



# A Comparative Study of Precedent Procedures for Shareholder Derivative Actions

Xiang Liu<sup>(✉)</sup>

University of Glasgow, Glasgow G12 8QQ, UK  
x1151369@gmail.com

**Abstract.** As a specialized form of civil pre-litigation, the shareholder derivative pre-litigation procedure actively promotes reconciliation between companies and shareholders and extrajudicial resolution of disputes. Because of the corporate governance structure and social traditions, the shareholder derivative pre-litigation procedure in the United States has distinctive characteristics and has had a significant impact on its dispute resolution function. It is necessary for the Chinese Company Law to acquire reasonable elements from it to improve the Chinese shareholder derivative pre-litigation procedure, prevent abusive and improper litigation, and enhance its extra-litigation dispute resolution function. The US institutional framework for shareholder-derived pre-litigation proceedings has significant implications for the resolution of extra-judicial disputes in China: to emphasize the balancing function of shareholder-derived pre-litigation proceedings, to identify reasonable targets for shareholder-derived pre-litigation proceedings, to increase court review of shareholder-derived pre-litigation proceedings, and to strengthen the procedural law status of shareholder-derived pre-litigation proceedings.

**Keywords:** Shareholder derivative action · Preliminary proceedings · Pre-trial review

## 1 Introduction

The Supreme People's Court's recently released "Provisions on Certain Issues Relating to the Application of the Company Law of the People's Republic of China Provisions (V)" (hereinafter referred to as "Company Law Interpretation V") and the pertinent materials from the Ninth National Conference on Civil and Commercial Judicial Work show that the number of situations in which shareholder derivative actions are applicable in China is gradually growing. Mr. Cai Yuanqing noted in 2006 that small and medium shareholders can file lawsuits on their own without any limitations, and that the shareholder derivative action system has, in some ways, undermined most of the capital principle. The shareholder derivative action will have an impact on the company, the shareholders, and other parties, so it is important to balance the interests of all parties while designing the shareholder derivative action system [1]. As the shareholder derivative action system itself is a break with the separate personality of the company and the principle of majority of capital, if the system is not set up properly, it will be more susceptible to abuse than other systems [2].

The current Chinese legislation has established a prior procedure in the shareholder derivative action system, meaning that before a lawsuit can be formally filed, the plaintiff shareholder must first apply in writing to the company to file a lawsuit. This is done to deter shareholders from filing lawsuits arbitrarily. The shareholder may file a lawsuit on its own behalf if the firm declines to sue, does not react within 30 days, or meets the requirements for urgency. In conclusion, the corporation itself has no real vote in whether a shareholder derivative action that would damage its own interests should be initiated under the current shareholder derivative action regime in China. From the standpoint of effectively safeguarding the interests of minority shareholders, this is reasonable. However, the goal of a shareholder derivative action should be to safeguard the company's interests because how can the interests of minority shareholders be safeguarded if the company's interests are not adequately safeguarded? When a shareholder files a lawsuit, the court will just assess the case's procedures; it won't decide whether it should be filed or not. This pre-procedure is ineffective at stopping a shareholder from filing an incorrect or even malicious litigation. As a result of respect for the idea of corporate autonomy, US legislation or judicial practice grants the courts varied degrees of discretion about whether a shareholder derivative action should be filed. It is essential that China learn from the lessons of shareholder derivative litigation in the US to better prevent the occurrence of improper litigation and to protect the legitimate rights that enterprises should have.

## 2 Literature Review

The research that are now available in China on shareholder derivative actions generally concentrate on determining the plaintiff's eligibility, the exclusion of past proceedings, and dual shareholder derivative actions. Few studies have focused on the pre-review processes established in foreign derivative litigation or have believed that a formal level review is sufficient. Some academics, though, continue to emphasize the development of efficient antecedent methods. For instance, Geng Lihang (2013) notes that the court should serve as an active administrator of litigation and conduct substantive review to assess the appropriateness of derivative litigation and whether it will significantly affect the company from the perspective of balancing interests and lowering the risk of abusive litigation [3]. Hu (2021) argues that from the perspective of protecting the interests of the company and giving the company the right to defend itself, a prior judicial review should be set up before the trial of the derivative action [4].

