

Improving the Protection of Minority Shareholders in Chinese Company Law

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ABSTRACT

This thesis deals with improving protection of minority shareholders in China. The minority shareholders are faced with the dual oppression from the managerial power and the majority rule, but they cannot get sufficient remedies through preventive mechanisms or remedial legal actions.

After introducing the main defects regarding minority protection in the Chinese Company Law, the Author examines the main mechanisms to check the management and majority shareholders, and the remedies available to shareholders under some major legal systems in the common law world. During or after the examination, the Author makes some comments on the mechanisms and remedies and offers his opinions on selectively adopting them in China.

RÉSUMÉ

Cette thèse étudie la question à savoir comment augmenter la protection des détenteurs d'actions minoritaires au sein d'une société commerciale. Les détenteurs minoritaires d'actions font face à une oppression à double volet du pouvoir des gestionnaires et du pouvoir des détenteurs d'actions majoritaires. De plus, les détenteurs minoritaires n'ont pas accès à des recours adéquats comme des mécanismes préventifs ou des poursuites en justice.

Après avoir présenté les principales déficiences de la protection des détenteurs minoritaires d'actions dans la Chinese Company Law, nous chercherons à examiner les principaux mécanismes qui existent en contrepoint contre les gestionnaires et les détenteurs d'actions majoritaires, et les recours qui sont disponibles pour les détenteurs d'actions minoritaires dans les autres systèmes légaux majeurs de la tradition common law. Des commentaires seront présentés sur les mécanismes et les recours qui sont offerts dans ces pays de common law et nos opinions seront données sur l'adoption de ces mécanismes et recours dans le système Chinois.

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1.0 Introduction

1.1 Reasons for Special Protection for Minority Shareholders

When discussing the issue of protection for minority shareholders, the following question is inevitably posed: why does the company law offer minority shareholders special protection, if the parties are merely following the majority rule (for majority shareholders¹) or if they are exercising managerial power (mainly for directors mainly), two practices that are totally lawful?

The underlying reason stems from the potential dual oppression by managerial power and the majority rule.

The managerial power is expanding greatly in order for companies, especially large ones, to survive the increasingly competitive modern economy. It is also expanding because of the dispersive share structures, the remote distance of shareholders from the corporate business, and the heightened requirement for managerial skills within companies. Increasingly, boards of directors, instead of the shareholders, are becoming the power organ within the corporation. Therefore, an improved control over the management will not only benefit the minority shareholders, but will also be of benefit to the corporation by monitoring and rectifying the breaches of duties by the management.

As for the notion of majority rule, although it is one of the cornerstones of modern company law, its mechanical application, without any constraint, will lead to unfair consequences that will violate reasonable shareholders' expectations. This is not only unfair to the minority shareholders, but also contrary to both the legal notions of justice and equality. Eventually it would harm the company on the whole as well.

While admitting to the benefits of a rule-oriented approach in dispute resolution within the domain of corporate law, Professor Welling highlights the dilemma that exists within modern corporate law:

¹ In this thesis, “majority shareholders” actually refers to “controlling shareholders” who do not necessarily hold more than 50 percent of shares. It is based on the actual controlling power, not the mathematical sum of the shares they hold. Although this usage is not always mathematically accurate, it should be true that the likelihood for majority shareholders to control the corporation is much higher in the corporate politics.

Canadian legislators have gradually been brought to the realization that those benefits were purchased at the cost of individual oppression. Just as the civil rights activists taught us that minority oppression was inherent in the system, not just in individual attitudes, so have commentators on corporate law taught us that our system, by its very design, actively discriminates against the minority shareholder.²

The awareness of this systematic cost and the vulnerability of minority shareholders has aided in justifying the special protection for minority shareholders.

1.2 Efforts by Other Legal Systems in Minority Protection

In order to improve minority protection, various mechanisms have been designed. For this purpose, the judicial and the legislative have often resorted to such theoretical tools as the fiduciary duty towards minority shareholders, the theory of abuse of power, the reasonable shareholder expectations.

UK judges before the 1989 amendments to the *Companies Act* 1985 were quite conservative in their consideration of minority protection although they were amongst the first to allow a remedy for unfair prejudice. The judges generally followed a rigid “hand-off” and “right” approach, “saying that they were powerless to deal with the internal management of corporations.”³ The rigorous rule in *Foss v. Harbottle*⁴, which prevented shareholders from bringing suit for the harms inflicted upon the corporation, was very influential for centuries. Although judges, at a later date, made limited exceptions where shareholders were allowed to bring such suits, the complexity and limited applicability of these exceptions remained barriers to an accepted notion of minority protection. This having been said, UK company law will still much affect the topic of this thesis.

² B. Welling, *Corporate Law in Canada: the Governing Principles*, 2nd ed. (Toronto: Butterworths, 1991) at 509.

³ *Ibid.* at 511.

⁴ [1843], 2 Hare 461, 67 E.R. 189 (Eng.).

The US has made considerable contributions to the concept of minority protection in its explorative spirit and active economic activities. Issues such as the majority shareholders' fiduciary duty to minority shareholders, cumulative voting, and contemporaneous ownership rule did arouse special academic interest, although their value is sometimes questioned in this thesis.

Canada is, by far, doing the best, or at least the most open-mindedly, regarding the development of minority protection. The "remedy" approach and the oppression remedy discussed in this thesis have mainly been the creation of Canadian legal community.

As for civil law traditions, they heavily rely on such abstract doctrines as fairness, honesty, credibility and good faith in protecting minority shareholders when the infringers are committing lawful but oppressive acts. These concepts are helpful in some cases, but are difficult to put into practice. This is particularly true in China, where judges are extremely reluctant to apply vague principles in trials. Besides, they cannot address all of the contents of the oppression remedy. Therefore, we will mainly concentrate on the discussion of experiences from common law countries, countries in which the more detailed existing mechanisms may help Chinese judges applying their discretion to protect minority shareholders. The protection is also recognized to be more thorough in these countries.

To summarize, the typical mechanisms for minority protection include the fiduciary duty towards minority shareholders, cumulative voting, class voting, personal suit, derivative action, oppression remedy, appraisal remedy, and so on. They will be discussed and addressed further in this thesis.

1.3 Problems in Chinese Company Law

Professor Welling has summarized the following four elements as the foundations of Canadian company law. They could just as well serve as the touchstones of the Company Law of China.

Corporate law in Canada is now built upon four major principles:

- (a) corporate personality...;

- (b) managerial power...;
- (c) majority rule...;
- (d) minority protection....⁵

In contrast, there is no difficulty in finding serious problems in all the four principles in Chinese Company Law. For now, only the later three principles, which are more closely related to the topic of this thesis, will be briefly discussed.

Managerial power is not efficiently controlled as instances of conspiracy between the directors and the majority shareholders are prevalent in China.

The majority rule under Chinese Company Law is an absolute one. Majority shareholders are dominant within the power structure of a corporation. A shareholder holding 51 percent of shares can lawfully decide on all the important issues of the corporation.

The quest for the improving of minority protection is the central topic of this thesis. If the notion of minority protection did not pose a problem, it would not have chosen as the current topic of this thesis.

1.4 Methodology in Writing the Thesis

It is sought, in this thesis, to conduct a comparative research on minority protection and to offer some proposals by which to improve minority protection in China. In doing this, much significance is attached to the possibility of adapting the mechanisms from other legal systems to the legal and social contexts of China.

This thesis is developed following the internal logic of minority protection. Since potential oppression mainly comes from the (uncontrolled) managerial power and the (absolute) majority rule, efforts should be made in these two aspects. Therefore, after an examination of the defects concerning minority protection in China, some important preventive mechanisms seeking to adjust the relationships between directors and minority shareholders, and then the relationships between majority shareholders and minority shareholders, will be examined. The legal and social contexts that shape legal reforms in

⁵ Welling, *supra* note 2 at 53.

China will be discussed. Various remedies that could pose as a safety valve for shareholders will also be investigated.

2.0 Overview of Minority Protection in the Company Law

2.1 The Legal Framework

As regards the protection of shareholders, the Company Law of People's Republic of China (hereinafter referred to as "the Company Law") is, naturally, the most important statute. Its supporting laws and regulations include the Securities Law of People's Republic of China (hereinafter referred to as "the Securities Law"), the Contract Law of the People's Republic of China (hereinafter referred to as "the Contract Law"), the Criminal Law of People's Republic of China (hereinafter referred to as "the Criminal Law"), the General Principles of Civil Law of People's Republic of China (hereinafter referred to as "the GPCL"), the administrative regulations enacted by China Securities Regulation Commission (the "CSRC") and the judicial interpretations of the Supreme Court of China.

Amongst all of these laws and regulations, the Company Law affords the most comprehensive protection to shareholders as the special legislation in this domain. The Securities Law does, however, deal with some aspects of publicly listed companies, such as legal liability for misrepresentation.⁶ The Contract Law is the basis of many activities within the corporation. The Criminal Law attempts to protect shareholders by providing criminal sanctions for certain serious offences that could be committed against them. The GPCL's basic civil law principles, such as the *bona fide* doctrine, are useful in cases in which there is no specific regulation to apply. The CSRC regulations are mostly guidelines regarding market supervision or detailed rules of certain administrative regulations by the State Council. The judicial interpretations of the Supreme Court of

⁶ One of the main characteristics of the Securities Law is its stress on administrative and criminal liabilities rather than the civil liabilities. Among its 36 articles in the chapter of "Legal Liabilities", only 3 are related to civil liabilities, while all of them are related to administrative liabilities, and 18 of them are related to criminal liabilities. This has been one of the reasons why minority shareholders can hardly get civil compensations for their losses.

China are legal opinions of the Supreme Court on individual and specific legal issues—they are binding in court trials.

These laws, regulations and judicial interpretations form the main framework of the protection for minority shareholders in China. However, an in-depth analysis of all these laws and regulations will not be effectuated. Instead, a serious discussion of the Company Law will be undertaken.

Generally speaking, the Company Law has attempted to establish system of protection for minority shareholders, but the protection has proven to be unsuccessful. On one hand, minority shareholders have no effective means to supervise the management and on the other hand, the absolute majority rule leaves minority shareholders unprotected from the oppression by majority shareholders. Moreover, the remedy that can be obtained from lawsuits is extremely limited. Therefore, minority shareholders are inevitably often confronted by the dual oppression of both the management and the majority shareholders. In order to effectively protect the minority shareholders, improvements need to be made in these two situations. First, some mechanisms should be designed to prevent, in advance, the oppression from the management or the majority shareholders; secondly, if the preventive measures are not successful, remedial mechanisms, including personal suits and derivative suits, should be allowed to be brought—not only against illegal wrongs by the majority shareholders or the directors, but also for technically legal but oppressive conducts.

2.2 The Background of the Promulgation of the Company Law

The Company Law was promulgated in 1993. Before its enactment, there did not exist a codified law in this field, and the governing regulations were those passed by the administrative departments. The most influential administrative regulation at that time was the Regulatory Opinions on Limited Liability Companies by the then State Economic Reform Committee in 1992. This regulation was composed of only 79 articles, and was rather primitive. More importantly, because it was only an administrative regulation enacted by a Committee, its legal status was often challenged: first, it was sometimes not

applied by the courts, especially in those cases in which there were several conflicting administrative regulations enacted by different departments; secondly, the lack of the Company Law indicated that the Chinese government was still hesitating in welcoming companies, and shareholders justifiably felt some insecurity for their investments.

Against this background, the Company Law came to be a breakthrough in the legislation of China. It adopted some common corporate principles of other countries, assured the legal status of “corporations”, and afforded some protection to shareholders. The principle of limited liability and the majority rule were also both recognized, although the protection for minority shareholders was quite weak. In comparison to the period that preceded the Company Law, shareholders could feel more secure as the promulgation of the Company Law meant that their investments in corporations were at least allowed, if not fully encouraged.

