.3 Legal Personality and Derivative Action

The corporate name by which a body can contract and hold property, can sue and be sued, is not a John Doe put forward by some recognized and well-defined person or persons who for some technical reason need such a disguise.[32] A company is an independent legal person. It is, therefore, that it should have the sole power to take legal action to remedy an infringement of its rights, which was explicitly stated by Lord Davey in the Burland v. Earle.[33] Under the usual distribution of powers between the various bodies of a company, the administration of its affairs, which includes the power to commence a law suit, is vested in the board of directors or in some occasions, the board of supervisors.

In theory, under ideal circumstances, it is the right of the company to seek compensation for the wrongdoing done to itself in accordance with the proper plaintiff principle which is originated from U.K.[34] This "non-interference" rule adopted by courts is not only the natural result of the basic assumptions set out above, but also reflects sound commercial logic. It is true that the directors of the corporation are thoroughly conversant with the range of economic, commercial, organizational and personal problems facing the company. Besides, from the point of view of the business, or of the usual administrative procedures, it is not at all desirable, that shareholders who are less experienced in the company's affairs than the directors, should interfere with their activities.

A company is regarded as a separated legal entity, and it is usually the board of directors who represent the company to bring a derivative action for the reason of breach of fiduciary duty. Under some circumstances that the directors themselves indulge in misconduct to the company, it is unlikely that the directors will sue themselves.

[32] W. M. Geldart, Legal Personality, 27 L. Q. Rev. 90, 97 (1911)
[33] Burland v. Earle 1 A.C. 83, 93(1902)
[34] Foss v. Harbottle, (1843) 67 Eng. Rep. 189 (Ch.) 202-04; 2 Hare 461

Directors could walk off with corporate assets without incurring liability, because directors will not decide to take action against themselves on behalf of the company.[35] In that case, the court permits individual shareholder to initiate an action for the interest of the company.[36] Theoretically, plaintiff shareholder act for the interests of all shareholders, that's the reason why a legal mechanism to address agency problems which do exist between shareholders and management is necessary. As a consequence, in order to protect the each individual shareholder' interest in the company, the derivative action was created to allow a member to litigate.[37]

2.2 Corporate Governance and Derivative Action

2.2.1 Economic Background

Although theoretical origins do exist, the sheer complexity of the modern firm is a contributing factor. Industrial organization is often called a study of market structure, although it has nothing to do with how markets function, and the most important elements of the study are pricing and output policies of firms, inter alia when monopoly exists.[38] Contracts are a basic, and probably universal, legal tool and according to contracting theory, an organization is a web with both written and unwritten contracts.[39] This view of the company as a nexus of written or unwritten contracts could function as the missing link in the descriptive and prescriptive inquiry of corporate law and its dilemmas.[40] It would be much simple in companies under the contracting theory if contracts between the company and each of its constituencies fulfilled the model of contracting within separate markets, where each transaction could exactly be described

[35] Zhong Zhang , The Shareholder Derivative Action and Good Corporate Governance in China: Why the Excitement is Actually for Nothing, 28 UCLA Pac. Basin L.J. 174, 180(2010-2011)
[36] Fleer v. Frank H. Fleer Corp., 125 A. 411, 414 (Del. Ch. 1924)
[37] Huang Hui, Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis (August 8, 2012). (2012) 27 Banking and Finance Law Review 619. Available at SSRN: http://ssrn.com/abstract=2140613
[38] Id. at 62
[39] Adam Smith, The Wealth of Nations (Cannan ed. 1904) (1st ed. London 1776)
[40] Eli Bukspan, The Notion of Trust as A Comprehensive Theory of Contract and Corporate Law: A New Approach to the Conception that the Corporation is A Nexus of Contract, 2 Hastings Bus. L.J. 229, 233(2006)

as enter into by a clear contract and drop out by clear performance.[41] Contracts between the company and most of its constituency departure from idealized discrete contracting. The large size company mainly challenges the view that the shareholders are the controller of the modern giant company. Since the large size of modern companies unavoidably leads to separation of ownership, management purportedly assumed effective control.[42] Under such certain circumstances, there was justification for supposing that those in control of a modern company would choose to operate it in the interests of the owners as well.

2.2.2 Separation of Ownership and Control

The separation between ownership and control concerns a fundamental understanding of corporate governance. Observers of the corporate scene have long struggled with the dilemma of corporate control. Shareholders are residual owners and the managerial power are under the control of the board. Decision-making requires specific knowledges which vary from industry to industry and the transfer these relevant knowledges between different agents are expensive. All levels of the organization which are characterized by the separation of ownership and control are facing this problem. Under the corporate governance theory and the provisions of company law, the shareholder meeting is the highest organ of authority. However, the truth is that a shareholder meeting which usually described as a rubber stamp, works for the interest of the majority shareholders.[43]

Shareholders do not vote collectively on every company decision, though they are called the residual owners of the company. Rather, the power of decision-making is delegated to a small group of representatives by all shareholders.[44] It is called the

[41] Macneil, The Many Futures of Contract, 47 S. CAL. L. REV. 691, 738 (1974)
[42] Supra note 40, at 323
[43] Jiong Deng, Building an Investor-Friendly Shareholder Derivative Lawsuit System in China, 46 Harv. Int'l L.J. 347 2005, 352; Cindy A. Schipani & Junhai Liu, Corporate Governance in China: Then and Now, 2002 Colum. Bus. L. Rev. 1, 36 (2002)
[44] Del. Code Ann. tit. 8, §141(a) (2011)

genius of the company. By means of delegation, the power of the company is efficiently centralized. However, this is the peril as well. The human nature of self-interest may sometimes cause the representatives behave badly, for example, directors expropriate the company is common to see. Take these flawed managers into consideration, suing a company shall be a plausible maneuver, though not easy, for redressing a misconduct. By means of litigation, the damages of a rogue leader is halted and sound corporate governance is promoted. It is not rare to see that the decision processes of a few public companies seem to under the control of an individual, for example, the chief executive officer. Due to the problem "separation of ownership and control" exists, thus a company's decision making process consists of the initiation and carry out of a decision, and the approval and supervision of a decision. The above mentioned constituents can be summarized as the decision management and control, which helps to reduce the individual to expropriate the residual claimants' benefits in the company.[45] The mechanism of derivation action leads to a balance between the decision making of the board of directors and the self-interest of those directors.

2.2.3 Good Corporate Governance and Derivative Action

A balanced corporate governance imposes restrictions on inappropriate managerial peculation or other kinds of exploitative behaviors. Good corporate governance motivates the managerial power to pursue the best interest of the company, and at the same time provides effective supervision. It encompasses a set of relationships between managers, shareholders and many other stakeholders of the company. Investors, companies, governments and legislators will refer to the principles of corporate governance issued by OECD especially after the global economic crisis since 2008. A set of rules clarifying the duties of the board of directors was set forth in Principles of Corporate Governance and Structure: Restatement and Structure issued by the American Law Institute (ALI) which also outlined an organizational structure for

[45] Supra note 40, at 323

corporate governance.[46]

The increasing complexity of business and financial transactions and the judiciary's attempts to handle these problems demonstrate the inadequacy of traditional theories of fiduciary obligation as measures of majority shareholder responsibility owed to the minority.[47] There’s a consensus that derivative actions are de facto related to the issue of corporate governance. In the first half of the 20th century, investors were allowed to purchase shares on a public stock exchange due to the proliferation of public companies. Those investors owned the shares but played no active role in the management which led the proliferation of derivative actions at that time.[48] The structural separation between active management and passive ownership was regarded as the intrinsic danger by some scholars. A modern public company has large scale of asset and the equity of shareholders are decentralized, generally summarized as dispersed ownership, which trigger the separation between shareholder ownership and management.

Directors owe a triad of fiduciary duties under the law of the United States, which are a duty of good faith, a duty of loyalty, and a duty of care.[49] If shareholders believe directors and officers are acting in their own interest, mismanaging the corporation, or failing to exercise proper supervision, except selling their shares in the market, file a shareholder derivative action in the court is often their only choice.[50] When managers engaging in mismanagement or self-interest digging, shareholders own the right to seek remedy on behalf of the company.[51] However, according to economically motivated and rational shareholder theory, when the financial income of such action surpasses the

[46] Lewin, The Corporate-Reform Furor, N.Y. Times, June 10, D1, col. 3(1982)
[47] Julian Javier Garza, Rethinking Corporate Governance: The Role of Minority Shareholder-A Comparative Study, 31 St. Mary's L.J. 613 (1999-2000)
[48] Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property xxx-xxxv (rev. ed. 1967) (1932)
[49] McMullin v. Beran, 765 A.2d 910, 916-17 (Del. 2000); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000)
[50] Henry G. Manne, The "Higher Criticism" of the Modern Corporation, 62 Colum. L. Rev. 399, 409 (1962)
[51] Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 95-97 (1991)

cost, shareholders will choose to sue the wrongdoers.[52]

2.3 Business Judgement Rule and Corporate Governance

2.3.1 Introduction to Business Judgement Rule

The business judgment rule was originated from the Anglo-Saxon law, and U.S. courts recognized it as a reason of dismissal 200 years ago.[53] Directors act as persons of intellect and reason shall be protect, if law demands these directors higher degree of precognition than people of ordinary knowledge and the directors' fail of foresight lead to responsibility, no one is willing to be a director. This is the rational of the business judgment rule which gradually grew from the judicial judgments.[54] It primarily addresses the care with which directors make decisions, meaning that the board of directors is entitled with entire discretion to make a decision that whether to bring an derivative action or not after judging the economic circumstances that the company is surrounded, while the shareholders generally shall not intervene into which considered to fall within the scope of the company's commercial operation. In order to protect and further this power it is necessary that corporate directors be free to exercise their good-faith discretion in managing business affairs. Hence, the business judgment rule developed defensively to shield a diligent director from personal liability should certain business decisions later prove improvident.[55]

The business judgment rule has two significant meaning in the corporate legal history and corporate governance, (1) as a shield that directors shall not be liable for business decisions which has been comprehensively considered and business judgements which are made with honest mistakes; (2) the breach of the rule lead to liability. Courts may investigate board decisions: (i) for fraud, unlawful, ultra vires, or waste; (ii) under a

[52] Dan W. Puchniak & Masafumi Nakahigashi, Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation, 45 Vand. J. Transnat'l. 1, 4-6, 25-26 (2012)
[53] S. Samuel Arsht, The Business Judgment Rule Revisited, 8 HOFSTRA L. REV. 93, 93 (1979-1980)
[54] Id. at 97
[55] Id.

reasonableness test, to determine (a) director in pursuant to the duty of due care, or (b) whether director action was brought in bona fide; and (iii) under a complete equality test[56], for the substantive merits of commercial operation decisions, where director loyalty is involved.[57]

2.3.2 Business Judgment Rule Defense

If the non-interference rule is strictly applied, it will lead to a situation in which there could be no interference with the directors' discretion, even if they themselves have infringed the company's rights and refuse to sue themselves in the company's name.[58] Those directors whose judgment is untainted by any personal interest are entitled to the benefits of the business judgment rule. The business judgment rule renders an umbrella that directors shall be equipped with, without afraid of second-guessing by shareholders of their decisions by means of derivative actions, to satisfy their duty to properly manage the company. There are other noteworthy justifications stated that judges are not good at making commercial decisions since they are not experts in business and directors are better-suited than courts to make business decisions. Directors have used the business judgment rule to obtain dismissal of shareholder actions by claiming that such actions are not in the best business interests of the company.[59]

The shareholder derivative action is recognized as an exception to the business judgment rule. A shareholder is permitted to assert a claim based upon a wrong done to the corporation rather than a wrong solely affecting the individual shareholder.[60] To establish that the demand is futile or that the demand is wrongfully rejected by the board, the plaintiff must first prove that the decision of the board of directors does not fall within the scope of business judgment rule defense.[61] The business judgment rule

[56] Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993)
[57] Lyman Johnson, The Modest Business Judgment Rule, 55 Bus. Law. 625, 631-632(1999-2000)
[58] Aharon Barak, A Comparative Look At Protection Of The Shareholders' Interest Variations On The Derivative Suit, Int'l & Comp. L.Q. 22, 20(1971)
[59] Higbee, Alan, Misapplication of the Business Judgement Rule to Dismiss Shareholder Derivative Suits against Directors, 33 U. Fla. L. Rev. 589 (1980-1981)
[60] Ashwander v. Tennessee Valley Authority, 297 U.S. 288, 318-19 (1935)
[61] Aronson v. Lewis, 473 A.2d 805, 814-15 (Del. 1984), overruled on other grounds by Brehm v.

protects a director from the outcome of a decision if, among other things, the decision was made on the basis of all relevant facts, including those facts he or she should have known had due care been exercised. The court holds a premise that, unless shown otherwise, that the directors have de facto exercised, bona fide, commercial operation judgment in what they are convinced of to be in the best interests of the company. For example, in the case of Ashwander v. Tennessee Valley Authority,[62] Chief Justice Hughes and three concurring justices held the opinion that in this case, where the complaint alleged illegal conduct by corporate management, the business judgment defense did not applied.

2.3.3 The Balance between Business Judgment Rule and Derivative Action

Where an injured shareholder accuses that a director prevails self-interest over the company's interest in decision making, it is necessary for the court to assess the nature and degree of that interest to determine whether or not it eliminates business judgment as a defense. A court will enjoin the transaction or hold directors liable to the company, if the court determines that the business decision made by directors is not an outcome of honest business judgment.[63] The business judgment rule was applied in the case of Auerbach v. Bennett.[64] This case was defined as a derivative action against directors of General Telephone and Electronics Corporation involved in recovery of improper payments abroad. The court reviewed the investigation conducted by the special committee, concerning integrated factors which was involved in, for instance: the reasons for the payments, the participation degree and benefit by each individual director, both the advantages and disadvantages to the company, and whether public confidence could be cultivated if the action continued.[65] After reviewing of above

Eisner, 746 A.2d 244, 256 (Del. 2000)

[62] 97 U.S. 288 (1935)

[63] Gimbel v. Signal Companies, Inc., 316 A.2d 599, 610 (Del Ch.)