As described by Jeffries (2014), shareholder derivative actions provide shareholders with an effective instrument to defend the company's rights, but they also create the potential for abuse. In derivative litigation, the shareholder essentially assumes the role of management. However, due to factors such as conflicts of interest and short-sighted behavior, the shareholder is not the best person to decide whether to sue the company. As a result, some US state laws permit the board of directors to regain control of the litigation from the shareholder plaintiff by establishing an independent special litigation committee [5]. A special litigation committee files a motion to dismiss the lawsuit on behalf of the company with the court, which evaluates the motion and decides whether to dismiss the lawsuit. According to research by Zhandossova (2019), the number of

derivative litigations has decreased since the introduction of special committees, a trend that has persisted for nearly three decades [6]. In addition to drawing on the experience of the relevant systems, the concerns and reflections raised by some academics about the US review model are also noteworthy. Using the Special Litigation Committee system as an example, Coffee (1993) demonstrates through an empirical study that the Special Litigation Committee is generally opposed to shareholder derivative lawsuits and that there are few proposals to support litigation [7]. In this context, the independence and appropriateness of the institution is often questioned.

### 3 Comparative Analysis

Through the method of comparative analysis, this article focuses on the differences between Chinese and American predecessor proceedings, taking the application problems in China as an example, and makes suggestions for the improvement of the predecessor proceedings of shareholder derivative actions in China.

There is no doubt that shareholder-derived litigation is a “double-edged sword” that, if misused, can either interfere with the normal operation of the company or harm the protection of shareholder interests. In order to achieve dispute resolution, the pre-procedure is designed to strike a balance between the preservation of shareholders’ interests and the maintenance of the company’s operational efficiency. The United States has accomplished this by defining the eligibility of shareholders, the subject matter of claims, the waiting period for shareholders, and the commercial judgement rules. The United States has attained this equilibrium in terms of both procedure and substance. In contrast, China’s legislative design disregards the function of shareholder derivative predecessor process as a balance. On the one hand, while the Chinese Company Law sets limits on the percentage of shareholding of shareholders who may apply, it lacks additional qualification requirements as to whether shareholders can fairly and adequately represent the interests of the company; on the other hand, while the Chinese Company Law emphasizes the obligations of directors and other management personnel and holds directors accountable, it lacks provisions to protect directors, such as those found in the United States business law. This situation is not conducive to balancing the protection of shareholders’ interests with the maintenance of the efficiency of the company’s operations, and it may induce shareholders to abuse their rights by bringing derivative actions against directors for minor breaches of their duty of care, to the detriment of the company and its shareholders. Therefore, in future modifications to the Company Law in China, business judgement rules should be introduced based on the concept of maintaining a balance between the interests of shareholders and the efficiency of the company, and additional qualification requirements should be imposed on whether shareholders can fairly and adequately represent the company’s interests.

It is up to the internal bodies of the company (primarily the board of directors) to determine whether to bring an action for damages in response to a shareholder pre-action. However, the query is who accepts a shareholder’s pre-suit request on behalf of the board when there is a conflict of interest in deciding whether to sue? The United States approach is to allow the independent litigation committee or the general meeting of shareholders to review the shareholders’ request, which does not grant an absolute right to decide on

a particular subject, but rather grants the right to file a lawsuit on a variety of subjects, creating a mutual check. In contrast, the Chinese Company Law only permits a pre-action request to be made to the solitary recipient, the supervisory committee. The advantage of this approach is that the supervisory board has access to relevant information and a certain level of expertise; however, the issue is whether the supervisory board can make genuinely independent and impartial decisions [8]. It should be emphasized that in the US, a general meeting or independent litigation committee's pre-litigation assessment could potentially have the impact of preventing shareholder derivative proceedings. To put it another way, the court might uphold the target's choice to forego legal action, which would lead to the dismissal of the shareholder's derivative lawsuit. The Chinese Company Law, on the other hand, states that a shareholder may bring a representative action if the party being sued declines to be sued by the company itself, regardless of whether the body's decision to decline to sue was just and reasonable. The law does not, however, specify whether a court may reject an unsuitable shareholder representative action. Due to this, it is even more crucial that the supervisory board be given a subject that is also open to pre-action requests, as well as that the Chinese Company Law offer a reasonable definition of the subject of the request.