At the same time, it is unfortunate that the Company Law neglected to enact mechanisms that would seek to protect minority groups. Majority shareholders are given a lot of privileges. Also remembering that in most large companies the majority shareholders were the State-Owned-Enterprises (hereinafter referred to as “the SOEs”) or state agencies,⁷ it can be inferred that the ideological inclination towards the public ownership is one of the reasons for the contrasting positions of the majority and minority shareholders. While its ideological inclination helped the Company Law to obtain approval at a time when the Chinese government was debating between such terms as “socialism” or “capitalism”, it was at the price of the unfair treatment of minority shareholders, shareholders who were often individuals.

2.3 The Contents of the Protection

⁷ In the 1135 publicly listed companies up to April 30th of 2002, 39.21% of the shares were state shares or enterprise shares controlled by the state. The average shares that the biggest shareholders hold reached 43.93%, and 80% of the biggest shareholders are state agencies or the SOEs. See YinYin Zhang, “Domination by Majority Shareholders Persists; Minority Shareholders’ Rights Unprotected”, China Business and Trade Newspaper (22 July 2002) C1

In order to thoroughly investigate the thesis, it would first be helpful to describe the relevant provisions in the Company Law that treat of the protection for shareholders in general, and for minority shareholders in particular.

2.3.1 The Legislative Goal of the Company Law

Article 1 of the Company Law states that the protection for shareholders' rights is one of its legislative goals. This article reads as follows:

This Law is formulated in accordance with the Constitution in order to adapt to the needs to establish a modern enterprise system, standardize the organization and activities of companies, protect the legitimate rights and interests of companies, shareholders and creditors...

Fortunately, the term "shareholders" means those persons whose legitimate rights and interests will be protected by this provision. Literally, the "minority shareholders" should also be included for protection as are the "shareholders". Whether this statement will prove to be true will be determined after a more thorough examination of the Company Law.

2.3.2 The Majority Rule

Item 1 of Article 4 of the Company Law is a brief description of the rights of shareholders in accordance with the Company Law:

The shareholders of a company, as capital contributors, have the right to enjoy the benefits of the assets of the company, make major decisions, choose managers etc. in accordance with the amount of capital they have invested in the company.

This article pretests several fundamental rights for shareholders. It deserves special attention here because it lays the theoretical foundation for the absolute majority rule with “the capital they have invested in the company” as the sole basis for the shareholders’ right to vote. There is virtually no restriction placed upon the right to vote. Although majority rule is necessary for a company, it should not be accepted if its price is the oppression of minority shareholders. This is even true even in those cases in which when the majority shareholders are doing nothing illegal, but are conducting themselves in an “oppressive” fashion by using their majority powers.

The establishment of the absolute majority rule is confirmed by Articles 43 and 106 of the Company Law. Since a more detailed analysis will be realigned in the following sections, here it will suffice for now to summarize by saying that these two articles have provided for the majority rule that strictly follow the “one share, one vote” doctrine with no exceptions.

2.3.3 The Principle of Limited Liability

Article 3 of the Company Law gives some protection for shareholders with the limited liability principle.

All limited liability companies and companies limited by shares are enterprise legal persons.

In the case of a limited liability company, a shareholder is liable to the company to the extent of the amount of the shareholder's capital contribution. A limited liability company is liable for the debts of the company with all its assets.

In the case of a company limited by shares, its entire capital is divided into shares of equal value and shareholders shall be liable to the company to the extent of the shares held by them. A company limited by shares is liable for the debts of the company with all its assets.

One aspect of needs to be mentioned about the “limited liability companies” and “company limited by shares”. These two awkward terms are used in the officially approved translations of the Company Law. Two more popular alternatives would be, respectively, “closely held corporations” and “publicly held corporations”, respectively. In the following parts of this thesis, these terms are used interchangeably.

Thanks to the limited liability principle, the personal patrimony of shareholders, including minority shareholders, is safe from their loss in the corporations. This is one of the most fundamental principles of modern corporate law. Chinese corporate law does not have such mechanism as “piercing the corporate veil”, and it would be most difficult to hold shareholders personally liable with the alternative mechanisms like “holding the majority shareholders directly liable for their acts”. Since minority shareholders are not as likely as the majority shareholders to control the company or abuse the legal personality of the company (this is where the “corporate veil” will be “pierced” in some corporate theories), it would be the majority shareholders who would benefit more from the lack of “piercing the corporate veil” or like mechanisms.⁸

2.3.4 Enumeration of Some Specific Rights

After the introduction to the macroscopical principles, it would be helpful to enumerate the specific rights of shareholders in the Company Law. Although protection for minority shareholders extends beyond the rights, this overview still remains beneficial. The rights include the following:

1. The right to appear at the shareholders’ meeting and to vote,⁹;

⁸ It might be interesting to consider this question: although minority shareholders seldom have opportunities to abuse the legal personality of the corporation, do they qualify to sue majority shareholders as “claimants” as creditors do when the majority shareholders abuse the legal personality of the corporation? The prevalent schools deny this, but one might argue that what makes the minority shareholders so special that they cannot resort to this mechanism for protection? Is that just because they happen to have some, maybe not substantial, shares of the corporation? Another possibility is that they might want to resort to oppression remedy for protection.

⁹ Company Law, Item 1, Article 106.

2. the right to examine the company's articles of association, minutes of shareholders' general meetings and financial and accounting reports, and to make proposals or inquiries in respect of the company's operations¹⁰;

3. the right to request for the holding of the interim shareholders' general meeting¹¹;

4. the right to initiate proceedings in the people's court to require that the acts of violation or infringement be stopped if any resolution adopted by a shareholders' general meeting or the board of directors violates any law or administrative regulation or infringes the lawful rights and interests of shareholders¹²;

5. the right to request a company limited by shares to formally deliver share certificates to its shareholders immediately upon its registration and establishment¹³;

6. the option of the current shareholders to buy the newly issued shares of the same class¹⁴;

7. the right to transfer his shares in accordance with the law¹⁵;

8. the right to request for the proportional distribution of the remaining profits after the company has made up its losses and made allocations to its common reserve fund and statutory common welfare fund¹⁶;

9. and the right to request for proportional distribution of the company's remaining properties after its debts have been repaid in accordance with the provisions related to the dissolution procedures¹⁷.

2.4 Summary

¹⁰ Company Law, Article 110.

¹¹ Company Law, Item 3, Article 104.

¹² Company Law, Article 111

¹³ Company Law, Article 136

¹⁴ Company Law, Item 4, Article 138.

¹⁵ Company Law, Article 143

¹⁶ Company Law, Item 4, Article 177.

¹⁷ Company Law, Item 3, Article 195.

The Company Law has tried to establish a legal framework by which to protect shareholders, although these efforts have not been proven to be successful. This “system” is characterized by the inability to protect minority shareholders. The remedies available to them, if any, are extremely limited. In fact, their position is so dire that Dr. Min’An Zhang, among other commentators, has even argued that the expression “shareholders”, as persons whose “legitimate rights and interests” are protected by Article 1, does not actually include minority shareholders.¹⁸ This is also the answer to the question that was raised in part 2.2.1: Whether the legislative goal of the Company Law did include the protection of minority shareholders as well as simple “shareholders”.

3.0 The Defects of Minority Shareholders Protection in the Company Law

3.1 Introduction

As the authoritative organization of the company, the general meeting of the shareholders imparts very broad powers. According to Articles 37, 38, 102 and 103 of the Company Law, the shareholders’ gathering not only meets to decide on such simple matters as the election, replacement, remuneration, and the approval of final accounts, but also the changes in the form and structure of the business. In other words, these articles

¹⁸ The Author agrees with Dr. Zhang on this issue. According to Dr. Zhang, although “shareholders” in Article 1 should literally include minority shareholders, the latter are, in fact, unfortunately excluded from this protected group. He supports his argument with the following reasons. “First, minority shareholders do not have the right to sue on behalf of the corporations. Articles 38 and 103 of the Company Law empower the majority shareholders to decide on all corporation operations with either ordinary majority rule or special majority rule. When majority shareholders abuse the majority rule, minority shareholders have no mechanisms to prevent, revoke resolutions of such abuse, or, to the extremity, be bought out at a fair price. Secondly, the fiduciary obligations of directors and managers are not toward minority shareholders, but toward the company solely, or the majority shareholders virtually. Thirdly, although the Company Law provides for two kinds of corporations, namely the limited liability corporation and the corporation limited by shares, it does not provide for appropriate remedies according to the differences in these two kinds of corporations. Fourthly, dogmatically following traditional corporate theories, the Company Law does not provide for majority shareholders’ obligation toward minority shareholders.” See M. An Zhang, “Legal Protection for Minority Shareholders’ Rights”, in Huixing Liang, ed., *Civil and Commercial Law Review*, vol. 9, (Beijing: Press of Law, 1998) 87 at 160. The Author generally agrees with Dr. Zhang. Even though the legislators had not meant to disregard minority shareholders, the actual effect of the Company Law has pushed them into a miserable situation.

try to arm the shareholders with powers broad enough, that, during the shareholders' meetings seeking to verify the behaviors of the management, their rights and interests would not be harmed.

However, these powers were placed in the hands of the majority shareholders, without first granting appropriate remedies to minority shareholders. First, the minority shareholders are very weak when confronted by the management. One of the main reasons for this is the lack of detailed and feasible rules that would allow the minority shareholders to exercise their rights provided in the Company Law. In most cases, the Company Law only provides that they "shall have certain rights" or that "the directors shall not commit certain wrongs". It remains silent, however, in instances where it should have provided specific procedures for the minority shareholders in order for them to exercise their rights or to seek for remedies when directors commit certain wrongs. Secondly, the absolute majority rule in the Company Law makes the position of minority shareholders weak when faced with that of the majority shareholders. There are virtually no restrictions upon the majority shareholders' control of the shareholders' meeting. Thirdly, it is extremely difficult for minority shareholders to bring personal suits and impossible for them to bring derivative suits. More importantly, the concept of "oppression" is generally not accepted as long as the conducts of majority shareholders and directors remain technically lawful. It is not likely to hold them liable even in those cases in which their conducts are unfair and equitably wrong.

Therefore, for the minority shareholders, the rights existing within the Company Law remain abstract and exist solely on paper. They are not realistic ones that can be exercised. It is often inevitable for minority shareholders to be oppressed by both the majority shareholders and the management.¹⁹

3.2 The Inability to Protect the Minority Shareholders from the Management

¹⁹ In recent years, aggressive fraudulent acts in publicly listed companies have proved the truth of this claim. One of the most common acts is to disclose false financial accounting reports and cheat the individual shareholders to buy their stocks.

3.2.1 About the Right to Convene the Shareholders' Meeting

3.2.1.1 In the Company Law

The shareholders' right to vote can only be exercised at shareholders' meetings that are lawfully convened according to the prescribed procedures. Otherwise, the "resolutions" would not be lawful nor binding on the company, the management or any other shareholders.

The first step would be to convene the shareholders' meeting. Articles 43 and 104 of the Company Law provide for the convention of shareholders' meetings for limited liability companies (closely held corporations) and companies limited by shares (publicly held corporations), respectively. According to these articles, shareholders' meetings are divided into regular or annual meeting, the first being for closely held corporations, and the latter being for publicly held corporations, and interim meetings. The shareholders' meeting, either annual, regular or interim, shall be convened by the board of directors and presided by the chairman of the board of directors (or the managing director in a closely held corporation that lacks a board of directors). Although the Company Law requires that the regular meetings and the annual meetings be held regularly, no provision exists that treats of a situation in which the management does not fulfill the duty to convene the meeting. Similarly, there is no provision treating of a situation in which the management asserts that it is for the best interest of the company not to convene the interim shareholders' meeting. In other words, the power to decide the time for the shareholders' meetings, either regular/annual or interim, falls completely into the hands of the management. There is no way for minority shareholders to participate in this decision.