[64] 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979), rev'g 64 A.D.2d 98, 408 N.Y.S.2d 83 (2d Dep't 1978)

[65] Id. at 107, 408 N.Y.S.2d at 87-88

elements, the New York Court of Appeals respected the decision made by the special committee which held an opinion that initiate an action is not at the best interest of the company. The onerous burden of proof was allocated on the shoulder of complaining plaintiffs and if, under such circumstances, those plaintiffs who failed to reveal self-interest, absence of due care, bad faith, or improper incentive of the discretional decisions made by directors, may receive dismissal from the court.

It is not easy to achieve a balance between the application of derivative action and business judgment rule, and sometimes misapplication of business judgment rule happens. The land mark judgment in Hawes v. Oakland was considered as one misuse of business judgment rule,[66] in which plaintiff alleged that the City of Oakland shall pay for water services provided by the company of Hawes and the court dismissed the action. Because contemporarily, the Hawes served the City of Oakland with water of gratuity. The business judgment rule was adopted in Hawes as a defense against the plaintiff's assertion, not to eliminate the action before it began. There was no assertion on fraud on the minority or misconduct on the part of the directors in the plaintiff's claim. Under the court's statements, directors of Hawes had reasonably and thoroughly determined public service mentioned above was in the best interests of the company, and thus the business judgment rule insulated the directors' decision. As a consequence, federal court dismissed the shareholder actions in this case and precedents like Hawes v. Oakland may not be applicable to factually dissimilar cases.

Therefore, it might be reasonable for a group of directors to balance these factors with the dubious compensation and come to a conclusion that an action would be financially irrational. Modern courts supposedly would not agree the controversy that inappropriate actions are in the best interests of the company merely for the reason that such actions might gain income for the company. When properly applied, the rule balances the directors' right to substantial discretion to act without fear of liability with the

[66] Hawes v. Oakland, 104 U.S. 450 (1882)

shareholders' right to responsible decision making.

2.4 The Institutional Function of Derivative Action

2.4.1 Overview of the Debate on the Function of Derivative Action

Both legal scholars and practitioners are concerned about the function of the derivative action mechanism. They also have noted how courts have concluded that the purpose was to deter mismanagement and, at the same time, to indemnify the company.

Proponents of the compensatory rationale hold an opinion that if the function of derivative action is to deter wrongdoings, courts shall permit anyone rather than the current conditional[67] acceptance—shareholders only. Furthermore, several scholars argue that derivative actions compared with criminal actions are not the perfect choice to achieve the optimal level of deterrence, and besides, such a level is hardly to be accurately evaluated.[68] Opponents of the compensation rationale generally criticize the compensatory rationale in the following three aspects. Primarily, parties who were not actually harmed may benefit from a recovery due to the constantly changing stock ownership. Second, the injury to the shareholders may not equal the injury to the corporation. Third, any recovery is typically insignificant on a per share basis. Therefore, they argue, a derivative action cannot yield any kind of meaningful compensation on an individual basis.[69] Nevertheless, the derivative action imposes very little monetary cost on an individual defendant because the defendants have "director and officer liability insurance". The plaintiffs are facing the economic pressure which resulting in a non-pecuniary and speedy settlement.[70]

2.4.2 Compensatory Function

[67] James D. Cox, Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures, 52 Geo. Wash. L. Rev. 745, 761(1983-1984)
[68] Kenneth B. Davis, Jr, The Forgotten Derivative Suit, 61 Vand. L. Rev. 387, 408(2008)
[69] David W. Locascio, The Dilemma of the Double Derivative Suit, 83 Nw. U. L. Rev. 729,754-755(1988-1989)
[70] Supra note64, at 416

According to economically motivated and rational shareholder theory, when the financial income of such action surpasses the cost, shareholders will choose to sue the wrongdoers. It was the dominant approach in early period of derivative action to understand shareholder action.[71] This theory maybe appropriate for the rising period of derivation action, however, the later empirical research clearly showed the de facto beneficiary were attorneys rather than the company or plaintiff. During the 1970s, risk allocation was popularly applied in the analysis of the function of the derivative action mechanism. In an efficient market, any injury suffered by the company would systemically translate into a decrease in each share price. It was still possible that the sum of shareholders' total loss would exceed that of the company, even if we assumed that the security market was fully efficient. In reality, the attorneys representing shareholders gained most of the indemnity in the form of attorney fee while those shareholders who initiated the derivative actions hardly acquired real monetary compensation.[72]

A 1991 study, conducted by Professor Roberta Romano, who investigated the period of late 1960s to 1987 and analyzed 535 present and former NYSE and NASDAQ National Market firms involved in shareholder derivative actions.[73] According to his statistics, the average amount involved in each case was six million US dollar which equaled to five percent of the company's total assets. Among all these cases, twenty-one percent of the actions were the company directly paid the shareholders.[74] Another study which analyzed derivative actions from 1999 to 2000 in Delaware, found that merely 6 resulted in monetary recovery of the total 50 leading cases settled.[75] Companies generally funded their compensation and the increased premium rate could safeguard managers from personal liability. The company's directors and officers liability

[71] Supra note 56, at 25-26
[72] Roberta Romano, The Shareholder Suit: Litigation Without Foundation, 7 J. L.ECON. & ORG. 55, 65 (1991)
[73] Id. at 61-62
[74] Id.
[75] Robert B. Thompson & Randall S. Thomas, The Public and Private Faces of Derivative Lawsuits, 57 VAND. L. REV. 1747, 1775-1776, n.147 (2004)

insurance covered the responsibilities which shall borne by the directors and officers. Thus, the directors and officers liability insurance would pay the compensation, in case that pecuniary compensation was acquired by the shareholders on behalf of the company. This was a dilemma. Because the company's premium increases possibly counterbalanced a substantial proportion of the recovery.[76]

2.4.3 Deterrent Function

During the 1970s, risk allocation was popularly applied in the analysis of the function of the derivative action mechanism. Due to the application of business judgment defense and the existence of exculpatory statutes, it was increasingly difficult to challenge the directors for wrongdoing on the grounds of breach of duty. The promulgation of exculpatory statutes, resulting in the remove of the traditional compensatory function. The fact that the compensation rendered by the judgment has been more theoretical than real justifies for the derivative action shall gradually rely upon the role of deterrence to the management. The organizing principle around which the derivative action should be reconstructed is a deterrent one: the derivative action should serve as the principal means by which to enforce the fiduciary duties of company's managerial rights and to punish the violation.

The institutional function of derivative action largely depends on the economic and legal context where companies are situated and the purpose of which it is expected to reach. The determinant of the efficiency and sufficiency of derivation action lies in the comparative costs of alternative enforcement mechanisms which are gradually looming in recent decades, for instance: securities class litigations. From a perspective of economic and corporate governance, if the financial income of derivative actions exceed their costs, then the shareholder would be convinced to sue. It is no doubt that no clear black or white answer exists, inter alia, according to the empirical evidence of

[76] JEFFREY M. GORRIS, Jr., Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis, 52 GEO. WASH. L. REV. 789, 805-06 (1984)

the compensatory value which shows with vagueness in a myriad of jurisdictions.

2.4.4 A Compromise Solution

The compensatory and deterrent function of the derivative action mechanism was supplemented and substituted by the some institutional developments by the late 1960s.[77] Due to the existence of informational asymmetry in company governance and divergent motivations to sue, the derivation action mechanism was extraordinary perplexing, which demanded the regulation design of ingenuity. The most important and valuable function embodied in the derivation action mechanism was the potential deterrence to the managerial rights and thus promoting company governance. Recently, more functions of derivative actions are recognized, such as promoting good corporate governance and providing remedy to a damaged shareholder.[78]

In the case of Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R.[79], the United States Supreme Court concluded, however, that deterrence alone did not justify an action because there was a possibility that juries or courts might award unjust windfalls to plaintiffs who were not materially harmed. In recent, most of the stock option backdating cases are defined as derivative actions. In case that the wrongdoers do not obtain interests or the company does not suffer substantial share value decline, the application of derivative action may be make sense. Thus, the function of derivative action may be as a resolution for self-transaction and breach of fiduciary duty claims.

Notwithstanding the reconstruction of the institutional function of derivative action mechanism is increasingly emphasized on deterrence, the economic context of the company contribute to the diverse application of such actions. In small and medium companies, wrongdoings are much easier to get rid of the awareness of the public,

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[77] Supra note 74, at 411

[78] William Kaplan & Bruce Elwood, The Derivative Action: A Shareholder's "Bleak House ", 36 U. BRIT. COLUM. L. REV. 443,455 (2003)

[79] Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R., 417 U.S. 703, 717 (1974)

because shares in these companies are generally not actively traded in a public market. It is also very hard for governmental officials to regulate small and medium companies.

Justice Holmes held that law is a man with good knowledge but merely cares material outcomes. The knowledge of this bad enable him to foresee the consequences of his behavior.[80] Holmes' bad man theory has been applied to revision of substantive company law. Perhaps it is better to stand Justice Holmes's subject on its head, approaching the law as would a "good man, who finds reasons for his behavior, or some of them at least, in the vaguer sanctions of conscience."[81] If we can follow this rule, it would be without doubt give one a different view of derivative actions and of the chilling effect current constraint should have had on derivative suits in much of various jurisdictions.[82]

Chapter III The Revolution of Derivative Action in the United Kingdom

The invention of the derivative action is that of the law-makers' response to recognized misuse of economic organizations viewed against popularly accepted standards of business conduct.[83] In the process of exercising the shareholders' right to sue against misconduct, a myriad of suspicion and friction arouse successively. The continuously application of shareholder derivative action convincingly illustrates the necessity and utility of this remedy mechanism. There is no denying that this mechanism has some defects or flaws and needs further perfection. A historical comparative study on the various jurisdictions may serve this significant and debatable subject of company law. Under the current prevailing rule, the plaintiff involved in a derivative action shall establish not only that a knowing criminal act caused an economic loss to the

[80] 0. W. Holmes, The Path of the Law, in Collected Legal Papers 171 (1920)
[81] Id.
[82] Douglas M. Branson, The American Law Institute Principles Of Corporate Governance And The Derivative Action: A View From the Other Side, 43 Wash. & Lee L. Rev. 399 (1986), http://scholarlycommons.law.wlu.edu/wlulr/vol43/iss2/4, 408
[83] Bert S. Prunty, Jr., The Shareholders' Derivative Suit: Notes on Its Derivation, 32 N.Y.U. L. REV. 980 (1957)

corporation, but that the resulting loss exceeded the competitive benefits gained through violation.

3.1 The Genesis of Derivative Action

The shareholder's right to initiate an action against the misconducting managers and the court's judicial power to intervene in the affairs of a commercial company were firmly established long before the Foss case.[84] The court had previously ascertained its judicial power upon the affairs in the company and accept class action, thus render a remedy to a minority shareholder.

The derivative action can be traced back to early time class litigation which is considered as the cornerstone of this remedy mechanism in the United Kingdom, and through class litigation the courts of equity presumed their right to hear and settle conflicts among the members of the company family. During the 18th century, in order to make a final decision, the English Court of Chancery required the joinder of all parties involved in the case had material interest. This was defined as the proper parties rule or necessary parties rule.[85] Soon followed was the creation of exception to this rule by cases involved with similar facts, for instance, the 1751 case of Leigh v. Thomas[86] and the 1807 case of Good v. Blewitt.[87] Through these cases, the English Court of Chancery gradually discarded the concept of consent by the board of directors, instead, the court recognized the group's shared interest as the deciding point despite the accurate extent of organization demanded for a seeking of shared interest diverse and manifold.

Meanwhile, the English Court of Chancery established judgments involving the owner of businesses for example, partnerships and joint-stock companies, which were deemed

[84] Foss v. Harbottle, (1843) 67 Eng. Rep. 189 (Ch.) 202-04; 2 Hare 461
[85] Geoffrey C. Hazard, Jr.,Indispensable Party: The Historical Origin of a Procedural Phantom, 61 Colum. L. Rev. 1254, 1255-56, 1262-70 (1961)
[86] Leigh v. Thomas, (1751) 28 Eng. Rep. 201 (Ch.); 2 Ves. Sen. 312
[87] Good v. Blewitt, (1807) 33 Eng. Rep. 343 (Ch.); 13 Ves. Jun. 397

as predecessor of the modern shareholder derivative action. In 1722, the English Court of Chancery accepted that shareholders who were part of the owners of an enterprise had the right to initiate an action on behalf of themselves and other proprietors against mismanagement in the case of Chancey v. May.[88] The court stated that it would be impossible and inefficient if all owners of the enterprise were made plaintiffs which means coming of no justice. It was stated in the case of Lloyd v. Loaring,[89] under general circumstances, the proper parties rule shall prevailed. However, when the demand of necessary parties was in conflict with substantive justice, exception shall be made.

It was not until 1810 that came the first explicitly admitted shareholder representative action.[90] In the case of Adley v. The Whitstable Co., the articles of association of the Company of Whitstable Fishermen stipulated that any freeman engaging in any other oyster fishery on the coast of Kent should forfeit £10 and until payment should be excluded from all share of the profits. The Plaintiff had been unduly prevented by the bylaw from working in any manner as freeman. The Plaintiff filed the Bill and later died. The action was revived by his Representatives. The Defendants insisted, that the partnership was duly dissolved that they were only accountable for the partnership property at the time of the dissolution. The importance of the case lied in the fact that the equity court took jurisdiction of an intra-corporate dispute.[91] The emergence of derivative action was a practical response to the diffusion and multiplication of ownership.