Further research is necessary to determine if an independent litigation committee, a shareholder general meeting, or a court of law should decide this matter. First off, if the perpetrator is the controlling shareholder, it will be challenging for the general meeting of shareholders to render a fair decision. Additionally, general meetings are highly expensive to arrange and frequently do not produce prompt and useful decisions, especially in businesses with a big number of shareholders. Furthermore, because it significantly raises the bar for shareholders to initiate a derivative action, most US states have abandoned the practise of asking shareholders to make a request to a shareholders' meeting considering current trends in US corporate law. A simple mention of this practise would undoubtedly make it more challenging for shareholders to bring derivative actions and undermine confidence in the exercise of shareholders' rights, so it is not advisable to make a shareholders' meeting the subject of the request given the relatively low application of derivative actions by shareholders in China. Second, it is obvious that when the court is the target of the petition, the court's decision as an outsider is more unbiased and fairer, but it is not without issues. For instance, the court lacks expertise in commercial judgments, and the court's decision is inescapably time-consuming, expensive, and costly. This is not suggested. Finally, if an independent litigation committee is the subject of a petition, it can, on the one hand, avoid the potential costs of a shareholders' meeting and the risk of shareholders being coerced by the wrongdoer; on the other hand, it does not suffer from the lack of expertise that exists when the court is the subject of a petition, and it can lessen pressure on the court. However, it does not suffer from the court's lack of knowledge and lessens the burden of litigation on the court. Given the foregoing, this article supports pre-litigation demands that call for the formation of an impartial litigation committee. It is not appropriate to increase the supervisory committee on top of the shareholders to the independent litigation committee to apply for derivative litigation. Instead, the shareholders should choose between the two and apply to it. As for the additional litigation committee and the supervisory committee for

the choice between the relationship or common relationship, from the current Chinese shareholders' rights awareness to be enhanced this reality.

Due to the nature of shareholder derivative actions, the court will be required to determine whether the company's refusal to sue is justified, whether the shareholder's derivative action is established, and whether the shareholder's claim should be dismissed in the preliminary proceedings. This will not only eliminate the need for shareholder derivative actions and prevent shareholder rights abuses, but it will also exclude impossible, unnecessary, and unwarranted litigation, reduce the burden on the courts, conserve judicial resources, and provide information to facilitate the smooth conduct of future shareholder derivative actions. The Chinese Company Law does not specify the criteria by which subsequent people's tribunals should evaluate the propriety of shareholder derivative actions, which is a significant deficiency. In this regard, the U.S. approach merits consideration: the court's role in reviewing the derivative action by allowing dismissal of the derivative action after preliminary proceedings based on the independent litigation committee's decision not to prosecute and by granting the court discretion in determining the issue. In the future, it would be highly desirable for China to include a provision in the Companies Law that specifies the factors that the people's courts must consider when reviewing the appropriateness of shareholder derivative actions, while also granting judges a moderate amount of discretion.

## 4 Conclusion

As previously mentioned, the Federal Rules of Civil Procedure and state court rules reflect the pluralistic approach that the United States takes to shareholder-derived pre-litigation procedures. This model of legislation strongly emphasizes the procedural law nature of shareholder-derived pre-litigation procedures and reveals their role in dispute resolution. In contrast, Article 151 of the Company Law in China is the only provision for a shareholder-derived pre-litigation procedure, and the relevant legislation is excessively principled and abstract in its few words, which might easily obscure the fundamentals of its procedural law. According to the author, it is necessary to incorporate additional provisions into the Civil Procedure Law and its judicial interpretations regarding the particulars of the shareholders' derivative proceedings, the procedural content of the procedure, and how it interacts with subsequent proceedings. Doing so will not only improve the procedure's practicality and operability but will also amply demonstrate its original extra-judiciary nature.

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