This puts minority shareholders in a disadvantaged position. In a situation in which the management harms the company or the shareholders between regular/annual shareholders' meetings, the most powerful weapon for the minority shareholders in order to address these harms would be to convene an interim shareholders' meeting and vote against the harmful action or vote to remove the defaulting directors. However, the minority shareholders do not have the right to convene the shareholders' meeting. Instead, they can only "*request*" to convene the meeting if they are fortunate enough to hold

enough shares to do so (one-fourth for closely held corporations, and one-tenth for publicly held corporations),²⁰ but their “requests” could be lawfully refused by the management. In such cases, the Company Law does not provide any further channels that could serve to solve the disputes. The minority shareholders can neither convene the shareholders’ general meeting by themselves, nor apply to the court to order that the meeting be convened. Therefore, under the Company Law, the minority shareholders cannot stop the harmful acts of the management (who are often controlled by the majority shareholders) with the convention the shareholders’ meetings. They are therefore deprived of one of the most important weapons needed in order to effectively protect themselves from the infringements of the management.

3.2.1.2 In the Regulatory Opinions 2000

Contrasting with the Company Law, the Regulatory Opinions for the Shareholder’ General Meetings of Publicly Listed Companies 2000 Revised Edition (hereinafter referred to as “the Regulatory Opinions 2000”), enacted by the CSRC, demonstrates a more positive attitude regarding this issue. The Regulatory Opinions 2000 was first enacted in 1998 and revised in 2000. China’s economic development and progress regarding the idea of the rule of law has brought some fresh air into this discussion. Articles 16 to 26 of the Regulatory Opinions 2000 provide for the procedures that can be undertaken by the shareholders when their requests for convention of a shareholders’ general meeting are refused by the board of directors.²¹ These provisions empower shareholders with 10% or more shares to automatically convene the shareholders’ general meeting if their such requests are refused by the board of directors. The rights and obligations of these shareholders, as well as some procedural regulations, are also prescribed. Therefore, it at least gives minority shareholders of publicly listed corporations the chance to have their voice heard at the shareholders’ general meeting. This is an important progress in comparison with the lack of any provisions to this effect in the Company Law. It can serve as a good reference for a revision of the latter.

²⁰ See Company Law, Item 1 of Article 43 and Item 2 of Article 104.

²¹ Regulatory Opinions 2000, Articles 19 to 26.

On the other hand, these provisions cannot replace the Company Law and do not make it any less necessary to revise the Company Law in the relevant aspects. The reasons for this are detailed in the following paragraphs.

First, the legal status of the Regulatory Opinions 2000 as an administrative regulation enacted by the CSRC is its fatal defect. As an administrative regulation, its *de facto* change in the related provisions of a law is problematic. Besides, since it is not law enacted by the National People's Congress or its Standing Committee, the courts may sometimes refuse to follow it in trials.

Secondly, it is only applicable to the publicly listed companies, which are only a very small portion of all companies. Minority shareholders in other companies are excluded from protection by these provisions.

Thirdly, for companies that are publicly listed, it is very difficult for the individual shareholders to hold at least 10% of all voting shares—the shareholders that actually do so can be more reasonably defined as majority shareholders. Therefore, these provisions may be regarded as improved protection for majority shareholders, being not so meaningful for minority shareholders.

Fourthly, although Article 42 of the Regulatory Opinions 2000 provides that the parties may bring suits to the people's courts when they disagree on the decision to convene a shareholders' meeting or the legal effect of the resolutions of such meetings, this is not binding on the courts. The courts may refuse to hear such cases, claiming that such an issue would be of a managerial nature and that it should be dealt with within the company. Again, because the Regulatory Opinions 2000 remains an administrative regulation that does not have the authority to prescribe the causes of action, it is difficult to affirm that the court is wrong in refusing to hear such cases.²² Lastly, while the Regulatory Opinions 2000 does not suffice to resolve this issue on the one hand, it might, on the other hand, constitute an abuse of the right that allows to convene shareholders'

²² Although the Regulatory Opinions 2000 also provide for some other protection like the challenge of voting and the right to raise motions at the meeting, the fatal weakness that it is not a law greatly decreases its significance.

meeting by the minority shareholders. Professor Feng Guo holds such view and suggests that any restriction on such a right should be dealt with by the intervention of the courts.²³

3.2.2 About the Right to Raise Motions at the Shareholders' Meeting

3.2.2.1 In the Company Law

After the shareholders' general meeting is convened, the next issue that arises would be the right to raise motions, or, as stated in the Company Law, "the matters to be considered at the meeting". Unfortunately, the Company Law seems to have failed the minority shareholders again. Articles 44 and 105 imply that "the matters to be considered by the shareholders' meeting" are raised by the board of directors²⁴, but do not elaborate as to the procedures need by the shareholders in order to raise such issues. The result is that the management (or the controlling shareholders) retains the actual power to decide on these issues, while the minority shareholders still have no say in the matter. Furthermore, Article 105 of the Company Law provides that "An interim shareholders' general meeting shall not adopt resolutions on matters not stated in the notice",²⁵ thus depriving the minority shareholders of the last opportunity to voice their wishes at the meeting. The reason for this is simple: the sending of the notices announcing the shareholders' meetings is prerequisite to these meetings, and the content of the notice is controlled by the management. Whatever issue brought unfair prejudice by the minority shareholders remains meaningless unless the issue had been previously listed in the Notice. Clearly, in this circular argumentation, the minority shareholders have no channels by which to express their opinions, be it either in the notices or at the meetings.

²³ Minority shareholders' right to convene the shareholders' meeting is "automatic" because it provides that, if the board of directors refuses the minority shareholders' proposal to convene the shareholders' meeting, these minority shareholders may either give up their proposal, or convene the meeting by sending out the notices for the meeting at the expenses of the company. Professor Guo holds that it is an important omission not to restrict the right of minority shareholders to convene shareholders' meeting. He suggests that the restriction should be done through the intervention of the court. See Feng Guo, "Exercising and Protecting Minority shareholders' Rights at Shareholders' Meetings", (2001), online, available on the website <<http://www.civillaw.com.cn>> (date accessed: 25 August 2003.)

²⁴ Company Law, Article 44, Article 105.

²⁵ Company Law, Item 1, Article 105.

According to Article 105, their opinions shall thus not be voted on at the shareholders' meeting. Before an assembly of minority shareholders that do not have the right to raise motions, the management can freely disregard their interests. This is exactly what is occurring in many companies.

Perhaps, the only article that links the minority shareholders with any motions is Article 110, which provides that “shareholders have the right to...make *proposals or inquiries* in respect of the company's operations.” Once again, nothing is mentioned about the procedures that are needed in order to make such proposals or inquiries. Moreover, the Company Law does not provide for the consequences of such proposals or inquiries, and does not elaborate upon the necessary procedures to undertake in the case that the management disagrees with the shareholders on such proposals. The management can simply ignore them as if they did not exist. This leads us to believe that the so-called “right to propose” has to be ineffective in that it cannot supervise the management as motions do.

3.2.2.2 In the Regulatory Opinions 2000

Again, the shareholders of publicly listed companies may find some comfort in the Regulatory Opinions 2000 of the CSRC. Article 12 of the Regulatory Opinions 2000 provides that “the shareholders with 5% or more voting shares (either individually or collectively) or the board of supervisors may raise motions at annual shareholders' general meetings”²⁶. The Regulatory Opinions 2000 divides the motions into two categories according to whether prior notice is needed in the specific circumstances. Motions needing prior notice are linked to important issues such as the merger and division of a company, acts that are prescribed in Article 6 of the Regulatory Opinions 2000. Other motions do not need prior notice are of lesser significance to the company as they can be raised directly at the annual shareholders' meeting. Furthermore, according to Articles 12 and 13 of the Regulatory Opinions 2000, the motions of the first category need to be examined by the board of directors before they can be recorded in the notice

²⁶ Regulatory Opinions 2000, Article 12.

and voted on at the shareholders' general meeting. Article 13 also lists the guidelines that the board of directors shall follow in the examination of such motions.²⁷

The fact that the Regulatory Opinions 2000 does provide some feasible procedures that can be applied to the motions in each categories is quite praiseworthy. This is a great progress compared to the Company Law. Nevertheless, the Regulatory Opinions 2000 cannot be thought of as the final solution either. The reasons for this are somewhat similar to those demonstrating why the Regulatory Opinions 2000 should not replace the Company Law regarding the calling of the shareholders' meeting.

The first reason is simple; the legal status of the Regulatory Opinions 2000 remains administrative and cannot be thought of as a formal piece of legislation.

Secondly, the Regulatory Opinions 2000 does not cover the interim shareholders' general meetings, which are especially important because they are usually convened at times when the company is facing important and urgent decisions, or during periods the right to raise motions is most necessary.

Thirdly, the Regulatory Opinions 2000 might conflict with the Company Law regarding certain issues. This conflict is unacceptable as the Regulatory Opinions 2000 is a regulation that was enacted "according to" the Company Law. For example, the period allowed for an announcement that is prescribed in the Regulatory Opinions 2000 covers a period of only 10 days before the meeting, a time-frame which is clearly inconsistent with the requirement of 45 days allowed by Article 105 of the Company Law.²⁸

Even in the situation that a shareholders' meeting was convened and that the relevant motions were allowed to be raised, minority shareholders would still not be protected from their hardships. They would still find themselves confronted with another oppression, the one from the majority shareholders.

3.3 The Inability to Protect the Minority Shareholders from the Majority Shareholders

²⁷ Regulatory Opinions 2000, Article 13.

²⁸ Company Law, Item 2, Article 105: "Where bearer shares are issued, a public announcement shall be made about the matters in the preceding paragraph forty-five days before the meeting."

3.3.1 The Content of the Absolute Majority Rule

As was introduced in Section 3.1, Articles 38 and 103 both grant broad powers to the shareholders' (general) meeting, as it is seen as the authoritative organization of the company.²⁹ The goal of these two articles is to assure that the shareholders shall enjoy the initial and the ultimate powers of the company.³⁰ In other words, they both authorize the shareholders to supervise the managerial powers with their rights as shareholders.

The majority rule is the governing rule that allows the shareholders to exercise these powers at the shareholders' general meeting. In the Company Law of China, the powers of shareholders to supervise the management are solely controlled by the majority shareholders. Unlike the majority shareholders who can express their wishes with their controlling voting, minority shareholders do not have the necessary procedures that would

29 Company Law, Article 38:

“The shareholders' meeting exercises the following powers:

- (1) to decide on the company's operational policies and investment plans;
- (2) to elect and replace directors and decide on matters relating to the remuneration of directors;
- (3) to elect and replace the supervisors who are representatives of the shareholders, and decide on matters relating to the remuneration of supervisors;
- (4) to examine and approve reports of the board of directors;
- (5) to examine and approve reports of the board of supervisors or any supervisor(s);
- (6) to examine and approve the company's proposed annual financial budget and final accounts;
- (7) to examine and approve the company's plans for profit distribution and recovery of losses;
- (8) to decide on increases in or reductions of the company's registered capital;
- (9) to decide on the issue of bonds by the company;
- (10) to decide on transfers of capital contribution by shareholders to a person other than a shareholder;
- (11) to decide on issue such as merger, division, change in corporate form or dissolution and liquidation of the company; and
- (12) to amend the company's articles of association.”

Article 103:

“The shareholders' general meeting exercises the following powers:

- (1) to decide on the company's operational policies and investment plans;
- (2) to elect and replace directors and decide on matters relating to the remuneration of directors;
- (3) to elect and replace the supervisors who are representatives of the shareholders and decide on matters relating to the remuneration of supervisors;
- (4) to examine and approve reports of the board of directors;
- (5) to examine and approve reports of the board of supervisors;
- (6) to examine and approve the company's proposed annual financial budget and final accounts;
- (7) to examine and approve the company's profit distribution plan and plan for recovery of losses;
- (8) to decide on increases in or reductions of the company's registered capital;
- (9) to decide on the issue of bonds by the company;
- (10) to decide on issue such as merger, division, dissolution and liquidation of the company and other matters; and
- (11) to amend the company's articles of association.”