In the case of Adair v. New River Company,[92] the New River Company was created by the concession of King James I and the King's original share was divided into hundreds of shares which later bought by more than one hundred individuals. One shareholder

88 Chancey v. May, (1722) 24 Eng. Rep. 265; Prec. Ch. 592
89 Lloyd v. Loring, (1802) 31 Eng. Rep. 1302 (Ch.)
90 Adley v. The Whitstable Co., 17 Ves. Jun. 315, 34 Eng. Rep. 122 (Ch. 1810)
91 Bert S. Prunty, Jr., The Shareholders' Derivative Suit: Notes on Its Derivation, 32 N.Y.U. L. REV. 982 (1957)
92 Adair v. New River Co., (1805) 32 Eng. Rep. 1153 (Ch.), 11 Ves. Jun. 429

claimed that he was being wrongly taxed and that the total tax payments charged on him was disproportionately. The jurisdiction of this case was an equitable charge for the legal interest lied in the Corporation. The Plaintiff was entitled without reference to the construction of the Land-Tax Act. Though the Bill by the annuitant was dismissed due to the Court refused to raise an equity as to the profit which arisen from disobedience to the Act, Lord Eldon stated that all persons interested should be parties which was summarized as the general rule requires, however, where it was impracticable or extremely difficult, this requirement could be dispensed. Whereas in this case it was absolutely necessary to bring before the Court all the proprietors. Some may be in circumstances perfectly distinct from all the others. Some, for instance, may had redeemed the land-tax. In such a case, in order to obtain a decree, to establish the right of suit to a mill, for instance, the Court shall require parties sufficient to secure a fair contest, and if the right was established in that way, consequential relief may be had against the rest in another suit.

3.2 Foss v. Harbottle Case and Its Subsequent Interpretation

The most cited case of Foss v. Harbottle happened in 1843 was recognized as the first case. Throughout the nineteenth century, courts in the Anglo-American legal system regarded the case as a milestone of derivative action history.[93] This case established the basic position in English law that the court would not intervene in the application of a shareholder when the rights of the company were infringed by its directors. The case of Foss v. Harbottle was wrongly cited when it was asserted to be the first example of the exercise of this power.[94] This case shall be regarded as a case emphasized on limiting shareholders' right to sue derivatively rather than establishing or expanding.

In the Foss v. Harbottle, plaintiffs asserted that the board of directors abuse their

[93] David A. Skeel, Jr., Shareholder Litigation: The Accidental Elegance of Aronson v. Lewis, in the Iconic Cases in Corporate Law 167
[94] Bert S. Prunty, Jr., The Shareholders' Derivative Suit: Notes on Its Derivation, 32 N.Y.U. L. REV. 993 (1957)

decision-making power. The board of directors sold their own lands to the company at a price surpassing the market value of equivalent lands. Besides, they also mortgage the lands to finance the purchases. All decisions were made in the name of the company. This case reflected the opinion hold by the court that judges were reluctant to intervene the business operation and shall not substitute the directors to make decisions for company. Two significant principles were generated from the case, and the first was proper plaintiff principle, which separated the company with its shareholders, confirming the company's legal capacity to sue. The second was the 'majority rule principle', which recognized that shareholders in the general meeting were the residual source of authority in the company and that this authority can simply be exercised by majority vote.[95]

The Foss v. Harbottle case established a limitation of rights rather than expansion appeared to be comprehensively recognized, and in 1867 the court got two cases which were Hallows v. Fernie and Atwool v. Merryweatber, the significant term that the majority shall not abuse its governing power to defraud the minority.[96] Later courts' interpretation of the case Foss v. Harbottle revealed that, if the action was not supported by most of the shareholders, a shareholder could make the controversy a bill on behalf of himself and all other shareholders even it had nothing to do with internal argument. Four exceptions were identified and developed in the following cases, (i) ultra vires and illegal acts, which was established in the 1982 case of Prudential Assurance Co Ltd v. Newman Industries Ltd,[97] (ii) breaches of special resolution procedures, which was established in the 1950 case of Edwards v. Halliwell,[98] (iii) personal rights, and (iv) fraud on the minority, which was developed in the 1902 case of Burland v. Earle.[99] When an illegal or ultra vires conduct was done to the company, a shareholder may sue to compensate the company. The jurisprudence under this principle was that the

[95] Pettet, Lowry and Reisberg (Pettet's Company Law), 213: Hirt (The Enforcement), 73ff
[96] Hallows v. Fernie, L.R. 3 Eq. 520 (1867); Atwool v. Merryweatber, L.R. 5 Eq. 464 n.3 (1868)
[97] Prudential Assurance Co Ltd v. Newman Industries Ltd, (No. 2) (1982) Ch 210
[98] Edwards v. Halliwell(1950) 2 All ER 1064
[99] Burland v. Earle(1902) AC 83, 93

majority has no capability to ratify conducts ultra vires the company. A minority shareholder may initiate action before the court when the behavior complained of was illegal or a "fraud on the minority". Frauds on the Minority means where the wrongdoer manipulated such a conduct, against whom a minority shareholder may initiate a derivative action. Lord Davey defined the concept of fraud in the case of Burland v. Earle.[100] The wrongdoers by means of direct or indirect attempt to occupy properties or money for their own interest. The properties or money belonged to the company and the shareholders who initiated the derivative action were the residual owners of the company.

In the case of Cook v. Deeks,[101] directors extracted excessive unjust remuneration, which amount to misappropriation of assets of the company. The fact was directors concluded contracts in their own names which they ought to have contracted and gained the interests for the company they worked for. The contractual rights were theoretically vested in directors on behalf of the company, while a resolution, which had actually been passed in general shareholders meeting via their own votes as shareholders, and which asserted to approve of what they had done for their own interest, could not be supported. Therefore, the minority shareholders had the right to bring a derivative action to protect what really pertained, in equity, to the company. This formula in Cook v. Decks could be applied in the following two aspects: (a) it can help to mark off from cases such as N.W. Transportation v. Beatty[102] case in which the essence of transactions originated by the majority is regarded as fraudulent within the meaning of this Heading;[103] (b)it might be used to explained in cases where the company had an equitable property in the interests gained by the directors, and in consequence, minority action was a feasible remedy.

[100] Id.at 93-94
[101] Cook v. Deeks, (1916)1 A.C. 554
[102] N.W. Transportation v. Beatty (1887) 12 App. Cas. 589
[103] Greenhalgh v. Arderne Cinemas (1951) Ch. 286, 291

3.3 The Statutory Era

Minority shareholders generally had no effective remedy to protect themselves or the company, or to discipline corporate management.[104] Under traditional English common law, the shareholder derivative action was described as ambiguous, intricate and unreachable save to attorneys professional in this realm. In 1850s, the English Parliament promulgated a series of legislation, which largely impair position of derivative action as a procedure in the English court, solving both substantive and procedural aspects with regard to joint stock companies, corporations, and friendly societies.[105] In 1862, the first codification of English company law occurred[106] and was supplemented by common law decisions at the same time.

From then on, the derivative action which was gradually established through case law by the English Court of Chancery. In the report of Explanatory Notes to the Company Law Reform Bill, in order to decide if a shareholder was entitled to file a derivative action, a set of new procedural rules providing more fair and speedy remedy should be established.[107] The former derivative action mechanism was substituted by the adoption of the Companies Act 2006 in which, for the first time, statutorily allowed shareholders to bring derivative actions. In 2006, the United Kingdom completely and comprehensively revised its company law and adopted the new Company Act 2006. The restriction on the application derivative action was abolished and substituted by the Company Act 2006, provided with a cost-efficient and flexible remedy mechanism for minority shareholder.

The United Kingdom enacted its first statutory company law, which was Companies Act 2006. From then on, derivative action could only be brought under the statutory

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[104] Bernard Black, Legal Liability of Directors and Company Officials Part Two: Court Procedures, Indemnification and Insurance, and Administrative and Criminal Liability (Report to the Russian Securities Agency), 2008 Colum. Bus. L. Rev. 1, 26 (2008)

[105] Katharina Pistor et al., The Evolution of Corporate Law: A Cross-Country Comparison, 23 U. PA. J. Int'l Econ. L. 791, 798 (2002)

[106] Id.

[107] The report of Explanatory Notes to the Company Law Reform Bill, para 6.15

provisions. The cause of action should be the director involving in breach of trust or breach of duty. A shareholder asserted a derivative claim which was actually a proceeding. The right to sue wrongdoers were primarily vested on the company, when the company refused or failed to initiate an action, the shareholders were allowed, on behalf of the company, to seek relief.[108] The British legislators made it clear, however, that the sections in part 11 of the Companies Act were not intended to substituted the rule revealed in Foss in substance but, to provide for a set of procedures for bringing such claims by using and supplying standard for the courts summarized from the jurisprudence of Foss v. Harbottle.[109]

3.4 Reform and Brief Comment on English Derivative Action Mechanism

Though we have explored a few cases above, de facto, derivative action is extremely rare in the United Kingdom in the past hundreds of years since its origin. This perhaps reflects a traditional English attitude towards derivative action, the judicial power was reluctant to intervene the internal affairs of a company and holds a deep belief in the self-governance by exercising collective nature of a company. Meanwhile, there was no denying that derivative action was a feasible remedy for individual shareholder. From 1843 to 1875, the English courts were focused on keeping this balance. The effort to maintain a balance between the judicial reluctance and the desire to restrain abuse has triggered much of the subsequent refinement of the rule of the derivative action.

The common law derivative action mechanism had long been criticized for its complexity and ambiguity.[110] A consensus on the reformation of derivative action was formulated as a response to severe criticism and reaction to international development in the field of company law. The English Law Commission were required by the

[108] UK company act 2006
[109] Pettet, Lowry and Reisberg (Pettet's Company Law), 212, note 11, 225, with reference to the Explanatory Notes on the Companies Act 2006, para, 491
[110] S Watkins, The Common Law Derivative Action: an Outmodel Relic?, 30 Cambrian Law Review 40, (1999)

president of the Board of Trade and the Lord Chancellor to propose a reform of shareholder remedy mechanism. The United Kingdom had made the effort to reform the derivative action mechanism by statutory improvement. The Department for Business Enterprise and Regulatory Reform of the United Kingdom explained the rationale as follows. Company law was created to provide a legal framework and promote business activities. However, with the development of economy, the business circumstances evolved, which resulted in the separation of law and commercial practice. The separation could hamper the business activities and this was also the incentive to update the law.[111]

The long been criticized standing to sue rule was, to a significant extent, repealed after the United Kingdom introducing the statutory derivative action in 2006, granting courts immense discretion in deciding whether an action falls within the scope of legitimate and permissible derivative action . The previous pre-condition of Fraud on the minority and wrongdoer dominance were substituted by judicial approval. To this end, a broad and general standard was established by the respective legislatures of these countries. From then on, the judges could refer to this criteria when deciding whether a proposed action was allowed.[112]

However, the fear of frivolous actions or strike suits, to some extent, was a dominant consideration in the discourse of the United Kingdom Company Act 2006. The development of derivative action in the United Kingdom showed that lawyers and judges were more focused on controversy of shareholders' rights on matters of pleading and procedure. The evolution of the derivative action under the English common law was a track of the efforts of judges and attorneys to execute that responsibility. And at the same time, not only the right of a majority of the members of a company organ to decide the affairs of that organ was not harmed. The development of derivative action

[111] Department for Business Enterprise & Regulatory Reform, Explanatory Notes, Background 1 3, available at http://www.legislation.gov.uk/ukpga/2006/46/notes/ division/2
[112] Supra note 39, at 184

provided a more feasible solution for inter-company conflicts.

Chapter IV The Evolution of Derivative Action in the United States

4.1 The Application and Exception of Proper Plaintiff Rule in Early Stage of Derivative Action

It was not until the case of West v. Randall in 1820 did the Courts in the United States introduced the necessary party rule.[113] And in 1829, the courts introduced exceptions to that rule, which could be traced back to the case of Mandeville v. Riggs,[114] from the English Court of Chancery. Justice Story dealt with many cases involved the application of this rule. In the book which was named Commentaries on Equity Pleadings, published in 1838, he gave detailed analysis on the application of the necessary party rule and its exceptions.[115]

In the history of early United States federal case law, the 1820 case of West v. Randall was regarded as one of the earliest class action lawsuits. The case was classified as an equity action and an important precedent. The modern class action lawsuit originated from equity actions such as the case West v. Randall. The dispute of this case involved the heritage of William West who died in 1814. There were eleven heirs of William West. The plaintiff was one of the eleven heirs of William West, and he brought an action claiming the estate of William West in trust was used to pay the debts of William West by the survivors of trustees. The problem was the plaintiff did not make all the heirs be the parties of this action.

Justice Joseph Story wrote the decision when he served on the United States Court of Appeals for the First Circuit. Under normal conditions, all interested persons should be made parties to the action, either plaintiff or defendant. This is called the necessary

113 West v. Randall, 29 F. Cas. 718 (C.C.D.R.I. 1820) (No. 17,424)
114 (Mandeville v. Riggs, 27 U.S. 10 Wheat., (1829)
115 Joseph Story, Commentaries on Equity Pleadings and the Incidents Thereof §§72-238, (Boston, Charles C. Little and James Brown, 4th ed. 1848) 85-282

parties rule which was a general principle in derivative action mechanism. When the interested persons were enormous or unable to participate in the action, it was the court's discretion to decide the application of exception to the necessary parties rule according to the real merits. The substantive justice and convenience were two main issues to be considered.[116] This case somehow revealed that the class action mechanism was well-recognized before adoption of Federal Equity Rule 48 by United States Court of Appeals.