³⁰ Bin Qi, “Protection for Shareholders' Rights in Publicly Held Corporations” in Baoshu Wang, ed., *Commercial Law Review*, (Beijing: Press of Law, 1997) 591 at 601.

assure that their voices are heard and taken into account in the cases in which they would have different opinions from the majority shareholders. The majority shareholders thus retain a dominant status in the corporation, while the minority shareholders are not protected from domination by the majority shareholders, the latter who are able to lawfully decide every issue of the corporation with their voting powers.³¹ This is the reason why the rule is referred to as the “Absolute Majority Rule”.

The absolute majority rule was first embedded in Article 4 of the Company Law, which specifies that “the capital they have invested in the company” is the sole reason as to the shareholders’ right to vote. No restriction is applied to the exercise of this right to vote, thus laying the theoretical foundation of the absolute majority rule. As long as the majority shareholders can form a majority resolution, the minority shareholders would be in an extremely difficult position if they were seeking to overthrow the resolution or other remedies, not to mention the oppression remedy.

Based on this theoretical foundation, Articles 41 and 106 establish the specific absolute majority rule. Article 41 applies to closely held corporations, while Article 106 applies to publicly held corporations. The contents of these two articles are substantially the same. Article 41 provides that “Shareholders shall exercise voting rights at shareholders' meetings in accordance with the proportions of their capital contribution.”³² As for Article 106, it exchanges “the proportions of their capital contribution” with “one vote for each share they hold”, and provides for the ordinary majority rule and the special majority rule.

Shareholders present at a shareholders' general meeting have one vote for each share they hold.

Resolutions of the shareholders' general meeting shall be adopted with half or more of the voting rights held by shareholders present at the meeting. Resolutions of the shareholders' general meeting on merge, division or dissolution of a company shall be adopted by shareholders with two-thirds or more of the voting rights present at the meeting.

³¹ For more information, see Yunxia Qiu, Xiaoling Ge, Weiguo He, “Domination of Majority Shareholders in Publicly Listed Companies” (2002) 14:3 Social Sciences Journal of Colleges of Shanxi 33.

³² Company Law, Article 41.

Despite the different expressions used in both articles, the fundamental principle of the majority rule is that the shareholders shall vote according to the capital that they have invested in the company. One share equals one vote. If you have 99% of the shares, you have 99% of the votes. That is exactly the content of the majority rule detailed in the Company Law. The same rule applies to all of the resolutions at the shareholders' general meeting, from the selection of directors to the passing of other resolutions concerning important management issues. Perhaps the only "restriction" on the (ordinary) majority rule is the special majority rule that is applicable in several important corporate issues. However, it is often not difficult for the majority shareholders to have certain resolutions adopted by the special majority rule.

3.3.2 No Fiduciary Duty by Majority Shareholders—Abuse of Majority

Fourthly, although Articles 214 through 217 of the Company Law have elaborated the legal liabilities of directors, supervisors and managers for breaches of their legal obligations, they have not addressed the idea of the fiduciary duty of the controlling shareholders towards the minority shareholders. Therefore, in exercising their rights as majority shareholders, they are virtually free to exercise them in any manner which they choose. They do not need to consider the general interest of the corporation nor take the other shareholders into consideration. This would be problematic because the result of their voting as the majority shareholders does not only act on themselves, but also on the corporation and other shareholders. Under such provisions, the abuse of majority would almost be inevitable.

Yves Guyon in *Droit des affaires*, v.1 <<droit commercial général et sociétés>>, 7e éd., Economica, Paris, 1992, at p.468, para. 456, gives the following definition of an abuse of majority:

[Translation]

The challenged decision must have been made contrary to the company general interest and with the sole intent to favour the members of the majority to the detriment of the members of the minority.³³

This is an example of what would happen in such cases as when the fiduciary duty towards minority shareholders is not imposed on majority.

Although “Instruction of Articles of Associations for Publicly Listed Companies” (enacted by the CSRC in 1997, hereinafter referred to as “the Instruction”) provides that “controlling shareholders shall not harm the legitimate rights and interests of the company or other shareholders”,³⁴ the actual effect remains doubtful. As it has the status as an “Instruction” rather than a “regulation”, its worth is even lower than an administrative regulation such as the Regulatory Opinions 2000. It is not likely that the court would apply it. Besides, it cannot apply to companies other than those which are publicly listed.

3.3.3 No Cumulative Voting

There is no room for cumulative voting in the Company Law. The consequences of this is that the majority shareholders actually retain the unilateral power to appoint the directors. There is virtually no chance for minority shareholders to vote their representatives to the board of directors. Although it should be true that all the directors, whether chosen by majority shareholders or by minority shareholders, should act “for the best interest of the corporation”, there is no denying that the directors chosen by minority shareholders will be less likely to work partially for the interest of majority shareholders.

This situation became worse with the application of Articles 83 of the Company Law. This article requires that “[w]here a company limited by shares is to be established by the offer method, the shares subscribed for by the promoters shall not be less than thirty-five percent of the total number of shares of the company...”. Therefore, for a publicly held corporation that has been established by the offer method, there must be at least one shareholder that holds 35% or more shares of the company. In most large-

³³ The Honorable Pierre J. Dalphond, “Shareholder Remedies and Directors’ Liability in Quebec Corporate Law” (Civil Law Seminar, National Judicial Institute, Vancouver, 25 May 2001) [unpublished].

³⁴ The Instruction, Article 71.

medium-scale companies, this percentage is sufficient to assure actual control. Because of this provision, domination by majority shareholder has become inevitable in many cases.³⁵

3.3.4 No “Challenge of Vote”

There is no “challenge of vote” either, so majority shareholders can vote on issues with which they have conflicting interests with the company. Numerous actual cases have told us that many majority shareholders do not hesitate to have themselves benefit from certain situations to the detriment of the company and the minority shareholders. The most typical examples can be found in the associated trades between the controlling companies and the publicly listed companies that are their subsidiaries. For such things as an unreasonable profit transfer through associated trades, there is almost no action that could be undertaken by the minority shareholders to rectify the situation, because this transaction was authorized by the company’s resolution, that was reached through the lawful procedure: the majority rule.

Fortunately or unfortunately, the Regulatory Opinions 2000 has to again act as the “savior” again for the minority shareholders. According to Article 34 of the Regulatory Opinions 2000, “[w]hen the shareholders’ meeting is voting on associated trading, the related shareholders with interest in the trading shall not vote. Their shares shall not be counted as the present shares at the shareholders’ meeting”.³⁶

It should be admitted that this provision is an important protection for minority shareholders in the publicly listed companies. However, it does have shortcomings, such as those that were discussed in preceding section concerning the right to convene the shareholders’ meeting and the right to raise motions. Only two most important shortcomings will be mentioned: first, the problem caused by the legal status of the

³⁵ According to statistics, up to the end of 1999, in the publicly held corporations with state shares, 47.68% of them have a shareholder holding more than 50% of shares in their corporations, and 77.19% of the corporations have shareholders holding more than 40% of shares. See Hongbin He, “On the Protection for the Rights and Interests of Minority Shareholders in Publicly Held Corporations”, (2001) 12 Research on Financial and Economic Issues, 16, at 16.

³⁶ The Regulatory Opinions 2000, Article 34.

Regulatory Opinions 2000 as only an “administrative regulation”; secondly, its inability to apply to companies that are not listed in the stock market.

3.3.5 No Class Voting

The shareholders cannot even protect themselves with the class vote, not to mention the class veto. This does not mean that there is no division of classes in Chinese corporate practices. In fact, according to the differences of the owners, the shares can be divided into the classes of state shares, enterprise shares, and individual shares. The former two classes of shares exist widely in companies that are transformed from the SOEs. Only individual shares are transferable in the secondary stock market (the exit mechanism), and the public has to pay a higher price in order to purchase such shares in the secondary market. Naturally their value is higher than the state shares and the enterprise shares. However, during voting at the shareholders' meeting, all classes of shares are treated as if they were completely the same. This has resulted in the unfair treatment of individual shareholders. Because of the dominating position of state shares or enterprise shares in most publicly listed companies, the majority shareholders can more easily control the shareholders' meeting. They can easily impose their own wishes on the minority shareholders through lawful procedures.

3.4 The Inability to Bring Suits

3.4.1 Introduction

When the preventive measures fail to protect the minority shareholders, the remedial measures—lawsuits—would be the last weapon of choice. Generally, the lawsuits should include both personal suits (either class suits or individual suits) in their own names, and derivative suits (or representative suits as is argued for by Professor Welling)³⁷ on behalf of the corporation.

³⁷ Welling, *supra* note 2 at 544-547.

Once again, we would note the dire situation of minority shareholders in the hierarchy of the company. First, although they do have some chances to bring direct suits, the minority shareholders are burdened with excessive restraints and their chances to win are rare, if not completely impossible. Secondly, they are not allowed to bring derivative action.

3.4.2 Difficulties in Bringing Personal Suits

3.4.2.1 In the Company Law

Articles 63 and 111 are perhaps the most important articles concerning the right of minority shareholders to raise direct suits.

Article 63 provides that a director, supervisor or manager “shall be liable for damages” if his violation of the law, administrative regulations or the articles of association results in harm to the company:

Where a director, supervisor or manager of a company violates the law, administrative regulations or the company's articles of association while performing his official corporate duties resulting in harm to the company, such director, supervisor or manager shall be liable for damages.

But the manner by which to hold such a “director, supervisor or manager” liable is not mentioned. It would seem that this provision is weak because it is too abstract. When any minority shareholder tries to hold these “directors, supervisors or managers” liable with this provision, his or her requests would mostly be rejected. Although the inability of these *abstract* provisions should also be attributed to problems in the enforcement of laws and regulations, there is no denying that the primitiveness of these provisions is also to blame. As the focus of this thesis is not on the enforcement of laws, a discussion on how to improve the laws themselves rather than probing into the area of law enforcement will suffice.

One of the reasons that would explain the inability of Article 63 to be effective is Article 111, which is the first provision that provides for the concrete content of the shareholders' right to sue.

If any resolution adopted by a shareholders' general meeting or the board of directors violates any law or administrative regulation or infringes the lawful rights and interests of shareholders, shareholders have the right to initiate proceedings in the people's court to require that such acts of violation or infringement be stopped.

Compared with Article 63, Article 111 unfortunately shows a certain degree of concession in the content of the protection for the minority shareholders. In fact, it is not exaggerated to assert that it has constituted the legislative oppression on the minority shareholders. The reasons for this will not be discussed.

First, this Article only addresses the situations where the “law or administrative regulation” is violated, but, why should the “articles of associations be excluded?” The assurance that the management or the majority shareholders would obey the articles of association is essential in order to effectively protect the interests of the company and the minority shareholders. There would not seem to be any persuasive reason to exclude it. In addition, when certain conducts that are technically legal but oppressive, the possibility to obtain a remedy is zero.

Secondly, this Article only provides that the shareholders have the right to sue “to require that such acts of violation or infringement be *stopped*”, but keeps silent as to the shareholders' right to sue for *damages*. However, because the minority shareholders seldom have the opportunity to attend the meeting of directors, in most cases, they cannot know of these resolutions until they have been passed and carried out. Logically, it is often impossible or at least extremely difficult for the minority shareholders to *stop* these resolutions, and the remedy has to be often the *ex post facto* compensation.³⁸ Therefore, the right to damages often becomes the only powerful weapon for the minority

³⁸ G. Feng, “Fiduciary Obligation of Controlling Shareholders—Section 3” (2002) Available on the site <<http://www.civillaw.com.cn>>.

shareholders. Without the provision for civil damages, the minority shareholders would be deprived of the compensation they deserve and the wrongdoers would continue to profit themselves by harming the minority shareholders or the company.