The 1829 case of Mandeville v. Riggs[117] was another case decided by Justice Story, which involved stockholders of an unincorporated association. The plaintiff did not make all stockholders parties and some of the stockholders passed away during the action. Due to this defect, the Supreme Court reversed the verdict and exception to the necessary party rule was not applicable to this case. It was not rare that in many cases when there were a lot of parties. If the court strictly adopted the necessary party rule would hinder the justice, exception to the necessary party shall be applied. The courts of equity usually required all the parties to participate in the action so that future actions were reduced and justice was achieved. Considering both justice and convenience, if the application did not harm the justice, the court would permit exception. However, in this case, some of the parties passed away, if the decree against the defendants was valid, which meant the bill could against representatives of deceased stockholders, all stockholders had the right to debate each material fact of the decree in a later action.[118]

4.2 The Recognition of Derivation Action

In the case of Attorney General v. Utica Ins. Co.,[119] a specific and explicit theory was put forward for the first time, according to which a minority shareholder had the right to sue mismanagement. Neither shareholders nor wrongdoers brought a complaint in

[116] West v. Randall, 29 F. Cas. 718, 721 (No. 17,424) (C.C.D.R.I. 1820)
[117] Mandeville v. Riggs, 27 U.S. (10 Wheat.), 487-488 (1829)
[118] Mandeville v. Riggs, 27 U.S. (10 Wheat.), 487-488 (1829)
[119] 2 Johns. Ch. Rep. 371, 389-390 (N.Y. 1817)

this case. Chancellor Kent stated that trustees who breached their duty under the trust were liable to the beneficiaries. However, the jurisdiction governed this kind of cases should be limited. If the plaintiff asserted for fraud against wrongdoers, a bill would be used.[120]

The case of Robinson v. Smith decided in 1832 was widely recognized as the first case that allowed shareholders to initiate a derivative action. The plaintiff claimed for fraud and mismanagement of the directors on behalf of themselves and the other shareholders.[121] In this case, the directors used all the money of the company to buy and sell stocks and later the company was not in debt. The conduct of buying and selling stocks in the stock exchanges did not fall within the scope of the normal commercial company activity. According to the Articles of Association, the New York Coal Company was involved in exploring, digging and selling coal.

Three minority shareholders who merely held 160 out of 4000 total shares initiated an action. After reviewing the bill, the court supported the plaintiff. In this case, the company was under the control of the board of directors, thus the company refused to take action. For that reason the court allowed the minority shareholder to bring a bill in their own names.[122] The court clearly explained the rational of Robinson v. Smith's in the decision. It was not rare to see mismanagement of a company, which under normal conditions was attributed to commercial risks. The officers were not account for the failure, unless evidences of breach of fiduciary duty were found. The right to redress was reserved to the company, but if the wrongdoers who must be made defendants were in control of the company and officers failed to prosecute in the name of the company, the shareholders were allowed to take actions. The shareholders were residual owners and liable for the debts of the company, so they were real interested parties in the action. It was inconvenient, when there were numerous parties or some parties were impossible

[120] Id.
[121] Robinson v. Smith, 3 Paige Ch. 222 (N.Y. Ch. 1832)
[122] Id.

to take part in the action, to bring all parties before the court. The solution was one party might file a bill in the court without harming the substantive justice. In that situation, the judgment was applicable to the rest of parties who did not appear in the court. [123]

The relationship between shareholders and directors were defined as a sort of trust. In this case, the trustee abused their power and misused the funds, which led to sustained loss. In order to seek redress, shareholders initiated a bill claiming that the injury they had suffered was substantial common[124] and trustees were deliberately breach the duty under the trust. The plaintiff asserted that trustees should be personally liable to the sustained loss.[125] Settling the dispute within the ambit of existing and unquestioned doctrine satisfied the legitimacy of recourse to equitable jurisdiction, and the already existed substantive rules were applied to govern wrongdoers.[126]

4.3 The Establishment of Federal Jurisdiction on Derivative Action and Subsequent Development

It was not until 1855, the case of Dodge v. Woolsey[127] that the U.S. Supreme Court exercised its jurisdiction on a derivative action for the first time and firmly established the framework of derivative action mechanism. Before this period, general federal question jurisdiction was not yet fully established. If shareholders intended to apply derivative action, they should create diversity of citizenship. Because the federal court would only accept disputes arose cross states. By means of diversification, a case was inside the jurisdiction of federal court and able to be heard by federal court. Although it was somehow ironic, the validity of the shareholders' ability to hold managers accountable through the derivative action was first recognized by this case.

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[123] Id.
[124] Id. at 230-231
[125] Id. at 231
[126] Bert S. Prunty, The Shareholders' Derivative Suit: Notes on Its Derivation, 32 N.Y.U. L. Rev. 980, 986(1957)
[127] Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855)

The case of Dodge v. Woolsey, a shareholder seek to enforce a cause of action in the name of the company against a third party. A brief background introduction to this case seemed worth mentioning. This case reflected the derivative action was no longer limited to protect shareholders. Through the collaboration of both shareholders and directors, the best interest of the company were achieved. In this case, an extra state tax was collected from the company and the constitutionality of this local tax was under doubt. The board of directors found that it would be silly and burdensome to initiate a litigation in the courts of the state that had imposed the tax. However, if the action was brought by its shareholder who had habitual residence in another state, diversity jurisdiction would apply and the federal court took the jurisdiction, implying the action’s odds ration immediately increased.

The Supreme Court upheld the shareholder’s action on behalf of the company. According to the decision, a shareholder was able to take action though the virtual target was the state—a third party rather than the management misconduct. In this case, the Court held the directors' conduct to be a breach of fiduciary duty because the company refused to take any measure to challenge the state statute which imposed an income tax upon the company. The omission of directors irritated shareholders and triggered the shareholders to initiate an action to protect the best interest of the company. Federal jurisdiction had been generally established in 1875, and there was no longer a need for such a dubious device.

Successors who preferred to bring derivative actions before the federal court were spurred by the devious maneuver used in case of Dodge v. Woolsey. Usually, Shareholders sold a few shares to those who domiciled in another states to facilitate the action became a popular practice. Under the United legal procedure that only a dispute between individuals or legal persons were cross-states did the federal court had jurisdiction. Perhaps the enforceability of federal court judgments were more authoritative than these given by state court judgment. In the following thirty years, the federal courts were overburdened to deal with large amount of cases.[128]

It was not until the 1881 case of Hawes vs. Oakland did the contemporaneous ownership rule was established. From then on, a shareholder was able to bring a derivative action unless he or she was being a shareholder at the time the misconduct was complained. This rule was apparently generated from the case of Hawes vs. Oakland judgment promulgated on January 16, 1882. The right to assert compensation were primarily allocated to the company itself. The Supreme Court clearly explained the rule in its judgment. The derivative action initiated by the a shareholder against the defendants had to be justified by oath. The shareholders who brought the bill shall be the shareholder at the time of the wrongdoing occurred. If the successor of a shareholder acquired shares according to law, he was also qualified to bring a bill. The initiation of a derivative action was not an evasion of jurisdiction or judgment seeking. Before the initiation of a bill, Shareholders exhausted all kinds of available internal remedies so that the right to bring to an action was verified.[129]

4.4 The Establishment of Demand Requirement

Three cases, namely, Hawes v. Oakland,[130] United Copper Sec. Co. v. Amalgamated Copper Co.,[131] and Corbus v. Alaska Treadwell Gold Mining Co.,[132] decided by Supreme Court between 1882 and 1917, established that a shareholder was incapable of bringing a derivative action over the board's objection except the shareholder could demonstrate the directors' breach of trust or breach of fiducial duty. In the case of United Copper Sec. Co. v. Amalgamated Copper Co., the plaintiff did not asserted that the company was controlled by the wrongdoers. There was also no indication that the board of directors was related to the wrongdoers. Justice Brandeis stated in the case of United Copper Sec. Co. v. Amalgamated Copper Co. that neither the board of directors were

128 Hawes v. Oakland, 104 U.S. 453(1881)
129 Id.
130 Id.
131 United Copper Sec. Co. v. Amalgamated Copper Co. 244 U.S. 261 (1917)
132 Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903)

guilty nor the refusal of bring an action existed.[133]

The 1881 case of Hawes v. City of Oakland stated the requirements for shareholders to file a derivative action. These requirements were regarded as limitations on the shareholder’s right to bring derivative action. An action against the City of Oakland, the water company, and directors of the company was brought before the court of equity by a shareholder in the Contra Costa Waterworks Company. The company, without any charge, furnished the city with water. The shareholder believed this conduct far beyond what the law required the company to do. Thus the shareholder requested the directors to stop the misconduct, but directors, contrary to his request, continued to do so, to the great injury of himself, the other shareholders, and the company. The company refused to take measures and the shareholder was told that it was the company’s right to decide whether to charge the City of Oakland or not. Then the shareholder found that he was accessible to equitable redress.[134]

The existence of misconduct was the initial reason to seek relief, however, it was equally important that the shareholder should prove he had exhausted entire internal remedies. Under normal condition, the right to initiate an action was reserved to the company. The shareholder should as soon as possible to communicate with the management and requested the managerial body to take measures to stop the misconduct or reduce losses. When all these efforts had been done, the company still refused to take measures, the shareholder had the right to initiate a derivative action. The evidence of exhaustion shall be fully presented before the action was permitted by the court.[135] Hawes thus seemed more as a policy-motivated strategy seeking to constrain a disreputable form of litigation than a pillar for the standing requirement. Since 1875, federal jurisdiction on derivative action had been generally established, therefore, no doubt upon this device.

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[133] Id.
[134] Hawes v. Oakland, 104 U.S. 452 (1881)
[135] Id. at 461

Comprehensive requirements were established through the cases brought before the United States Supreme Court. A shareholder complainant shall fulfill these certain standards as long as he wanted to propose a derivative action. In 1938, the derivative action was regarded as a part of the class action litigation for their resemblance and the requirements were codified in Rule 23 of the Federal Rules of Civil Procedure. In 1966, Congress substantially revised the rules, and Rule 23.1 was added to treat derivative suits separately, with the distinctive aspects of derivative suits in mind.[136] Thirty-three states have developed their own statutory provisions addressing derivative actions[137] and thirty-two have incorporated these statutes into their rules of civil procedure, which tend to be more precise.[138]

4.5 The Morbid Booming Period

Following the case of Hawes v. City of Oakland, judges generally adopted a lenient and flexible attitudes towards derivative action. At the beginning of the 20th century, derivative actions were extraordinarily prevalent in the United States, a substantial portion of which were viewed as strike actions, while the situation in the United Kingdom were completely opposite. According to Black's Law Dictionary, the definition of a "strike action" was an action started with mere wish of winning private settlements or large attorney fees.[139] The morbid explosion of derivative actions were basically due to the proliferation of public corporations and large amount of investors who, without intention to have influence in the management, actively participated in purchasing shares in corporations on a public stock exchange.

In 1944, Survey and Report Regarding Stockholder's Derivative Suits, which was recommended by the Special Committee on Corporate Litigation of the Chamber of

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136 FED. R. CIV. P. 23.1. Full text

137 John C. Coffee and Donald E. Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 Colum. L. Rev. 261, 268(1981)

138 FLETCHER CYC CORP §5939 (perm ed. 1995)6, §4.02

139 Black's Law Dictionary, 5th ed

Commerce of the State of New York, shortly named the Wood Report of 1944, was commonly regarded as the first comprehensive empirical research on the compensatory value of the derivative action. This report revealed that rampant abuse of the derivative actions caused by strike actions. What's more, the report found that the real beneficiaries of abusive derivative actions were attorneys and that the economic costs surpassed the compensatory income for companies. States legislatures began adopting security-for-expenses statutes to curb the abuses of "strike suit" litigation.[140] Seventeen States enacted a security for expenses statute to suppress such kind of actions following the New York legislation.[141] The security for expense portion of this optional section, in pursuant to the Model Business Corporation Act, provided that no matter how the court found the cause of action, the company were conferred the right to seek "such security in such amount as the court having jurisdiction shall determine upon the termination of such action".[142]

Nonetheless, the attorneys and plaintiffs discovered various tactics by which to outflank these statutes. The principal such tactic had been to plead a federal cause of action and this was effective. The requirement of security for expenses would still apply to a state claim joined with the federal claim.[143]

Various other techniques also existed by which to outflank the corporation's motion for security. Plaintiffs may bypass these obstructive statutes by such techniques as filing in states with no statute (inter alia Delaware), by finding other shareholders willing to intervene and thus boosting the number of shares to the amount necessary to sue without posting security, or by acquiring stays to supervise company books in order t144o examine the shareholder list. In view of this last alternative, the corporation may decline

[140] John C.Donald E. Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 Colum. L. Rev. 261, 262(1981)
[141] N.Y. Bus. CORP. LAW §627. Also see N.Y. GEN. CORP. LAW §61-b
[142] ABA-ALI Model Bus. Corp. Act ANN. §43A, 1 (1960)
[143] C. Wright & A. Miller, Federal Practice & Procedure: Civil §1835, at 408 (1972) for a brief discussion of security-for-expenses statutes, their history, and their success
[144] A. Frey, J. Choper, N. Leech & C. Morris, Case and Materials on Corporations 705-06 (2d ed. 1977)

to ask for security, since access to the list was likely to result in significant adverse publicity and consequent expense to the corporation.[145]

Thus, the derivative action in the United States arrived to a new peak in 1960s and a remarkable portion of all these cases were strike actions. Due to this severe abuse, it was unfortunately that they too often taken the form of general and indiscriminate hostility to the derivative suit, and sometimes promoted, by the organized bar.[146] Dean Rostow sensed this fact when he wrote:

> "One would expect those concerned for the integrity and future of private business institutions to applaud the intrepid souls who ferret out corporate wrongdoing, and risk their own time and money against a contingency of being rewarded, if in the end sin is found to have flourished. Not at all. Such men are not treated as honored members of the system of private enterprise, but as its scavengers and pariahs. Their lawyers rarely become presidents of bar associations, or trustees of charitable bodies. They receive no honorary degrees. At best they are viewed as necessary evils, the Robin Hoods of the business world, for whom a patronizing word may sometimes be said, when they succeed in revealing some particularly horrendous act. Many judges dismiss them on any plausible technical ground. Procedural obstacles bristle, and are relentlessly enforced. The substantive doctrines of law, and especially the wide scope given to the directors' "business judgment," make liability infrequent. Both statutory and judge-made law treat as dubious, or worse, the professional stockholders' suit against those who misuse other peoples' money."[147]

In response to the condition, the special litigation committee was designed in the 1970s

[145] Note, Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience, 4 Colum. J.L. & Soc. Prob. 50, 62-65 (1968)
[146] Daniel J. Dykstra, The Revival of the Derivative Suit, 116 U. Pa. L. Rev. 74, 75(1967-1968)
[147] Rostow, To Whom and For What Ends Is Corporate Management Responsible., the Corporation in Modern Society, 49 (E. Mason ed. 1959)

as an approach to eliminate frivolous actions. Then the decrease continued for following thirty years. Even after three decades of decrease, the derivative action was still viewed by several leading US academics (though not all) as a critically important corporate governance mechanism.[148] The New York State Business Corporate Law §627 was enacted pursuant to Survey and Report Regarding Stockholder's Derivative Suits, which was recommended made by the Special Committee on Corporate Litigation of the Chamber of Commerce of the State of New York in 1944.[149] The subsequent thirty years practice showed the effectiveness of the adoption of special ligation committee, which generally owned the discretion of whether to sue or not, and courts normally applied the business judgement rule to review their decisions, which excluded any substantive review.

4.6 The Establishment of Special Litigation Committee

In 1976, the landmark case of Gall v. Exxon Corp[150] was decided by one federal district court in New York. It was the first time in the history of derivative action that the special litigation committee was created. The board of directors paid more than 50 million US dollars to the Italian political parties who were in charge of the government for five consecutive years. The purpose of the payment was to ensure the special interests of the company in Italy and the funds used to pay were from the company. The plaintiff shareholders claimed that the payment decided by the boards of directors were illegal and in violation to the shareholders' interests. The board of directors formed a special litigation committee soon after shareholders requested the company to take action. After a comprehensive investigation, the special committee determined that the action against the board of directors were contrary to the best interests of the company. The court supported the determination of the special committee and dismissed the action. Since the special litigation committee was comprised of uninterested and independent

[148] Dan W Puchniak, Harald Baum and Michael Ewing-Chow (eds) The Derivative Action in Asia: A Comparative and Functional Approach (Cambridge University Press, 2012) 66
[149] N.Y. Bus. Corp. Law §627 (Consol. Supp. 1979)
[150] Gall v. Exxon Corp.(418 F. Supp. 508 (S.D.N.Y. 1976)

directors who determined in good faith, the court explained that the business judgement rule should be applied. This case changed the relationship between the board of directors and courts of equity. [151] Nevertheless, the court did not mention the illegality of the special litigation committee and the application of that committee, thus, the status of special committee in law remained unsettled.

The case of Zapata Corp. v. Maldonado[152] decided in 1981, which established general rules with regard to the procedures of derivation action. In addition, the court explicitly explained the role of special litigation committee played in determining whether to take action or not. That is to say, if the special committee refused to initiate an action, the injured shareholder was incapable of bring a derivative action. The Delaware Supreme Court clearly stated the reason. Under common conditions, the court shall comply with the decision of refusing to take legal action made by the special litigation committee. The denial of the determination would invade the discretion of the directors' business operation.[153]

This case was brought before the Delaware Court of Chancery in 1975 by a stockholder of Zapata Company. The stockholder, named William Maldonado, claimed the directors for self-dealing which fell within the scope of breach of fiduciary duty.[154] Without demanding the board of directors to bring an action and exhaustion of internal remedies, Maldonado sued directly in the Delaware Court of Chancery in 1975. In response, a special litigation committee was soon set up by the company. A conclusion that the action shall not be initiated after a comprehensive investigation made by the special committee. According to the committee, the continuance of action would not be in Zapata's best interests.[155] While, Zapata, as the genuine plaintiff in interest, proposed

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[151] Kenneth B. Davis, Jr , The Forgotten Derivative Suit, 61 Vand. L. Rev. 387, 390(2008)
[152] Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981) (describing the balance of power in a derivative suit)
[153] Id.
[154] Id.
[155] Id. at 781

for dismissal.[156]

After an appropriate and thorough review, the court found the committee members were disinterested and independent. Besides, the committee had made their decision with "bona fide". The court stated that Zapata's committee was entitled to pursue dismissal.[157] The business judgment rule shall not be used to protect the decision of Special committee to seek dismissal except in an action attacking the decision directly.[158] Therefore, the court of chancery decided at its discretion to subject to the Special committee's decision.[159] Delaware Supreme Court adopted a more autonomous method and left it to the discretion of the trial courts whether to intervene in both a substantive and a procedural review of a special litigation committee decision.[160] The court stated that unless a refusal made by the committee was harmful to the company, the determination should be respected.

The following two-steps standard was established by the court to evaluate the correctness and appropriateness of the special committee's decision of refusal to sue. To start with, the independence of the committee should be examined. If the committee had conflicted interests with the company, the decision made by the committee would not be respected. The court consider had to consider the basis by which the decision was made.[161] The burden of proof was allocated on the company, which meant the company was responsible to prove the independence and good faith of the special committee. In addition, the company had to examine the reasonableness and thoroughness of the investigation as well. This equivalent to that the burden was allocated to those interested directors. This second step was obviously seek to serve as an "equitable out" for these trial courts that should a committee meet the technical requirements of comprehensive investigation, bona fide and independence yet not

[156] Id.
[157] Id. at 786
[158] Id. at 782, 787
[159] Id. at 788
[160] Id.
[161] 430 A.2d at 788

appear to meet the spirit of the rule.[162] Justice William Quillen explained that it was the courts' discretion to judge whether a motion would be granted according to its independent judgement rule. Thus, the two–step standard took burden of proof and judicial scrutiny into consideration. Interested directors' transactions might be proper while decision made by biased directors shall not be respected.

4.7 The Application of Business Judgment Rule

In 1979, the court apparently held that decision of refusing to sue made by the board of directors fell within the scope of business judgment. No matter how flawed the business judgment was, unless the independence or good faith of the directors were challenged, it was beyond the judiciary power to inquire the business judgment. This was summarized from the decision of Auerbach v. Bennett case.

The current and previous members of the board of directors of General Telephone & Electronics Corporation (GTEC) were involved in payment of bribes. They used the company's funds to pay foreign officials to get political preferential treatments. After a cmpany audit, Plaintiffs brought a derivative action against those directors. The board of directors appointed a few independent directors to form a special litigation committee. The committee carried out a comprehensive investigation and refused to take over the action. The special committee consisted of three directors who were not on the board at the time of the wrongdoing.[163] The special committee reviewed the auditor findings and refused to sue. In order to pursue the best interests of the company, they should not bring an action against the Board members. The defendant brought a motion for summary judgment. The trial court reviewed the anti-action decision and supported the defendant. In this case, the court require the committee to explain the reasons to pay for the foreign officials and the degree of the participation of

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[162] Michael Slone, Disinterested Director Committees and the Shareholder Derivative Suit, 70 Ky. L.J. 831, 851(1981-1982)

[163] Auerbach v. Bennett, 393 N.E.2d 994 (NY 1979)

the challenged directors. In addition, the court examined whether there were any public confidence lose incurred as well.

Nonetheless, this verdict was reversed by the appellate court. The appellate court held an opinion that the summary judgment was completely based on the factors stated by the committee. This meant that the defendant would obviously weigh the relative factors and select favorable information to submit to the court. The New York Court of Appeals explained that substantive judicial review of a board's decision was unavailable. In the New York court's opinion, it was under the board of directors' power to make a business judgment. If the judiciary power devoted itself into such issues, this meant the business experts in the company were deprived of the right to make business decision. In conclusion, substantive estimate with respect to business judgment were beyond courts' reach. [164]

The court explicitly held that judicial review was used to examine the appropriateness of methodologies and procedures which were used by the board. Thus, in order to protect its decision, the board must demonstrate a careful review of all the relevant evidences. However, the problem was courts are better qualified or more skilled than directors to perform such a review and thus again, the usual rules for judicial deference are less applicable. The court interpreted the business judgment doctrine as to give the special committee exclusive discretion to consider commercial, fiscal, legal, and cultural elements of the company. [165] A party was permitted to challenge the independence of such a special committee, however, once the independence of the committee is fully confirmed and the decision shall be protected in accordance with Business Judgment Rule.

However, considering that the application of business judgment rule could end some derivative actions prematurely. Feared of biased committees wrongly end actions, the

[164] Id.
[165] Id.

Delaware Supreme Court held that a court could measure based on its own business judgment in Zapata Corp. v. Maldonado. In the subsequent development, the independent special committee's capacity to dismiss a derivative action did exist in a myriad of states and federal policies. On the grounds of such policy, the special committee's decision of refusing to litigate was not required to the same degree of judicial independence as the ordinary business judgment.[166]

4.8 MBCA With regard to Derivative Action

After World War II, the Committee on Corporate Laws of the Section of Business Law of the American Bar Association created and provided the Model Business Corporation Act (MBCA). The first draft of MBCA largely referred to Illinois Business Corporation Act which was enacted in 1933. The MBCA was created by a unique form of authorship and most of the drafters were members of Chicago Bar Association.[167] The Model Business Corporation Act was a model law to unify the definition of corporation. Before the creation of MBCA, numerous actions were brought before courts due to the reason that variation and uncertainty between corporation laws in different states. There were more than twenty-six states adopted the MBCA which brought some clarity to other corporate law issues. In recent, the Revised Model Business Corporation Act (RMBCA) which is deemed to be an updated version of the MBCA by most of the states.[168]

It was not until 1960 that the derivative action provisions were adopted in MBCA and in 1981, amendment were proposed to those statutes. The Committee on Corporate Laws adopted renewed sections 7.40 through 7.47 to substitute the former 1960 MBCA section 7.40 provisions, accompanied with the Official Comment, and invited comments from the public. The updated amendment dealt with the issues as follows: (1) stipulated that, in order to initiate a derivative proceeding, demand on the board of

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[166] John C. Coffee, Jr.& Donald E. Schwartz, 81 Colum. L. Rev. 261, 300(1981)

[167] Jeffrey M. Gorris, Delaware Corporate Law and the Model Business Corporation Act: A Study in Symbiosis, 74 Law & Contemp. Probs. 107, 109(2011)

[168] Id. at 108

directors was a prerequisite, thus an action shall be dismissed if it had been properly determined by the SLC that the action was not in the company's best interests; (2) set forth the authorized organ to whom such a decision shall be made; (3) regarded the limitation of liability, a task force of the Committee on Corporate Laws was currently taking into account this problem; (4) made clear that, in a derivative action, the qualification of the plaintiff to fairly and adequately represents the interests of the corporation; and (5) clarified how the subchapter could be applied to foreign corporations.[169]

The proposal to revise the Model Business Corporation Act was, from time to time, prepared by the Committee on Corporate Laws.[170] The MBCA adopted a burdensome approach to derivative actions a revision proposed in 1990. Up to now, twenty-one states have adopted these provisions.[171] If the annoyed shareholder intended to initiate an action, a prerequisite which was defined as demand requirement shall first be fulfilled in pursuant to the MBCA. The independent and uninterested SLC's decision of dismissal should be respected by courts as long as that decision was made bona fide after a comprehensive investigation.

Among these twenty-one states, a few states had adopted a more accommodating strategy towards the derivative action mechanism and even three states, North Carolina, Iowa, and Texas, promulgated guiding examples. The MBCA went beyond the former Texas case law which merely recognized the SLC's discretion over the decision whether to sue on behalf of the company. Under normal condition where demand was required, in addition to abuse of power, breach of fiduciary duty or fraud, the refusal of the board of directors to take measures had to be showed, if the shareholder intended to proceed with the action.[172] If, in either the board of directors or the shareholder level, the

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[169] Committee on Corporate Laws, Changes in the Model Business Corporation Act -Amendments Pertaining to Derivative Proceedings, 44 Bus. Law. 543, 543-544(1988-1989)
[170] Id.
[171] Id.
[172] Supra note 74, at 445-446

wrongdoer was in control of the company, demand requirement was dispensed. In Delaware, MBCA was substantively superior to Delaware's corporate law, for example, a mere majority of voting shares could pass the amendment of articles of association; Though the company might have already accumulated large amount of deficits, it was still permitted that the company could pay dividends from the profits earned in the current year in pursuant to law.[173] However, the controversial issue of plaintiffs' attorneys' fees has yet not been settled as a result of the substantial part of court decisions delineating this issue. Though proposed amendment explicitly stated that there must be a substantial interests to the company to justify attorneys' fees.

The MBCA and state corporate law developed entwined but simultaneously maintain its distinction. Innovations of State corporate law are incented by local context. On the contrary, the revision of the MBCA was characterized by institutional refinement, restatement and clarification. These two source of law worked serves each other well.[174] The original designers did not foresee the development of the feedback loops between the states' corporate acts and the MBCA.