The third defect of Article 111 is that its applicable breadth is too narrow. It only applies to cases in which the majority shareholders or the management harm the minority shareholders at the shareholders' general meeting or the meeting of directors, but does not apply to harms done outside these meetings.³⁹

3.4.2.2 In the Notices by the Supreme Court

To make it worse, the Supreme Court of China released "The Supreme Court's Notice that Cases for Civil Damages in the Stock Market Shall Temporarily not be Heard by the Courts"⁴⁰ (hereinafter referred to as the "Notice 406") in September 2001, a notice which stated that actions for civil recoveries concerning insider trading, fraud, and market manipulation in the publicly listed corporations would temporarily not be heard by the courts. In January 2002, however, the Supreme Court did make some adjustments to its position by allowing cases of misrepresentation to be heard in "Notice by the Supreme Court About Hearing Torts Cases of Misrepresentation in the Stock Market"⁴¹ (hereinafter referred to as "the Misrepresentation Notice"). This did not, however, completely solve the problem mentioned above. Above all, the Misrepresentation Notice only covered cases of misrepresentations but excluded other cases such as insider trading or market manipulation from being heard by the court. This is not only unfair to the minority shareholders,⁴² but also inconsistent with the requirements of the Securities Law that say that such acts need to be banned (although the provisions in the Company Law and the Securities Law lack details, the principle to forbid such acts is explicit).⁴³

³⁹ Guo Feng, *supra* note 38.

⁴⁰ Open Notice by the Supreme Court, No. 406, 2001.

⁴¹ Judicial Interpretation of the Supreme Court, No. 2, 2003.

⁴² They are mainly individual investors in the stock market and are often victims of the infringements done by the management or the majority shareholders.

⁴³ For example, Article 63 of the Company Law provides that "Where a director, supervisor or manager of a company violates the law, administrative regulations or the company's articles of association while

3.4.3 The Impossibility to Bring Derivative Action

The notion of the derivative action, or “representative action” as is presented by Professor Bruce Welling, can be described as follows:

A shareholder derivative suit is a claim asserted by a shareholder on behalf of the corporation. In a shareholder derivative suit the law recognizes that corporate directors may not be acting in the best interests of the corporation when they refuse to assert the corporation's legal right to enforce the directors' fiduciary duty to the corporation. The purpose of the suit is to prevent abuse of authority by the board of directors.⁴⁴

Derivative action has been an important mechanism of minority protection. It has been a meaningful protective device, not only for minority shareholders, but also for the corporation. It is founded on the presumption that the wrongdoers would not sue themselves.

However, the Company Law has not provided for derivative action. In the event that any minority shareholder does attempt to bring a suit on behalf of the corporation, the applicable law would be Item 1 of Article 108 in the Civil Procedural Law of Peoples Republic of China (hereinafter referred to as “the CPL”): “The following conditions must be met when a lawsuit is brought: (1) the plaintiff must be a citizen, legal person or any other organization that has a direct interest in the case”. In those cases in which derivative action would be allowed, the entity considered to have a “direct interest in the case” would be the company rather than the minority shareholders or any other claimant. Therefore, such cases would not be allowed. Consequently, the minority shareholders and the company would be in an extremely disadvantageous position.

performing his official corporate duties resulting in harm to the company, such director, supervisor or manager shall be liable for damages.”

⁴⁴ E.C. Lashbrooke, Jr, “The Divergence of Corporate Finance and Law In Corporate Governance” (1995) 46 S.C. L. Rev. 449.

3.5 Summary

To conclude, minority shareholders within the provisions of the Chinese Company Law are in a difficult position. First, they can not efficiently supervise the management because of their inabilities to call for a shareholders' meeting and their inability to raise motions at the meeting. Secondly, they are in a fragile position when faced with the majority shareholders because of the absolute majority rule. Thirdly, in cases in which the former two positive measures have failed to protect them, it is extremely difficult for them to raise direct/personal suits for civil compensations, and impossible to bring derivative action. When the directors or the majority shareholders are doing something technically legal but equitably unfair, the minority shareholders can do nothing. It is no wonder that Dr. Min'an Zhang asserted that the expression "shareholders" whose legitimate rights and interests are protected in Article 1 does not actually include the minority shareholders, although, literally, it should have.⁴⁵

4.0 Minority Shareholders vs. the Directors

4.1 About the Right to Convene the General Meeting

4.1.1 Introduction

"The shareholders' general meeting remains the main vehicle for shareholders who wish to influence the course of corporate business."⁴⁶ Yet, as was discussed in Section 3.2.1.1, according to the Company Law of China, the minority shareholders can at best "request" that the general meeting be called and held, but they do not have the right to convene the meetings themselves if their such requests are declined by the management. "Without the right to *convene* shareholders' general meeting, the right to

⁴⁵ Min'an Zhang, *supra* note 18 at 160

⁴⁶ Welling, *supra* note 2 at 470.

request the convention of the meeting is doomed to end up with a fake.”⁴⁷ Therefore, the minority shareholders as defined by the Chinese Company Law are virtually deprived of one of the most important opportunities to protect themselves from oppression by the managerial powers. In order to rectify this defect, it would be necessary to empower the minority shareholders, not only to be able to request a convention of the general meeting, but also to convene the meeting themselves under certain circumstances.

4.1.2 Comments on the C.B.C.A.

Because of its obvious necessity and benefits, it has become common practice for major company laws in the world to give minority shareholders the right to convene. For example, in Canada, “[m]odern reforms have attempted to broaden the extraordinary power of shareholders to force the holding of general meetings...”⁴⁸ According to Canada Business Corporations Act (hereinafter referred to as the “C.B.C.A.”), the holders of not less than 5 percent of the issued shares carrying the right to vote at the meeting may requisition the directors to call a meeting of shareholders for the purpose stated in the requisition.⁴⁹ The directors shall call a meeting of shareholders to transact the business stated in the requisition subject to certain exceptions.⁵⁰ Unlike the Company Law of China, which provides no solution for the case where the directors refuse to call the meeting, the C.B.C.A. provides that “[i]f the directors do not within twenty-one days after receiving the requisition referred to in subsection (1), any shareholder who signed the requisition may call the meeting”.⁵¹ C.B.C.A. also provides for the reimbursement of the fees for the meeting. “Unless the shareholders otherwise resolve at a meeting called under subsection (4), the corporation shall reimburse the shareholders the expenses reasonably incurred by them in requisitioning, calling and holding the meeting.”⁵²

The C.B.C.A. is also quite considerate in providing for the specific procedures by which to assure that the shareholders can either have the meeting convened or convene

⁴⁷ Junhai Liu, *Protection for Shareholders’ Rights in Publicly Held Corporations*, (Beijing: Press of Law, 1997) at 313.

⁴⁸ Welling, *supra* note 2 at 489.

⁴⁹ C.B.C.A. s.143 (1)

⁵⁰ C.B.C.A. s.143 (3).

⁵¹ C.B.C.A. s.143(4).

⁵² C.B.C.A. s.143(6).

it themselves. There are specific steps that need to be taken by shareholders in the event that the directors do not convene the meeting. Unlike the provisions in the Company Law of China, the right of shareholders in the C.B.C.A. to convene the meeting is realistic, and this is a good beginning for protection through the general meeting. At the same time, it should be noted that the likelihood of the occurrence that “the shareholders otherwise resolve” in Section 143 (6) constitutes a potential threat that the minority shareholders may be forced to pay for the reasonable fees personally, even in the case that the meeting was beneficial to the corporation. This is more likely to occur when the defaulting directors are conspiring with the majority shareholders.

4.1.3 Comments on the UK Companies Act 1985

According to the Companies Act 1985 which was later amended by Companies Act 1989, their reasonable expenses must be paid by the company and recovered from fees payable to the defaulting directors.⁵³ A less favorable provision in the Companies Act 1985 explains that the shareholders must hold at least one-tenth of the paid-up voting capital in order to have the right to require the directors to convene a meeting.⁵⁴ This threshold is higher than the required 5 percent in the C.B.C.A., and is particularly demanding in large publicly held corporations. Another disadvantage for minority shareholders in the UK Companies Act resides in the fact that if the directors do not duly convene the meetings within the prescribed period, the requisitionists, *or any of them representing more than one half of the total voting rights of all of them*, may themselves convene a meeting to be held within three months of the date of the deposit of the requisition.⁵⁵ This requirement is higher than that of the C.B.C.A., which provides that “*any shareholder who signed the requisition may call the meeting*”⁵⁶, and may constitute an extra burden to minority shareholders.

Despite certain minor variations, other statutes contain similar provisions, be it in common law traditions or in civil law traditions, that seek to give the shareholders the

⁵³ The Companies Act 1985 s. 368(6).

⁵⁴ The Companies Act 1985, s. 368(1), (2).

⁵⁵ The Companies Act 1985 s. 368 (4), (6)

⁵⁶ C.B.C.A. s. 143(4).

right to convene the general meeting in the event that the directors refuse to convene a general meeting, in spite of the shareholders' request. It is difficult to imagine that the Company Law of China would omit this critical provision. It would be preferable that the Company Law of China would now choose to empower shareholders and give them the right to convene the general meeting in those cases in which their requests to the directors fail to be effective.

4.1.4 Proposals to Reform

The following issues need to be considered before the Company Law of China indeed gives the right to minority shareholders to convene the general meeting:

4.1.4.1 Qualifications of Such Minority Shareholders

The main qualification of such a shareholder is the minimum percentage of shares that the shareholders should hold in order to qualify for the right to be able to convene the general meeting when the directors fail to do so. As was discussed in Section 4.1.3, those of the C.B.C.A. and the Companies Act 1985 are, respectively, 5 percent and 10 percent of the issued shares carrying the right to vote at the meeting. The minimum percentage in other legislations varies from as low as 3 percent in Japanese Company Law to the high of 20 percent in the company laws of Italy and Belgium. While it is impracticable to find an exact percentage that is applicable to all countries, it might be reasonable to hold that the requirement of 20 percent is definitely prohibitively high, especially in publicly held corporations, where those holding 10% of the issued shares may well suffice to be the first majority shareholders. At the same time, the capital structures that are not so dispersed in closely held corporations might justify a higher requirement of the shares. In view of these differences, it is suggested that it might be reasonable for the Company Law of China to allow different percentage requirements in publicly held corporations and closely held corporations. In the former, the prevalent oppression of the majority shareholders and the difficult situation of minority shareholders should justify a lower threshold for minority shareholders that would enable

them to search for a remedy through the right to convene a general meeting. If the Company Law provides for 10% percent as the threshold, it would be too difficult for minority shareholders to qualify—and if they do hold so many shares, they can be more reasonably regarded as majority shareholders.⁵⁷ Therefore, 3 percent is suggested as the threshold in publicly held corporations. On the other hand, the less dispersed capital structure in companies limited by shares should justify a higher percentage, and 10 percent is proposed as the tentative threshold for these corporations.

The possibility of setting the number of shareholders as the criterion to qualify to convene the meeting could also be considered. For example, 50 shareholders, regardless of how many shares they are holding, may convene the meeting themselves if a request to this effect is not obeyed by the directors. This proposal looks attractive because it surmounts the danger of setting in a mechanical manner the percentage and is therefore more flexible. Yet, this idea should probably be disregarded, not only because it is not consistent with the capital democracy, one of the cornerstones of modern companies laws, but also because it would make it too easy for hostile complainants to abuse this right.

As to the question as to whether it is necessary to demand that the requisitioning shareholders must have held the shares for certain period in order to qualify to requisition (and to convene, if applicable) the general meeting, this would seem unnecessary. The reasons for this include the following: (1) as shareholders, they deserve to be protected and it should not matter when they have obtained the shares; (2) in the stock market, transference of shares takes place the most frequently, so many shareholders would be excluded from protection if this condition were added;⁵⁸ (3) the right to convene the general meeting is part of the value of the shares that should not be sacrificed by a time restriction; (4) the current overwhelming situation is that minority shareholders are faced with aggressive oppression without sufficient protection. In order to remedy to this, the law should probably work in a direction that is more favorable to the minority shareholders. If the absence of such a requirement results in the considerable abuse of the right after its implementation, the Company Law could add this requirement in the future.