4.9 A Brief Comment and the Status Quo of Derivative Action

According to what the Chief Justice stated in the early case of Dodge v. Woolsey, derivative action fell within the jurisdiction of courts of equity both in the United Kingdom and the United States.[175] The United States was a typical jurisdiction that derivative action played a far-reaching role in legal history, thus providing an essential point of reference for all other jurisdictions. It was in in the United States that shareholder derivative actions were mostly recognized and frequently used.[176]

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173 Jeffrey M. Gorris, Lawrence A. Hamermesh, Leo E. Strine, Delaware Corporate Law and the Model Business Corporation Act: A Study in Symbiosis, 74 Law & Contemp. Probs. 107, 108(2011)

174 Id. at 120

175 Dodge v. Woolsey, 59 U.S. (18 How.) 331, 341, 347 (1855)

176 Ann M. Scarlett, Imitation or Improvement? The Evolution of Shareholder Derivative Litigation in the United States, United Kingdom, Canada, and Australia , 28 Ariz. J. Int'l & Comp. L. 569, 615(2011)

The derivative action was first introduced by the English Court of Chancery during the colonial period and profoundly developed afterwards by its courts. However, as early developments in England and in the United States were comparatively independent, they were considered dually. Courts in the United States were more focused on what were defined as substantive rules compared with its counterparts in the United Kingdom. It was rare to see cases involving fraud by the controlling majority of the company were dismissed by courts in the United States.[177]

The common law method, developed case by case, was long been criticized for its vagueness on the standard of fiduciary duty. It was also criticized for lack of concrete stipulation to achieve balance between the public interest and the company's best interest. Therefore, detailed and explicit statutes instead of case-by-case approach on the derivative action are required to solve the rough problem mentioned above. Of course, the statutory solution not only deals with the issue on special committee's capability of deciding whether to sue or not, but a package of legislation on the mechanism of derivative action as well. A comprehensive and thorough integration of statutory legislation has not been attempted to establish in a number of years.

The recent tendency of private actions decrease under the application of federal securities laws makes states look anew and borrow the company law from quite a few of jurisdictions, for instance, New York State, California State, Pennsylvania State, and etc., as well as the Model Business Corporation Act, to draft a model statutes that promote a more balanced mechanism between the plaintiff and the defendant. A form of prepackaged history on legislation in sequence to achieve our model statutes. Nowadays, if a derivative action is brought in pursuant to company law, the applicable law shall be lex situs where the company is established. Most U.S. states have now statutorily enacted procedures governing shareholder derivative lawsuits, and many

[177] Skeel, David A. Jr., "The Accidental Elegance of Aronson v. Lewis" (2007). Faculty Scholarship Paper 182, http://scholarship.law.upenn.edu/faculty_scholarship/182

have adopted both the procedures and substantive liability standards of the MBCA,[178] which was first drafted by a committee of the American Bar Association in 1950. In 1984, the MBCA was substantially revised.[179] The Model Business Corporation Act states that the court shall dismiss a derivative action, if after a comprehensive and reasonable inquiry, the majority members of a special committee consisted of disinterested directors determined with good faith not to initiate an action.[180]

Chapter V An Analysis on the Derivative Action in China

The evolution and development of derivative action in China is not qualified to be called history due to the short existence of this mechanism and the lack of practice. Despite the vulnerability mentioned above, it is still worth to explore the development of derivative action mechanism which shall not be isolated from politics and was motivated by political power in China. The derivation action represents the corporatization process of Chinese company from the bureaucratic structures and political control which fails to obey the market-driven economy. By 2008, China's GDP was the second largest in the world. By the end 2013 total share capital of all the listed companies reached 2,575.17 billion shares, of which 2,373.11 billion shares or 92.15% of the total amount were tradable. The market capitalization of its listed companies in Shenzhen Stock exchanges was about US$ 2.2 trillion in 2015. Considering the economic importance and prospect in China, it is worthwhile to have a look at the Chinese derivative action mechanism.

The derivative action mechanism stipulated in the Chinese Company Law[181] is distinct from that in the common law or civil law tradition, and even varies from law in Taiwan or Japan. The exploration of the Chinese derivative action mechanism provides us with a sense that how a booming state directly introduced the modern company system and

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178 Stephen M. Bainbridge, Corporation Law and Economics §1.2, 5 (2002)
179 John E. Mulder, Foreward to ABA-ALI Model Bus. CORP. ACT, at iii (1959)
180 Model. B Corp. Act §7.44(a)-(b)us. (2014)
181 Article 151 of current effective Company Law of PRC

transformed the former bureaucratic entities into a market-driven modern company. Those former entities were set up and controlled by the government, dealing with commercial issues in the communist society. The derivative action is a symbolic evidence which proves china is moving towards a more capitalist system through disentangling political intervention from companies, decreasing regulation restrictions, and promoting the development of free market.

5.1 Background and Incentive

Since the accomplishment of socialist transformation in 1956, a full-scale planned economy system was firmly established in China which meant all issues concerning economy both the supply and consumption were under the control of government and the stock exchanges, opened in 1905 in Shanghai and the largest stock exchange in Asia of the moment, were closed. The whole enterprises were divided into two categories, which were defined as collective-owned enterprises (COEs) and state-owned enterprises (SOEs). All enterprises were included in these two categories and there was no private economy existed. The exact meaning of collectively-owned is puzzled by many foreigners and even local people. The difference between the SOE and the COE was the SOE was owned by the central government while the COE was at the control of local government or even jointly. The legal personality theory were not recognized in Chinese legal system at that time and all laws related to commerce were silent not until the reform and opening up policy was adopted. After the Cultural Revolution ended in 1978, China was opened to the rest of the world.

Enterprises could enjoyed the authority to manage and the burden of responsibility for the losses only if they were qualified as legal persons. The Reform and Open Policy was carried out with the purpose of conferring legal person qualification to enterprises from 1984 to 1993. During this period, the state-owned enterprises and collectively-owned enterprises were transformed into the transitional model which explained by the state as the contracting model or the state creditor's rights model as well.[182] More than 50% of the 110,000 collectively-owned enterprises and state-owned enterprises in China were at a loss at the end of 1994, and direct subsidies distributed to those collectively-owned enterprises and state-owned enterprises amounted to 4.7 billion US dollar, or approximately 60% of Chinese budget deficit.[183]

Unfortunately, this reform was eventually proved to fail to achieve its mission of reviving enterprises and economy. As economic reform progressed, a consensus that the existing system of ownership and control was not fit for the sustainable development was achieved by the Chinese leadership.[184] In order to promote reform in-depth and support economic growth, Provisional Regulation on Rural Collectively-Owned Enterprises was established in 1990, and subsequently in 1991, Provisional Regulation on Urban Collectively Owned Enterprises. The General Principles of the Civil Law enacted in 1986, recognized the legal personality. At the same year, Regulations for Controlling the Registration of Enterprises as Legal Persons were enacted.[185]

Sensitive political policy and unique economic history had significantly influenced the development of derivative actions in China. The primary and ultimate dilemma was the guideline of maintaining the control status of the state in the economy. The majority of state-owned companies were listed companies, which account for more than fifty percent of the total economy. In other words, the government were the owners or controller of companies. This was also the reason why the administrative power frequently interfere in the business management of companies. The ownership of companies were too concentrated in China compare with its counterparts in western world. The controlling shareholder(s) were more likely to abuse its power to injure

[182] Li Changjiang, ZHONGGUO ZHENGQUAN SHICHANG DE LISHI HE FAZHAN, [The History and Development of China's Security Market] 8 (1998)
[183] Lincoln Kaye, Fire When Ready, Far Eastern Economic Review Feb. 23, 50(1995)
[184] Nicholas C. Howson, China's Company Law: One Step Forward, Two Steps Back--A Modest Complaint, 11 Colum. J. Asian L. 127 (1997), 129, Available at: http://scholarship.law.berkeley.edu/facpubs/1868
[185] ZhaoXudong, Thirty Years of China's Commercial Law, China Law, at 10, 03 2012

minority shareholders. Contradiction mainly did exist between the controlling shareholders who were also directors in most cases and minority shareholders.[186]

5.2 Corporatization and Ownership Diversification

The Chinese leadership intended to abolish traditional state-owned enterprises and adopt a new corporatization policy. Under the new policy, transformation of the state-owned enterprise into the form of company was governed by the Company Law of the People's Republic of China.[187] The administrative governance and commercial enterprise management were distinct and should be separated. After comparing the market economy and planned economy, the leadership decided to build a stock market mechanism which they thought were more efficient at rationalizing productive assets. With the guidance of this policy, a stock market was soon created and the enterprises were responsible for the profits and losses in this market.[188]

China's ambition to build a unique socialist market economy and the economic reform in the 1980s brought prosperity to the Chinese securities market. In 1990, the Shanghai Stock Exchange and Shenzhen Stock Exchange were established.[189] Both Shanghai Stock Exchange and Shenzhen Stock Exchange are under the government of the China Securities Regulatory Commission (CSRC) in recent administrative system. Foreign investors are restricted to issue shares in Shanghai Stock Exchange and Shenzhen Stock Exchange and stock exchanges, while stock exchanges in other countries are open to all kinds of investors. The Chinese authority tightly controls the accounts in both Shanghai Stock Exchange and Shenzhen Stock Exchange. By May 2015, the market capitalization in Shanghai Stock Exchange amounted to 5.5 trillion US dollar. By the end of 2013, there were 997 listed stocks on SSE with a total market capitalization of

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[186] Howson, Nicholas Calcina and Clarke, Donald C., Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China (August 31, 2011), at 3-5, Available at SSRN: http://ssrn.com/abstract=1968732 or http://dx.doi.org/10.2139/ssrn.1968732
[187] Supra note 154, at 245
[188] Guanghua Yu, Comparative Corporate Governance in China Political Economy and Legal Infrastructure, 41, Routledge 2007
[189] William Arthur Thomas, Western Capitalism in China: A History of the Shanghai Stock Exchange. Aldershot: Ashgate Pub Ltd (2001, hardcover) 328

RMB 15,116.53 billion, decreasing by 4.75% year-on-year, and free-float market capitalization of RMB 13,652.64 billion, up 1.66% from the previous year.[190]

Since the implementing of the 1993 Company Law, "China has experienced an unprecedented wave of corporatization and privatization."[191] Nearly 80% of small and medium-sized SOEs have corporatized into the form of company rather than government entities.[192] Having experienced three decades of economic reforms driven by market force, economic entities in China had gained large degree of autonomy. The policy of ownership diversification and corporatization were proved to be right. Not only the majority of giant and medium state-owned enterprises (SOEs) have accomplished corporatization, but plenty of private enterprises have transformed into companies. Ownership diversification were achieved through two main forms. The first form is chosen by the majority of larger SOEs, whose shares were issued in both domestic and international stock exchanges. The second is chosen by small and medium SOEs, who take the form of sales to insiders.[193] Under Chinese law, most of the insiders are managers and employees. However, the stage of corporate governance in China is primitive and the dominant problem is management misconduct. It is common to see breach of fiduciary duty, fraud and appropriation in management. In order to solve this tough issue, legal sanctions is adopted instead of management self-discipline.[194] For instance, China suffers severely from abuse of insider control, which leads to mismanagement and asset-stripping; many Chinese corporations have majority shareholders that dominate minority shareholders.[195]

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190 Brief Introduction, Shanghai Stock Exchange, http://english.sse.com.cn/aboutsse/sseoverview/brief/

191 Yuwa Wei, The Development of the Securities Market and Regulations in China, 27 LOY. L.A. INT'L & COMP. L. REV. 492 (2005)

192 Donald C. Clarke, The Independent Director in Chinese Corporate Governance, 31 DEL. J. CORP. L. 125, 146-47 (2006)

193 World Bank and the International Finance Corporation, Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets (Washington, DC, 2002)1

194 Zhong Zhang , Making Shareholder Derivative Actions happen in China: How Should Lawsuits be Funded?, 38 Hong Kong L.J. 523, 524(2008)

195 Ann M. Scarlett, Investors beware: Assessing shareholder derivative litigation in India and China, 33 U. Pa. J. Int'l L. 173, 213-214(2011-2012)

5.3 The Early Stage of Company Law in People's Republic of China and Derivative Action

The legislation of statutory company law of PRC started in 1983, five years after the implementing of opening up policy. In 1979, the promulgation of Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China[196] indicated an acceptance of foreign capital which previously was illegal, leading to a booming on the establishment of companies. In 1992, the Commission for the Restructuring of the Economic System (CRES)[197] promulgated the Opinion Regarding Standards for Companies Limited by Shares which was widely known as Standard Opinions. This opinion ensured the legality of company as a kind of economic organization, and provided the legal basis for the form of company. For the first time, in the history of the PRC, companies were entitled to their own property and decided on their own will of business operation. In addition, shareholders were allowed to benefit from the company.[198] On 1 July 1994, the first statutory company law in the history of PRC, namely Company Law 1993, entered into force and provided the basis for SOEs to transform into state-owned companies, private companies or public companies. Four achievements were reached from the 1993 Company Law of PRC: primarily, firmly established the right of ownership; secondly, provided accurate definitions of rights and responsibilities; in addition, separated the enterprise from the government; and last and foremost, employed principles of scientific and appropriate management.[199]

Under the Company Law 1993 of People's Republic of China, the governing power of

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[196] Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China, adopted at the Second Session of the Fifth National People's Congress on 1 July 1979; First amendment made according to the Decision of the Third Session of the Seventh National People's Congress on Revising the Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China on 4 April 1990; Second amendment made according to the Decision of the Fourth Session of the Ninth National People's Congress on Revising the Sino-Foreign Equity Joint Venture Enterprise Law of the People's Republic of China on 15 March 2001)

[197] A commission dealing with reform issues

[198] Nicholas C. Howson, China's Company Law: One Step Forward, Two Steps Back: A Modest Complaint, 11 Colum. J. Asian L. 127, 131 (1997)

[199] Cindy A. Schipani & Junhai Liu, Corporate Governance in China: Then and Now, 2002 Colum. Bus. L. Rev. 1, 22 (2002)

the company was allocated between three organs according to the Basic Framework and Internal Governance System. The three authorized organs are shareholders meetings, the board of directors and the board of supervisors. The power of business management was allocated to the board of directors while the power of monitoring was vested in the shareholder meeting and the board of supervisors. Unlike the other jurisdictions, the Chinese company law only provided two patterns of company, excluding limited partnership and unlimited partnership. The limited partnership and unlimited partnership did not own the qualification of legal person under Chinese legal system.[200] Compared with Anglo-American jurisdictions, the Chinese limited liability company (LLC) equaled to closed corporation or the private company, while the company limited by shares (CLS) corresponded to the publicly-held corporation or public company.

This stipulation affected the later Company Law 2005 with respect to standing to sue. The Company Law 2005 distinguished shareholders of a limited liability company from that of a company limited by shares. A derivative action could be brought by any shareholder of a limited liability company without any limitation on the qualification of standing to sue, regardless of requirements of minimum ownership, the minimum holding period, and contemporaneous ownership rule. On the contrary, if a shareholder of a company limited by shares intended to initiate a derivative action, he shall hold at least 1% of the total stock in that company for a period of at least 180 consecutive days. However, this distinction was severely criticized for its unreasonable limitation on shareholders of a company limited by shares. With regard to this issue, detailed explanation would be given in the following text.

The first derivative action explicitly acknowledged by the Supreme People's Court was the case of Zhangjiagang Fiber Company[201] after the promulgation of the Company

[200] Company Law of the People's Republic of China (PRC), promulgated on 29 December 1993 and effective from 1 July 1994, amended in 1999, 2004, 2005 and 2012 in the PRC

[201] Reply letter on the issue of in whose name the Chinese party to a Chinese–foreign equity joint venture should bring suit when the joint venture has an economic dispute with an external party and the

Law 1993 of PRC. This case was decided in 1994. Zhangjiagang Fiber Company was a foreign-invested enterprise. Zhangjiagang polyester long fiber enterprise, together with Hongkong Jixiong limited liability company set up a joint venture, and involved in related transaction with Hongkong Daxing Construction limited liability company under the control of Hongkong Jixiong company. The Jiangsu Higher People's Court was not sure and requested the Supreme People's Court for guidance. The Chinese investor was a natural person without legal personality, and the Jiangsu Higher People's Court was confused that whether the investor was qualified to sue the Hongkong investor on behalf of the joint venture. The Supreme People's Court responded that the joint venture was under the control of Hongkong investor and the related transactions with Hongkong Daxing Construction Company were self-interested to the Hongkong investor. Therefore, the Chinese factory as a shareholder should have the right to exercise the joint venture's litigation rights. However, as disputes arose from the related transaction shall be resolved by arbitration according to contracts, the court dismissed the cause of action.

This case was relevant to the area of cooperative joint ventures or Chinese–foreign equity which were classified as foreign-invested enterprises.[202] The cases of Zhong Tian Int'l Co v. Shanghai Bi Chun Trade Dev Co is an often-cited high-profile case involving a Mainland-Hong Kong joint venture.[203] The courts exercised judiciary power over cases and those cases accepted by the courts were frequently concerned with Sino-foreign joint ventures which were mostly situated in regions such as: Beijing, Shanghai, Guangdong Province, Zhejiang Province, and etc. The courts in these regions adopted a rather liberal and supportive attitude, and permitted shareholders to initiate such action to protect their interest in the joint venture.

foreign party controlling the joint venture has a relationship of interest with the seller, issued 4 November 1994 (available at http://www.people.com.cn/item/flfgk/gwyfg/1994/113718199418.html)

[202] Supra note 154, at 264

[203] Zhong Tian Int'l Co v. Shanghai Bi Chun Trade Dev Co et al reprinted in Zuigao Renmin Fayuan Zhongguo Yingyong Faxue Yanjiusuo (Applied Jurisprudence Research) Institute of the Supreme People's Court), ed., Renmin Fayuan Anli Xuan (Selected Cases of People's Courts), vol. 24 (Beijing: People's Court Press, 1998) at 22

Before 1993, the explicit legal basis was absent, and there was hardly any recourse to courts. The first piece of legislation, enacted by the People's Congress of China regarding corporate structure, namely, the Company Law 1993[204] was widely criticized for failing to offer shareholders the right to take derivative actions.[205] There was, merely, Article 111, which was broadly criticized for both its ambiguity and obscurity. In pursuant to this article, a shareholder was entitled to launch an action to fight against wrongdoer(s). When the directors, senior managers or controlling shareholders were found violate provisions of law, administrative regulations, or the articles of association, the benefits of the company were severely damaged, so did the interests of shareholders. The people's courts shall have jurisdiction upon the complaint.

However, this statute never used the concept of derivative action. This abstract statute did not provide detailed procedures nor standard of application. Shareholders had no right to initiate a derivative action under this article. In pursuant to this article, the shareholder could exclusively seek remedy through action on the behalf of himself against illegal resolutions decided by the board of directors or the shareholders meeting. Thus several courts dismissed derivative actions because of the lack of standing to sue.

The Hongguang case[206] was the first case in which criminal penalty was imposed upon relevant liable persons in a listed company. In this case, the court refused the plaintiff's claim of civil liability of the directors. Chengdu Hongguang Industrial CO., LTD (previous stock code:600083) specialized in producing electron vacuum devices, for example, black and white and color television tubes and glass bulbs. The company applied to the CSRC for initial public offering in 1996. The company issued seventy

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[204] The Company Law of PRC was promulgated on 29 December 1993, then amended on 27 October 2005 and came into force on 1 January 2006

[205] Zhang Zhong, Shareholder Derivative Action and Good Corporate Governance in China: Why the Excitement is Actually for Nothing, 28 UCLA Pac. Basin L.J. 174, 176(2010-2011)

[206] Daniel M. Anderson, Taking Stock in China: Company Disclosure and Information in China's Stock Markets, 88 GEO L.J. 1919, 1931-33 (2002). For the CSRC's penalty decision, see Chufa Jueding [Penalty Decision] (promulgated by the CSRC, Oct. 26, 1998), CSRC investigation series number (1998) 75

million shares in Shanghai Stock exchanges that raised CNY 4,102,000,000. Suspicion was generated by the great disparity between Hongguang's projected profits in its prospectus after its IPO. Falsification of its profit record happened after its shares were listed in 1997 and 1998. In order to offset the enormous deficit it burdened, Hong Guang spent more than thirty per cent of total the capital collected to buy and sell shares on the Shenzhen Stock Exchange and Shanghai Stock Exchange. At that time, state-owned enterprises or listed companies were not allowed to participate in speculative trading and Hongguang was a state-owned company. The company evaded the prohibition by the opening of 228 individual trading accounts. The company never disclosed this as a major event.

In the 1997 interim and annual reports, the company underreported its deficit and its misuse of capital raised from the initial public offering. The entire money collected from the offering should be used in projects in accordance with the prospectus. However, the truth was the company only used less than 15 % of the capital. The rest of the raised capital was spent on offsetting the debts owed domestic and abroad banks. In 1998, an Enforcement Notice of the CSRC was given to Chengdu Hongguang Industrial Co. with regard to Severe Breach of Regulation. The investors of Hongguang tried to sue the board of directors.[207] Due to the lack of statutory basis for derivative action in Chinese legal system, quite a few courts dismissed such actions brought before them by minority shareholders.[208] In this case, though civil liability could be invoked on the ground of the Provisional Regulation on the Administration of Issuing and Trading of Shares,[209] the Court justified its dismissal. In the court's opinion, the cause of the deficit was unnecessarily attributed to fraud.[210]

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[207] Huang, Flora Xiao, Shareholder Revolt? The Statutory Derivative Action in China (December 1, 2009), CLPE Research Paper No. 49/2009, at 11, Available at SSRN: http://ssrn.com/abstract=1516448 or http://dx.doi.org/10.2139/ssrn.1516448

[208] Zhongtian v. Bichun, et al., RINMIN FAYUAN ANLI XUAN (Shanghai Interm People's Ct. Sept. 16, 1996) 43

[209] China Securities Regulatory Commission (CSRC), Regulations on the issuing and supervision of Stock), available at: http://www.csrc.gov.cn/pub/newsite/flb/flfg/xzfg_8248/200802/t20080227_191560.html

[210] Guanghua Yu, Comparative Corporate Governance in China Political Economy and Legal Infrastructure, (Routledge 2007)132

A high-profiled case concerning derivative action in China was happened in 2003, however, this case was dismissed by the court.[211] On the August 28th 2001, the China Securities Regulatory Commission decided to investigate the Shenzhen Sanjiu Medical and Pharmaceutical (Stock Code: 000999) Joint Stock Company, the controlling shareholder of whom were suspected for abuse of dominance. Sanjiu was a listed company whose initial public offering was on March 9th, 2000 and the amount of fund-raising was CNY 1,670,000,000. According to the report of the investigation, 2.5 billion RMB of the company's funds were misused by the controlling shareholder. The misused funds accounted for 96 per cent of the net assets belonged to the company. The funds were involved in related transaction which were considered to be self-interest to the controlling director and conflicted with the best interest of the company. Sanjiu was charged for a fine of CNY 500,000 according to the penalty decision made by CSRC.

A shareholder from Shanghai brought an action before the court on behalf of Sanjiu company, claiming for merely CNY 20, 000 compensation for the misconduct done to the company by the controlling shareholder Zhao Xinxian but the court dismissed the case. In the court's opinion, before the initiation of a derivative action, the plaintiff should first obtain the consent of the company or the rest of shareholders. The legal interests of all shareholders should be properly represented by the plaintiff.[212] Thus, the only penalty that the controlling shareholder got was criticism by the CSRC, and the company suffered both the CNY 500,000 pecuniary punishment and the management failure. It was not easy to sue evildoers by means of derivative action according to the Company Law or in the Articles of Association, because there was no explicit provisions with regard to derivative action.[213]

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[211] China Economic Times (24 April 2003), "Gudong Daibiao Susong Wei Shouli Cheng Yihan" (A Regret for Not Accepting Shareholders Representative Actions), available through Chinese National Knowledge Infrastructure (CNKI) at <http://www.cnki.net>

[212] Supra note 191, at 11

[213] Guanghua Yu, Comparative Corporate Governance in China Political Economy and Legal Infrastructure, 133, Routledge 2007

The above cases, to some extent, showed that breach of fiduciary duty may occur from time to time and managers may not always work for the best interest of companies. Listed companies were regarded as vehicles to collect capital from the investors and at the disposal of controlling shareholders. There was a vivid Chinese word to describe the appropriation by managers and controlling shareholders called "quanqian",[214] which meant collecting money effortlessly. Assets of listed companies were sometimes tunneled by individual insiders and controlling shareholders.[215] Though appropriation was a frequently happened problem in Chinese listed companies, the injured shareholders had no recourse to judicial relief. The courts were inclined to dismiss the derivative action if it concerned with the corporate governance problem stated above.[216]

China's securities regulators were worried about the inadequacy of shareholder protection. They focused on how to provide efficient remedies to the injured shareholders, because this booming capital markets were full of unsophisticated individual investors.[217] To some extent, active attitude was adopted with respect to derivative action in spite of lacking specific statutes in company law and these pioneer experiments laid the foundation for the changes in shareholder protection. In 2000, protecting the interest of investors was the top priority for the CSRC, stated by the then CSRC chairman Zhou Xiaochuan.[218] In 2003, the Shanghai People's Court formulated a set of concrete rules, issuing judicial Opinion on Some Issues in Trials for Legal Actions Related to Company Dispute (No. 1). Some scholars even regarded this as the introduction of directive action in China.[219] Subsequently, the Opinion on Some Issues in Trials for Legal Actions Applied with Company Law was issued by the Jiangsu High People's Court. In this judicial opinion, rules for shareholder representative actions were

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[214] Chinese words
[215] Supra note 154, at 249
[216] Zhong Zhang, Making Shareholder Derivative Actions Happen in China: How should Lawsuits be Funded, 38 Hong Kong L.J. 523, 528(2008)
[217] Huang, Flora Xiao, Shareholder Revolt? The Statutory Derivative Action in China (December 1, 2009), CLPE Research Paper No. 49/2009, at 5, Available at SSRN: http://ssrn.com/abstract=1516448 or http://dx.doi.org/10.2139/ssrn.1516448
[218] Jiong Deng, Note, Building an Investor-Friendly Shareholder Derivative Lawsuit System in China, 46 Harv. Int'l L.J. 347, 349 (2005)
[219] Supra note 191, at 4-5

established. Following the local legislation, in 2003, the initial draft of Regulations on Some Issues Concerning Trials for Company Dispute (No.1) was published by the Supreme People's Court. Compared with the Supreme People's Court, which generally adopted a conservative method to protect minority shareholders, the CSRC seemed to be more ambitious. A few regulations were aimed at refining corporate governance in listed companies. For example, in 1997, the Guidelines for Articles of Association of Listed Companies was issued by the China Securities Regulatory Commission; in 2002, the Principles of Corporate Governance for Listed Companies was issued; in 2001, Guidelines for Independent Directors to the Board of Directors of Listed Companies was issued; and in 2004, the Regulations for the Protection of Individual Shareholders' Rights was issued.[220]

5.4 The 2005 Company Law

Various deficiencies were rightly recognized shortly after the promulgation of 1993 Company Law. All these shortcomings hindered the derivative action to achieve its initial goal of protecting minority shareholders.[221] After much consideration and public consultation, by comprehensive and systematic company amendment of the former Company Law, for the very first time in the history of PRC, the Chinese legislators introduced the statutory derivative action.[222]

A major problem with regard to corporate governance was companies were tunneled by controlling shareholders, directors, or senior managers. The managerial power was used to benefit the management themselves and the interests of shareholders were ignored. The revised Company Law was ambitious to directly settle this tough issue. Thus, the original 1993 Company Law was comprehensively and profoundly amended. On January 1, 2006, the new company law, namely, the Company Law 2005 entered into

[220] Id. at 10
[221] Xiaoning Li, A Comparative Study of Shareholders' Derivative Actions, (KIuwer, Deventer, 2007), Chapter 5.4
[222] Baoshu Wang & Hui Huang, China's New Company Law and Securities Law: An overview and assessment, 19 AUSTL. J. CORP. L. 229, 236 (2006)

force. Meanwhile, both the Security Law and the Enterprise Bankruptcy Law were also comprehensively revised. The revised Company Law of the People's Republic of China stipulated derivative action in article 151. For the very first time, derivative found its legitimate status.