⁵⁷ For more information about the capital structure in the publicly listed corporations, please see: CSRC: “Introduction to China’s Securities Market”, 1999 CSRC Report, online: <<http://www.CSRC.gov.cn/CSRCsite/eng/esmintr.htm>> (date accessed: August 25, 2003).

⁵⁸ See Feng Guo, *supra* note 23.

4.1.4.2. Shall the Court Intervene in this Procedure?

The Companies Act 1985 gives shareholders the power to convene the shareholders' general meeting without turning to the court in cases in which the director has failed to call and convene the meeting as requisitioned by the qualified shareholders,⁵⁹ while company laws in some other countries, such as Japan, require that they should first get approval from the court in order to convene the meeting.⁶⁰ Professor Junhai Liu argues that the Company Law of China should follow the British example to protect against cases in which the potential undue intervention from the court could halt the minority shareholders from exercising their right.⁶¹ Professor Liu seems to have the correct opinion. Furthermore, because of the prevalent oppression of minority shareholders, the courts would be overwhelmed by a substantial number of applications if approval by the court would become a condition. Rather, minority shareholders should be allowed to automatically convene the general meeting without turning to the court. The company, the directors or other shareholders may raise suit to the court if the resolutions or procedures of the general meeting harm their legitimate rights and interests, or break the laws, regulations or the articles of associations. In addition, the requisitioning shareholders shall be held liable if it can be proved that their purposes, which may be partly reflected from the issues they raise at the meeting, are to abuse this right, or to illegitimately harm the company, the directors, or other shareholders. This may bring about an additional benefit, i.e., to reduce potential abuse of the right to convene the meeting.

This issue may also be considered from another angle, which may find some hint in the C.B.C.A., section 144. According to this section, if for any reason it is impracticable to call a meeting of shareholders in any manner in which meetings of that company may be called or to conduct the meeting in manner prescribed by the articles or this Act, or if for any other reason a court thinks fit, the court may order a meeting to be

⁵⁹ The Companies Act 1985, s.368 (4)

⁶⁰ The Commercial Code of Japan, s.237(1).

⁶¹ Junhai Liu, *supra* note 47 at 315.

called, held and conducted in any manner as the court directs. The court may so order on the application of any director or any shareholder entitled to vote at the meeting or the Director.⁶² It is suggested that the Company Law should also empower Chinese courts to call and convene the general meeting when necessary, but the meeting shall be held in accordance with the provided procedures in the laws instead of “in any manner the court thinks fit.” Giving such a broad power to a court would be too risky, given the fact that the civil law backgrounds of most Chinese judges are not used to the exercise of such the power in such a wide manner. Furthermore, it is widely admitted that the Chinese judges are generally not as qualified as judges under common law systems. To conclude, it is believed that the general meeting may be initiated but not stopped by the court, unless in circumstances of certain exceptions provided in law.

It is therefore recommended that the Company Law of China adopts the regulations in the Regulatory Opinions 2000 concerning the convention of the shareholders’ general meeting and makes the necessary amendments according to the proposals in the preceding paragraphs.

4.2 The Rights of Shareholders to Propose Resolutions

4.2.1 Introduction

After the question as to know when and how to convene the shareholders’ general meeting, the next and tougher issue would be that of persons proposing resolutions at the general meeting. As was seen in Section 3.3.1, Articles 38 and 103 of the Company Law give very broad powers to the shareholders’ general meeting, which should be the ultimate source of power of the corporation.⁶³ Therefore, minority shareholders in China

⁶² C.B.C.A. s.144.

⁶³ See Cindy A. Schipani & Junhai Liu, “Corporate Governance in China: Then and Now” (2002) *Columbia Business Law Review* 1 at 35. “In other words, the powers enjoyed by the board of directors and the board of supervisors are derived from the shareholders rather than from the legislature. This corporate governance philosophy resembles the political governance philosophy expressed by the Chinese Constitution. Pursuant to the Constitution, the ‘NPC . . . is the highest organ of State power.’ . . . As Chinese Corporate Law undergoes further revision, the question remains whether shareholders should keep their current powers or whether certain powers, particularly substantial managerial powers, should be transferred

should have more say at the meeting as part of the “ultimate source of power” than their peers in Canada, where the managerial powers in most jurisdictions derive directly from statutes rather than the shareholders.

Unfortunately, even though the general meeting has been convened, the minority shareholders in China do not have any channel to speak out their opinions via the general meeting, either in the notice before the meeting, or in the holding of the meeting. Therefore, they have lost another important opportunity to fight against managerial oppression.

4.2.2 Comments on UK Companies Act 1985

The manner by which to provide for the right of minority shareholders to propose resolutions is a difficult issue in any company law in the world, largely because it is so difficult to achieve a subtle balance between the protection for minority shareholders and the prevention of frivolous use of this protection. For example, in the Company Law of UK, “...the current statutory law, as we have seen, operates largely in terms of shareholder resolutions or the distribution of circulars in response to the board’s resolutions and ignores the potential value of a statutory right to ask questions, despite the Parliamentary pedigree which this method of democracy enjoys.”⁶⁴

This does not mean, however, that shareholders are prohibited from acting. Ben Pettet describes shareholders’ channels in the UK to voice their opinions as follows:

to the board of directors. It is reasonable to maintain the status quo in order to deal with excessive managerial power, particularly during a transitional period. However, it may be wise to consider the corporate governance arrangements in other legal systems and perhaps reduce some powers currently possessed by shareholders in order to harmonize the Chinese system of corporate governance with global investment requirements.” It can be seen that the Chinese Company Law is different from the reformed statute model in most Canadian jurisdictions but similar to the contractarian model in the UK. Generally speaking, minority protection in the contractarian model is not as good as the C.B.C.A. model. (...the technique of minority protection is, practically speaking, the single most important feature distinguishing division of powers corporations from those organized under a contractarian-model corporate constitution.” Welling, 58) This is perhaps one of the reasons why Canada is an excellent example for China to follow on many issues of minority protection.

⁶⁴ Paul L. Davies, *Gower’s Principles of Modern Company Law*, 6th ed., (London: Sweet & Maxwell, 1997) at 583.

Sometimes members will feel that simply voting against the board's proposals is too passive a form of opposition. Section 376 provides the means for such members, at their expense, to mount some sort of campaign against the board, by proposing resolutions backed by a carefully argued circular sent out to the members before the meeting happens. This mechanism can be invoked by any member or members representing not less than one-twentieth of the total voting rights of all the members having a right to vote at the meeting in question or alternatively, by not less 100 members holding shares in the company, paid up to at least £100 per member.⁶⁵ Although circulars can be sent round in relation to any general meeting, the right to propose resolutions only relates to resolutions to be moved at the AGM.⁶⁶

Therefore, the minority shareholders in British Company Law have, at least, the possibility to protect themselves by proposing resolutions. They are luckier than their peers in Chinese Company Law. Yet, it is regrettable that the shareholders will have to do initiate this procedure "at their expenses". This may constitute an unfair burden to such shareholders, especially when the resolutions they propose are indeed beneficial and necessary to the company (such as removing a defaulting director). The requirement to pay the expenses themselves may forestall such beneficial acts to the company. It is suggested that these expenses should be at least reimbursable to the proposing shareholders, if it is temporarily impossible to directly provide that such expenses shall be directly paid by the company. The conditions needed for reimbursement may include the adoption of the resolutions proposed by the shareholders. The underlying rationale to this way of thinking is that the adoption of the meeting indicates that the company is aware that the resolutions are beneficial to itself, so the beneficiary (the company), instead of the benefactor (the proposing shareholders), should pay for the expenses. Another circumstance under which the company should reimburse the shareholders is when the court decides so.⁶⁷ Again, the underlying rationale to this is to prevent majority

⁶⁵ The Companies Act 1985, s. 376 (2). Various other conditions and procedures are set out in ss.376-377.

⁶⁶ Ben Pettet, *Company Law*, (Harlow: Pearson Education Limited, 2001) at 168.

⁶⁷ In the Author's proposed reforms in Chinese Company Law, the court should not exercise this discretion unless the shareholders, the company, or the director so applies. The Author does not think it would be

shareholders from maliciously voting against the proposed resolutions in order to have the proposing shareholders pay for the expenses.

4.2.3 Comments on the C.B.C.A.

The situation in Canada seems to be better. This is so particularly with the amendments to the C.B.C.A. in 2000. Now most jurisdictions in Canada have provided for a statutory power of shareholders to force the corporate managers to circulate proposals for consideration by the general meeting.⁶⁸

Circulation of shareholder proposals before the general meeting...places in the shareholders hands a written series of proposals for corporate action, circulated at corporate expense. The provision in the Manitoba Corporations Act will serve as an example of the process:

131(1) A shareholder entitled to vote at an annual meeting of shareholders may

(a) submit to the corporation notice of any matter that he proposes to raise at the meeting, hereinafter referred to as a “proposal”; and

(b) discuss at the meeting any matter in respect of which he would have been entitled to submit a proposal

...

(3) If so requested by the shareholder, the corporation shall include in the management proxy circular or attach thereto a statement by the shareholder of not more than 200 words in support of the proposal, and the name and address of the shareholder.⁶⁹

Compared with the shareholders under the British Companies Act 1985, one of the advantages experienced by the Canadian shareholders is that the proposals are

appropriate to confer the broad powers like “in any means that the court deems fit” to the courts in China. The reasons were mainly the prevalent civil law tradition and the credentials of the Chinese judges that need to be considerably improved.

⁶⁸ Welling, *supra* note 2 at 471.

⁶⁹ *Ibid.* at 472.

circulated at the expense of the corporation. They also have a limited right to add items to the agenda.⁷⁰ In this respect, Canadian shareholders are at a more advantageous position. At the same time, in order to prevent the frivolous use of this process, some exceptions were stipulated to exempt the corporation from including the shareholders' proposal in the management proxy circular if:

“(a) the proposal is not submitted to the corporation at least the prescribed number of days before the anniversary date of the notice of meeting that was sent to shareholders in connection with the previous annual meeting of shareholders;

(b) it clearly appears that the primary purpose of the proposal is to enforce a personal claim or redress a personal grievance against the corporation or its directors, officers or security holders;

(b.1) it clearly appears that the proposal does not relate in a significant way to the business or affairs of the corporation;

(c) not more than the prescribed period before the receipt of a proposal, a person failed to present, in person or by proxy, at a meeting of shareholders, a proposal that at the person's request, had been included in a management proxy circular relating to the meeting;

(d) substantially the same proposal was submitted to shareholders in a management proxy circular or a dissident's proxy circular relating to a meeting of shareholders held not more than the prescribed period before the receipt of the proposal and did not receive the prescribed minimum amount of support at the meeting; or

(e) the rights conferred by this section are being abused to secure publicity.”⁷¹

This section is the direct result of the amendments effected to the C.B.C.A. in 2000. Under the new provisions, the exceptions are not as broad as they were previously,

⁷⁰ C.B.C.A. s. 137.

⁷¹ C.B.C.A. s.137 (5).

although difficulties still do exist. One of the principal difficulties would be the distinction between “personal grievance” and “corporate grievance”. In an actual case, the directors may well argue that the shareholders’ proposal to remove them from the board is out of “personal grievance” against them. Because of the disadvantages in resources, information and skills, it would be challenging for dissentient shareholders to refute this allegation.