This introduction of the statutory derivative action was a result of much consideration and public consultation.[223] Provisions with respect to derivative action was explicitly stipulated and courts were the final authority to protect shareholders. According to the revised company law, a company should comply with laws, regulations and its own charter. This provision varied from any current existing jurisdiction in the following two aspects. As mentioned above, the procedural rules of derivative action mechanism distinguished the company limited by shares from the limited liability company. In addition, shareholders may initiated substantive claims against two kinds of defendants in the name of the company. The first kind was directors, supervisors, and senior managers, who were classified as traditional fiduciary duty bearer, and this kind was common to see in company laws of many countries. The second was called "others". According to the explanation of law, others contained third parties and controlling shareholder(s) of a company.[224] Indeed, the balance between effectively remedying shareholders and commercial operation freedom of the company shall be elaborately designed when conferring shareholders the rights to sue wrongdoer of the company. The current effective Company Law explicitly states that a demand shall be made to the authorized and qualified organ. The board of directors and the board of supervisors are the two authorized organs. The courts have an exclusive power to examine the validity of cause of action and the burden of prove is allocated to the plaintiffs. But the company law does not mention the burden of cost of litigation fees.

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[223] Supra note 206, at 236

[224] Howson, Nicholas Calcina and Clarke, Donald C., Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China (August 31, 2011), at 16, Available at SSRN: http://ssrn.com/abstract=1968732 or http://dx.doi.org/10.2139/ssrn.1968732

5.5 The Implement of Derivative Action Mechanism after 2006

It was rightly recognized that there were various inadequacies in the laws which hampered the derivative action from delivering on its promise.[225] In April 2006, the Provisions of Several Issues Concerning the Application of the Company Law 2005 of PRC was formulated by the Supreme People's Court of People’s Republic of China, which was a response to the problem in applying the 2005 Company Law. This was an initial interpretation of Supreme People's Court to the newly promulgated Company Law. It resolved the procedural issues with regard to shareholder derivative actions. Article 4 of this Provisions explained the exact meaning of “180 consecutive days or more” and “aggregately holding 1% or more of the total shares of the company”. If the shareholder intended to initiate a derivative action, he or she shall already hold the shares for more than one hundred and eighty days in a consecutive calculation at the time of bring an action. The word “aggregatedly” here meant two or more shareholders were also permitted.[226] Under the situation that one single shareholder owned less than one percent of the total shares, he or she could persuade other shareholders to take part in the action. If the sum of the gathered shares amount to at least one percent,it was still possible to bring a derivative action before the court.

This interpretation provided a clear standard with respect to the qualification of a shareholder who intended to initiate a derivative action. However, the court realized that the statutes remained vague or silent on some other vital aspects concerning the derivative action, and took a frontline role of gap filling in the mechanism. Nevertheless, due to the judicial treatment of those issues lack of uniformity and consistence, it was submitted that the Supreme Court shall provide further interpretation and guidance to this imperative realm of company law.

[225] Xiaoning Li, "A Comparative Study of Shareholders' Derivative Actions" (KIuwer, Deventer, 2007), Chapter 5.4

[226] Provisions of the Supreme People's Court on Several Issues concerning the Application of the Company Law of the People's Republic of China (I)

By searching the authoritative database on the website,[227] until 03/07/2015, concerning derivative action, one hundred and thirty five judgments were found and three typical cases were published on the Gazette of the Supreme People s Court of the People' s Republic of China, namely, Zhejiang Hexin Electricity Power Development Ltd Co et al v. Tonghe Zhiye Investment Co. Ltd et al in 2008;[228] Chenquan & PiZhiyong v. Chongqing Bibo real estate development Co. Ltd et al in 2010;[229] Minfa Security Co. Ltd v. Beijing Chenda technology Investment Co. Ltd et al in 2012. Though China denied the principle of judge made law, the cases published in the Gazette of the Supreme People s Court of the People s Republic of China were de facto had res judicata and binding to the later cases.[230]

Each case was involved in a complicated facts and transaction relationships. For example, the case of Zhejiang Hexin was concerned about the shareholder's right to request for the distribution of profit, the related transaction of the targeted company's equity, cross-shareholding. The case of Zhejiang Hexin was one of the three cases appealed before the Supreme Court and published as a typical case. In addition, the case was settled under the mediation of the second instance court, together with a confirmation issued by the court which was equivalent to judgment in China. As the amount of money in dispute was over CNY 250,000,000, according to Measures of Charging Litigation Fees, the case recorded the court fee in total was about CNY2,443,677, including CNY459,703 for the first instance and appeal court fee of CNY640,917, of which CNY651,978 was borne by the plaintiff. Because all parties accepted the mediation which was suggested by the appeal court，the court fee for mediated cases was half the ordinary fee. Otherwise the original advance-payment of the acceptance fee born by plaintiffs should be as high as CNY1,741,537。

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[227] http://www.lawinfochina.com/index.aspx

[228] Zhou Dajun et al v. Inner Mongolia Hongfeng Group Ltd Co, Min Yi Zhong Zi No 70 (2006) (Supreme Court); Zhejiang Hexin Electricity Power Development Ltd Co et al v. Tonghe Zhiye Investment Ltd Co et al, Min 2nd Zhong Zi No 123 (2008) (Supreme Court)

[229] Li Xiaozhong et al v. Jin Rongzhong et al, Nan Chuan Fa Min Chu Zi No 538 (2006) (Chongqing Nanchuan District Court)

[230] Liu Nanping, An Ignored source of Chinese Law: the Gazette of the Supreme People's Court, 5 Conn. J. Int'l L. 271 1989-1990

A surprising and noteworthy finding of my research on the database was that a myriad of reported derivative action judgments[231] were related to limited liability companies, which fell within the scope of privately held companies, while the companies limited by shares were rarely detected. According to an empirical study on the derivation action, there were at least three reported derivative actions relevant to companies limited by shares before 2006. Involved three listed companies were Shenzhen Xingdu Hotel whose stock code was 000033; Henan Lianhua Weijing whose stock code was 600186 and Shenzhen Sanjiu Medical and Pharmaceutical whose stock code was 000999.[232] Explanations of this phenomena had been explored by many scholars and one tentative interpretation might be as follows:

> "Under the statutory law, any shareholder in private companies has standing to sue, regardless of their shareholdings and the length of holding period. Second, although there is the demand requirement to meet before bringing the derivative suit, it appears to be an easy hurdle for private company shareholders to clear."[233]

5.6 Brief Comment on the Reform of Derivative Action

China's reform strategy clearly demonstrated a formal convergence toward the Anglo-American governance model. In the process of establishing a socialist market economy, the Chinese authority took the advantages of western legal resources. However, the guideline of maintaining the control status in most listed companies, including a large amount of state-owned companies, made china unable to sufficiently utilize the advantages.[234]

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231 At least one hundred and thirty five judgments

232 Supra note 40, at 631

233 Supra note 40, at 645

234 Yu Guanghua, The Problem with the Transplantation of Western Law in China (March 30, 2004), at 28, Available at SSRN: http://ssrn.com/abstract=1535683 or http://dx.doi.org/10.2139/ssrn.1535683

We found that the comprehensive amendment of company law in 2005, which gave rise to innovation in corporate governance in China. And to a large extent, it was appropriate for the native Chinese economic circumstances, such as, the law permitted shareholder to initiate a derivative action suing third parties who were traditional not considered to be insiders or own a duty of care to the company. For both economic and political history reason, the controlling or oppressive shareholder may not necessary be a legal insider under company law. Court were not fully independent from local and central political power, and often interfered by the government or other regulatory agencies. The establishment of efficient and sufficient derivative action mechanism also required more expertise who were experienced in commercial management.[235] In conclusion, the mechanism of derivative action in China demands more efforts to reach its maturity. Primarily, legislation shall be made on the detailed and specified aspects, such as the procedure of derivative action, the burden of the litigation cost, the organ to which the demand is made, the status of the company in a derivative action, and etc.

China's securities regulators, including China Securities Regulatory Commission, were worried about the inadequacy of protection to the investors. The Chinese booming capital markets were full of unsophisticated individual investors.[236] An active and innovative attitudes were taken when dealing with issues related to liquidation, the position of the company, the distribution of burden of proof and etc. Tentative conclusions were illustrated to issues such as whether and how derivative actions can be brought against companies under liquidation, how to procedurally position the company in the litigation process, and whether the requirement to make demand on the company before initiating an action can be deleted under certain circumstances other than the narrowly defined statutory exceptions.[237] Nonetheless, the legal system with respect to derivative action has not been entirely uniform and consistent, which requires the Supreme Court to further provide greater clarity and certainty to this vital realm of

[235] Supra note 154, at 53-54
[236] Jiong Deng, Building an Investor-Friendly Shareholder Derivative Lawsuit System in China, 46 Harv. Int'l L.J. 347, 349(2005)
[237] Supra note 40, at 233

current company law.

Conclusion

There is an endless regulatory request to achieve the perfection of derivative action mechanism, if we make a study on the nearly two hundred years history of derivative action mechanism in different jurisdictions.[238] The shareholder derivative action originated as a remedy based on the right of equity. When the company refuses or fails to exercise its right, derivative action mechanism enables a shareholder to enforce a right which originally belongs to the company.[239] Derivative action promotes managerial accountability to the company they worked for. Under normal conditions, the right to sue is reserved for the company.[240] When the wrongdoers control the company, the company may fail to obtain relief. The derivative action is an action initiated by the shareholder, claiming for the interests of a company.[241]

In common law tradition, directors and senior managers who deceive the minority shareholders shall be liable to the company.[242] The common law position has been widely criticized for inadequacy in several aspects. In the primitive stage, derivative actions were prohibited and courts were unwilling to decide the internal affairs of companies. The demand requirement was not easy to accomplish and the demonstration of exhaustion of internal remedy was tedious as well. Besides, judges and parties were confused by the rule of necessary parties rule and its exceptions, because there was no explicit standard.[243] To avoid the undesirable consequences that a strict application of the proper plaintiff rule would otherwise cause, the derivative action has long been

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[238] Supra note 154, at 398

[239] Dr. Hui Huang, The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform, 4 Berkeley Bus. L.J. 227, 233(2007)

[240] Jesse H. Choper et al., Cases and Materials on Corporations(5th ed. 2000,ASPEN) 804

[241] William T. Allen & Reinier Kraakman, Commentaries and Cases on the Law of Business Organization(2ed, 2003,Aspen Pub)349

[242] James D. Cox, Corporations and Other Business Organizations 2013: Cases and Materials(10 Sup Una 1997, Foundation Press)398

[243] Center for Corporate Law and Securities Regulation, University of Melbourne, Ian M. Ramsay& Benjamin B. Sauners, Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action, 9-10(2006)

recognized in common law jurisdictions.[244]

Company law was created to promote commercial activities and maximize companies' value. There is a trend of convergence that company law should share a single principal goal both in emerging economies and developed countries. However, it is not practical for the emerging economies to merely copy legal resources of developed economies. Western laws were developed in a context filled with culture, custom, local market, government, and etc. This context varies from country to country.[245] In order to formulated a practical company law, five domestic contextual elements should be taken into consideration. Fist, the maturity of capital markets where the country is located; second, the purpose of the company law; third, the independence of judiciary power; fourth, the decider of economic power; and last, the culture in which the shareholders are brought up.[246]

According to the analyses above, if we ignore the specific context when we explored the derivative action mechanism, it does not make sense. Creating a unified set of rules with respect to derivative action is impossible according to the comparative research on the legal history. Each system developed in a contextual circumstances. This comparative study does not contribute itself to find a solution of unification. On the contrary, the exploration of the evolution of derivative action mechanism of the above three countries displays different contextual factors. Comparison between diverse jurisdictions upon derivative action mechanism may display myriad approaches and regulations concerning the derivation action issues and furnish valuable information for efficient and sufficient application of the mechanism. The comparative study seeks to provide the foundation for the future enrichment of corporate provisions. In general terms, the Chinese approach, as analyzed above, lacks associated procedures and concrete stipulations, is somehow a rough mechanism in contrast to.

[244] Supra note 39, at 181
[245] M. B. Hooker, The East India Company and the Crown 1773-1858, Malaya Law Review，Vol. 11, 1913(1969)
[246] Id. at 1920

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