4.2.4 Proposals for Reform

In Chinese Company Law, which places the ultimate power of the corporation into the hands of the shareholders,⁷² the shareholders should be more active in corporate affairs, and they deserve the protection by the right to propose resolutions at the general meeting. Although the Regulatory Opinions 2000 has provided for certain “rights”, its defects limit the effects that it could have. The Company Law should be amended to rectify this situation, and some proposals for reform will be made in the following paragraphs. Since the ordinary issues such as the requirement of prior notice should not be a problem, the following issues, that need special attention or that may attract more controversies, will be the main focus of the following section.

4.2.4.1 Who Decides on the Proposals?

Professor Feng Guo argues that the question as to whether the proposals of minority shareholders should be added to the agenda should be decided according to who has convened the meeting in the first place. If the general meeting is convened by the minority shareholders, this issue should be decided by the convening minority shareholders. If, on the other hand, the general meeting is convened by the board of directors or the board of supervisors, it should be decided by the relevant board.⁷³ This seems to be good, and it should be added that the reviews by the minority shareholders or the boards should be based on certain specific explicit rules. As long as the resolutions do not belong to the categories that are excluded by the Company Law, they should be

⁷² The Company Law, Articles 38 and 103.

⁷³ Guo Feng, *supra* note 23.

added into the agenda and be voted on at the general meeting. The exceptions are, in certain ways, similar to those in the C.B.C.A., but the limits should be less strict and more explicit in order to assure that the shareholders can exercise this right more effectively. This is compatible with the shareholders' status as the ultimate source of power in Chinese Company Law (similar to the contractarian model of the UK). The directors will have less discretion in this respect. This is a completely reasonable development in the background of Chinese Company Law, especially when one of the main legislative purposes of this right is to rectify managerial oppression through the imposition of more supervision.

4.2.4.2 The Qualifications of Proposing Shareholders

Secondly, and for the same reasons as were discussed in the preceding chapter, the minimum volume of shares that a shareholder (or a group of shareholders) should hold in order to qualify to propose a resolution should be lower, mainly because of the overwhelming majority domination in the stock market. For publicly held companies, 3 percent would seem to be the most appropriate threshold; for closely held companies, 10 percent would be proposed. These threshold percentages are compatible with the previous suggestions given in Section 4.1.4.1 on the right to convene the shareholders' general meeting.

As to the issue of whether it is necessary for the proposing shareholders to have held the shares for a certain period in order to qualify, this would seem unnecessary, mainly for the reasons that have been discussed in the preceding chapter.

4.2.4.3 Not Only the Annual (Regular) Meeting

It should be noted that the provisions concerning the right to propose resolutions should not only be applicable to annual general meetings (or regular meetings), but also to extraordinary meetings. The Regulatory Opinions 2000 has definitely erred in

excluding the extraordinary meetings, which would often be important occasions for minority shareholders to exercise this right.

5.0 Minority Shareholders vs. Majority Shareholders: Proposed Reforms

5.1 Theoretical Tool: Fiduciary Duty of Majority Shareholders Towards Minority Shareholders

5.1.1 Introduction

The manner by which to adjust the relations between majority shareholders and minority shareholders has always been a thorny issue in corporate law. On the one hand, minority shareholders are claiming that the majority shareholders are abusing their rights with their control over the corporate matters and, on the other hand, the majority shareholders are defending themselves with the assertion that they are simply exercising their legal rights as majority shareholders. In order to find the best solution, it would be necessary to first examine the relationship between the majority shareholders and the minority shareholders.

5.1.2 Overview

Under the traditional corporate theory, shareholders in general did not owe duties to other shareholders. The majority shareholders can exercise their rights fully for their own interests, not the interests of the corporation or the other shareholders. In fact, their interests might often be conflicting with the best interests of the later. Logically, the majority shareholders' oppression to minority shareholders would seem to be inevitable because they could easily turn their own wishes into resolutions of the corporation. They would also argue that the "oppression" to minority shareholders, if any, has to be the lawful result of the majority rule, and the minority shareholders should have expected this before they joined the company.

Legal developments in this area have changed this once-firm view. One of the main reasons that this change has taken place was the prevalent abuse of the controlling status, which not only resulted in harms to minority shareholders and the companies, but also pushed people to reconsider the implications of justice and equality in a corporate context.

In the US, by the beginning of the last century, majority shareholders had long been understood to owe a fiduciary duty to minority shareholders.⁷⁴ In as early as 1919, Justice Brandeis held in *Southern Pacific Co. v. Bogert*⁷⁵ that the control of the corporation alone sufficed to create the fiduciary duty to the minority shareholders by the majority shareholders:

But the doctrine by which the holders of a majority of the stock of a corporation who dominate its affairs are held to act as trustees for the minority, does not rest upon such technical distinctions. It is the fact of *control of the common property* held and exercised, *not the particular means by which or manner in which the control is exercised*, that creates the fiduciary obligation. (Emphasis added by the Author)

Subsequent cases have confirmed the majority shareholders' fiduciary duty toward minority shareholders. Up to now, it has become commonly accepted in the US that "...[w]hen shareholders vote for or consent to extraordinary corporate matters, which require shareholder approval, they are subject to fiduciary duties."⁷⁶ "In the closely-held corporation, not only do the normal fiduciary duties of controlling shareholders apply, but in addition the courts are prone to require a higher standard of fiduciary responsibility, sometimes by analogy to partnership law.

⁷⁴ *Pepper v. Litton*, 308 U.S. 295, 306-07 [1939]; *Southern Pac. Co. v. Bogert*, 250 U.S. 483, 492 [1919].

⁷⁵ 250 U.S. 483; 39 S. Ct. 533; 63 L. Ed. 1099; [1919] U.S. LEXIS 1768

⁷⁶ Harry G. Henn & John R. Alexander, *Laws of Corporations and Other Business Enterprises*, 3rd ed., (St. Paul, Minn: West Publishing Co., 1983) at 654. Professor Henn further mentioned the two bases for the fiduciary duties imposed on controlling shareholders: "(a) a *direct* approach, based on equitable principles that one who holds a position of superiority and influence over the interests of others is a fiduciary, concluding that the relationship of controlling shareholders to minority shareholders is a fiduciary relationship; (b) an *indirect* approach to the effect that if the officers and directors owe fiduciary duties, the controlling shareholders who dominate the corporation through their influence over the directors and officers are subject to analogous duties." Henn, *Ibid.* at 654.

5.1.3 The *Donahue* Approach: Heightened Fiduciary Duty

In closely held corporations, whose shareholders are thought to have more trust in each other like partners in partnerships, and where minority shareholders lack a flexible channel to exit the corporation, this majority shareholders' fiduciary duty is even more rigid.⁷⁷ "In the case of a close corporation, however, 'numerous courts have 'borrowed' a rule from partnership law, and have held that majority shareholders have a heightened fiduciary duty, one of the utmost good faith and loyalty, to the minority shareholders.'"⁷⁸

The leading case of this heightened fiduciary duty was *Donahue v. Rodd Electrotype Co. of Newingland Inc.*⁷⁹, a case heard by the Massachusetts Supreme Court. In this case, Tauro, C.J. held that the stockholders in the close corporation each had towards the other the same fiduciary duty as the duty that is owed by one partner to another in a partnership: "Just as in a partnership, relationship among stockholders of corporation must be one of trust, confidence and absolute loyalty if enterprise is to succeed."⁸⁰ Therefore, the degree of fiduciary duty is even more rigorous than the ordinary fiduciary duty or the traditional good faith and inherent fairness standard. This principle was cited approvingly by numerous cases such as *Wilkes v. Springside Nursing Home, Inc.*⁸¹, where it was held that stockholders in a close corporation owe one another the duty of utmost good faith and loyalty. Up to now, it has been prevalent in most jurisdictions in the US.

⁷⁷ This is true in most states in the US, but the courts of Delaware have generally refused to apply this theory. They think that even in closely held companies, the ordinary fiduciary duty is enough, and it should not be heightened to the "utmost good faith and loyalty". This is often referred to as "the Delaware Approach", while the heightened fiduciary duty in most other states is referred to as "the *Donahue* Approach", which is to be discussed in the following paragraphs. See John T. Richer, "When Controlling Shareholders Squeeze Minority Shareholders by Reverse Stock Split in Close Corporations—a Proposal for Kansas Courts" (2002) April University of Kansas Law Review 545 at 554-556.

⁷⁸ David C. Crago, "Fiduciary Duties and Reasonable Expectations: Cash-out Mergers in Close Corporations", (1996) 49 Okla. L. Rev. 1 at 4. The lack of a ready means of withdrawal from the business by disenchanted shareholders has been thought to make "the problem of exploitation ... uniquely related to illiquidity." Because he cannot use a market to exit the enterprise and recover his capital, the minority is vulnerable to a variety of devices that allow the majority to benefit from the minority's investment without compensating him for it. "It is this lack of a market that enables those in control to 'freeze-out' the minority." *Ibid.* at 7-8.

⁷⁹ [136] Mass.578

⁸⁰ *Rodd* at 588.

⁸¹ (370) Mass.842, 253 N.E.2d.657 [1976]

5.1.4 What About the Company Law of China?

The majority shareholders' fiduciary duty toward the minority shareholders can play an important role in protecting both the company and the minority shareholders. Unfortunately, the Company Law of China has not provided for the majority shareholders' fiduciary duty toward minority shareholders. On the contrary, the absolute majority rule makes the controlling status of majority shareholders almost unchallengeable. Oppression to minority shareholders becomes a natural and common result. If people admit that in Canada, where the protection for minority shareholders is comparatively strong, "...our system, *by its very design, actively discriminates against the minority shareholder*"⁸², they would have to agree that the systematic oppression on minority shareholders is much worse in Chinese Company Law. Numerous cases have served to confirm this view.

Although China accepted the *bona fide* doctrine in the General Principles of Civil Law (GPCL), the Chinese courts are usually extremely reluctant to apply such broad (and often vague) doctrines in trials. To impose the fiduciary duty on controlling shareholders would be an effective method to make it less vague and more likely to be applied by courts. The imposition of the fiduciary duty will enhance minority protection in two ways. On the one hand, the failure by the majority shareholders in their fiduciary duty will offer causes of action for compensation—in fact, civil compensation might often be the most efficient mechanism to prevent the majority shareholders' oppression from occurring. On the other hand, the fiduciary duty constitutes the theoretical foundation for some other mechanisms designed for minority protection.

The aforementioned "Instruction of Articles of Associations for Publicly Listed Companies" provides that "controlling shareholders shall not harm the legitimate rights and interests of the company or other shareholders",⁸³ and makes the first step toward the fiduciary duty of majority shareholders. However, this is only the minimum requirement

⁸² Welling, *supra* note 2 at 509. "The plight of the minority shareholder has been obvious for a long time. Wegenast, in 1931, asked at p.316: 'Is there any limit to this power of the majority to control the company? Is it absolutely within the power of the majority in furtherance of its own selfish ends to sacrifice the interests of the minority? Has the minority no rights which it can assert against the majority?'"

⁸³ The Instruction, Article 71.

for fiduciary duty, not to mention the heightened “utmost good faith and loyalty” in closely held companies in most states of the US. Besides, its defects discussed in Section 3.3.2 have made its effect insubstantial. Therefore, the Company Law of China should take this responsibility to provide for the fiduciary duty of majority shareholders toward the minority shareholders.

One issue that is worth considering is whether to follow the *Donahue* approach of heightened fiduciary duty or the Delaware approach of ordinary fiduciary duty. The *Donahue* approach would seem to be the preferred approach. The reasons for this are similar to those of the judges who approvingly cited the *Donahue* rationale. First, generally speaking, shareholders in publicly held corporations have different expectations from the shareholders in closely held corporations. The former would be more likely to expect to profit from the buying and the selling of shares, while the later are more likely to expect to participate in the managerial issues of the corporation. The comparison to the closely held companies as the “incorporated partnerships” is not without justification. The Company Law should take the different expectations of shareholders into consideration in granting appropriate remedies by following the *Donahue* approach. Secondly, the lack of a ready exit mechanism in the closely held corporations make the minority shareholders more prone to oppression and freezeouts in corporate affairs, to this end, the heightened fiduciary duty by the majority shareholders should be provided for in order to better prevent such oppressions or freezeouts. Thirdly, the usually informal management style and the less disclosed corporation information make the heightened fiduciary duty necessary to protect the minority shareholders.

5.2 Cumulative Voting

5.2.1 Definition: Cumulative Voting vs. Straight Voting

Traditionally, corporations have adopted the practice of straight voting. “Under this system, each share entitles its owner to cast only one vote for each candidate,

although the shareholder may vote for as many candidates as there are seats to filled”⁸⁴. In corporate politics, the method of straight voting often gives complete control to majority shareholders. As it is put by one commentator, “[u]nder straight voting a shareholder group with fifty-one percent of the corporation’s voting stock could fill every director position while a single minority shareholders with as much as forty-nine percent of the voting stock would be unable to elect even one director to the board.”⁸⁵

Straight voting thus makes it more convenient for majority shareholders to behave in an oppressive manner to minority shareholders. In fact, “[a] dissatisfied minority will often find itself both defeated on policy issues in the general meeting and without even a minority voice on the board of directors.”⁸⁶

Cumulative voting was first adopted in the Illinois Constitution in the US in 1870, and later required by constitutional convention in the election of directors in private corporations. This was done as “[t]he objective was to protect minority interests against overreaching by a majority, particularly in circumstances in which representation on the board would give the minority the information necessary to police against fraud.”⁸⁷

Furthermore, “[c]umulative voting allows a shareholder to multiply the number of votes he/she (hereinafter "he") has, as determined by the number of shares he holds, by the number of directors to be elected and to cast all his votes for any one candidate or distribute his votes among the candidates in any way he chooses.”⁸⁸ One of the consequences of this is “to allow a substantial minority to concentrate their voting power and ensure the election of at least one director of their choice.”⁸⁹

5.2.2 Illustration: the Formula and an Example

Cumulative voting is a more complicated process than straight voting, and some expertise is usually needed in calculating the shares or the distribution of shares in the

⁸⁴ Robert Charles Clark, *Corporate Law*, (Boston: Little, Brown and Company, 1986), at 362.

⁸⁵ June A. Striegel, “Cumulative Voting, Yesterday and Today: the July, 1986 Amendments to Ohio’s General Corporation Law” (1987) 55 U. Cin. L. Rev. 1265 at 1267.

⁸⁶ Welling *supra* note 2 at 459.

⁸⁷ Jeffrey N. Gordon, “Institutions as Relational Investors: a New Look at Cumulative Voting” (1994) 94 Colum. L. Rev. 124 at 143.

⁸⁸ Striegel, *supra* note 85 at 1266.

⁸⁹ Welling, *supra* note 2 at 460.

voting. The following formula is usually used to calculate the minimum number of votes needed in order to elect representatives into the board of directors with cumulative voting.⁹⁰

$$X=[(Y \times N1)/(N+1)]+1$$

Where

X=number of shares needed to elect a given number of directors;

Y=total number of shares at meeting;

N1=number of directors desired to elect;

N=total number of directors to be elected.

For example, in a company with 100 voting shares, the shares the minority shareholders would have to muster in order to elect 2 representatives onto a board which consists of 10 directors would be $(100 \times 2)/(10+1)+1=18.2$ ⁹¹. This means that a group of minority shareholders with 21% of shares may choose 2 directors if they cast all of their votes directly to these two candidates. If the majority shareholders are not careful and do not calculate their votes accordingly but, instead, evenly spread their votes to the desired candidates, the minority shareholders have the chance to choose even more directors. Sometimes, when the number of shares held by the majority shareholders do not substantially exceed those held by minority shareholders, the end result may be that the majority shareholders would find themselves capable of choosing fewer candidates than would the minority shareholders.

After a simple mathematical conversion of the formula, a minority shareholder may also determine if the shares he or she holds suffice to assure his or her choice of directors, and if they do, how many directors may be chosen.

$$N1=(X-1) \times (N+1)/Y$$

⁹⁰ Ralph J. Baker & William L. Cary, *Corporations Cases and Materials*, 3rd ed., (Brooklyn: The Foundation Press, Inc., 1959) at 207. This formula presumes that fractional shares do not carry the right to vote. A more sophisticated approach is developed and explained in Glazer & Grofman, "Cumulative voting in Corporate Elections: Introducing Strategy into the Equation", (1984) 35S.Car. L. Rev.295.

⁹¹ It should be rounded off to the next higher integer, since normally no fractional shares are outstanding.

If a particular shareholder holds 20 of the 100 voting shares, and the board will be composed of 10 directors, the number of directors this shareholder can choose would be $n1=(20-1)\times(10+1)/100=2.09$. Obviously, since no fractional director can be voted, the number should be rounded off to the lower integer, which is two. Therefore, the maximum number of directors that can be chosen using cumulative voting is two.

5.2.3 Rise and Fall of Cumulative Voting

In order to evaluate cumulative voting, it is important to first understand its history in American corporate law, especially the rise and fall of mandatory cumulative voting.⁹²

Cumulative voting was first required during the Illinois constitutional revision of 1870 for the Illinois House of Representatives. Afterwards, the constitutional convention also required cumulative voting in the election of directors for private corporations.

Cumulative voting spread relatively rapidly in the late 19th century. According to statistics by Gordon, seven states had adopted mandatory cumulative voting provisions by 1880, and the number had increased to eighteen by 1900. At a later date, certain states began to enact permissive cumulative voting statutes, which permitted corporations to adopt cumulative voting by charter provision or in their by-laws. By 1945, twenty-two states had mandatory cumulative voting provisions, while fifteen had permissive cumulative voting provisions. The first Model Business Corporation Act also called for mandatory cumulative voting.

Matters changed abruptly, however, in the 1950s. The seven states that had adopted cumulative voting during this period all eventually chose the permissive form. In the 1960s and early 1970s the trend was even more pronounced: states began switching fast from mandatory to permissive. The 1980s were a rout. Twelve states switched from mandatory to permissive. By 1992, only six states maintained mandatory cumulative voting; forty-four jurisdictions (including the District of Columbia) chose the permissive

⁹² The following paragraphs of the brief history of cumulative voting is picked up with some editing, from Jeffrey N. Gordon, *supra* note 87 at 143-161.

form; one state (Massachusetts) did not allow the practice of cumulative voting. In fact, no important corporate law jurisdiction maintained mandatory cumulative voting.⁹³

Another angle may also be useful in the analysis of the numbers of corporations that have adopted cumulative voting. According to the statistics put forth by Gordon,

In the 1940s cumulative voting was found in 40 percent of a sample of 2900 of the most significant corporations. By 1982, after the pressure from proxy contests beginning in the 1950s and from takeovers thereafter, approximately 24 percent of NYSE firms had cumulative voting. By 1989, after a decade of intense takeover activity, of a sample of nearly 1500 publicly-traded firms, only 18 percent had cumulative voting. A 1992 survey of the Fortune 500 indicated that of the 395 firms for which data was available, 14 percent had cumulative voting.⁹⁴

Similarly, in an empirical study conducted in 1993, among the 553 corporations that had been incorporated under the Alberta Business Corporations Act (the ABCA) and were listed on one or both of the Alberta Stock Exchange (ASE) and the Toronto Stock Exchange (TSE), as of April 28, 1990, only three of them had adopted cumulative voting.⁹⁵ Although these corporations were all listed corporations that are not the best circumstances for cumulative voting, this insignificant number reveals that cumulative voting has lost its popularity. One point that is worthy of mentioning is that none of the three corporations provided for interim directors or extended director terms, thus preventing from the undercutting effect to cumulative voting by staggered terms of directors—which will be the discussed later in this thesis.

5.2.4 Analysis—Pros and Cons

⁹³ J. N. Gordon, *supra* note 87 at 146-147.

⁹⁴ *Ibid.* at 161.

⁹⁵ See R. J. Wood, & M. T. Brown & R. W. Bauman, “Modifications to Corporate Constitutions in Alberta: an Empirical Study” (1993) 31 *Alberta Law Review* 263 at 270 and 288.

The question as to whether cumulative voting is a good idea has yet to be answered concretely. There have been conflicting views concerning this topic ever since cumulative voting first appeared. Judging from its shrinking influence, certain people may rush to conclude that the cons have outweighed the pros.

There is ample literature discussing the reasons for or against cumulative voting.⁹⁶ Ralph, in *Corporations Cases and Materials*, has provided a very good summary of arguments supporting cumulative voting and against this process:⁹⁷

Some arguments for cumulative voting include: (1) Perhaps foremost of the varied arguments made by proponents of cumulative voting is that it is basically fair for the minority shareholders to gain representation on the board of directors in proportion to their holdings. (2) Cumulative voting does not change the majority rule. (3) Significant conflicts of interest can develop between stockholders groups (or the stockholders in general) and management and the board of directors. Unless minority groups can gain representation on the board, they may fail to get an adequate voice in the policy. (4) In many larger corporations, cumulative voting represents a substantial and potential power that can successfully assert stockholders' points of view. (5) The balance of power between the minority shareholders and the majority shareholders and the management lies heavily with the "ins" who hold great advantages in the event of a proxy fight. (6) Minority representation on the board can be helpful in protecting or advancing the interests of minority groups.

Some of the arguments against cumulative voting include: (1) Cumulative voting means the election of directors who are by their very nature partisans of particular interest groups; and the role of a partisan on the board of directors is inherently inconsistent with the proper function of a director. (2) The board of directors is an integral part of management team. (3) Disharmony on the board can dissipate and destroy the energy of management and lead to an atmosphere of uncertainty and inaction at the top level. (4) A director who cannot be trusted may leak such information and harm the corporation. (5)

⁹⁶ See Clark, *supra* note 84 at 363-364.

⁹⁷ Ralph, *supra* note 90 at 209-210. Please note that the Author made some abridgements to the original excerpts. See also Sobieski, "In Support of Cumulative Voting", (1960) 15 Bus. Law. 316 (favoring cumulative voting); Sturdy, "Mandatory Cumulative Voting: An Anachronism", (1961) 16 Bus. Law. 550 (against cumulative voting) Steadman & Gibson, "Should Cumulative Voting For Directors Be Mandatory?--A Debate", (Nov. 1955) 11 Bus. Law. 9 (arguments both for against cumulative voting).

Too frequently cumulative voting tends to be used in practice by persons who are motivated by narrow, selfish interests rather than by the broader interests of the stockholders. (6) Opposition groups could use cumulative voting to secure a toe-hold in a long-run fight for control of the company. The result is that each meeting of the board becomes a skirmish in a continuing battle.

Weighing the different arguments is quite difficult, and the debates which surround them have never ended. If one takes into consideration the actual situation of minority shareholder protection in China, it is relatively preferred to disagree with the opponents. The reason for this disagreement will now be explained.

Regarding the first reason, that of the “partisan concern”, it does not seem to be necessarily the case that the cumulated voted directors be “partisans”: perhaps the reasons for which minority shareholders elect them are that they are regarded as impartial or loyal to the corporation. Furthermore, as directors, although they are voted to their position by the minority shareholders, they bear the fiduciary duty to the company and must make their decisions on their own. If they unduly put the interests of minority shareholders above those of the corporation out of partisan considerations, they may have breached their fiduciary duty, and the corporation or other shareholders may begin relevant lawsuits to hold them liable.

The second reason more or less overlaps the first one. Bound by the fiduciary duty, the directors chosen by the minority shareholders will not necessarily destroy the “integrity of the team”—if the “integrity” does not mean “conspiracy against the corporation or the minority shareholders”. On the other hand, there is no guarantee that the directors chosen by the majority shareholders would not destroy the integrity.

As to the third reason, that of the appearance of these representatives on the board, this would not necessarily create disharmony. Besides, if the “harmony” on the board was to be used to inflict harm upon the corporation or the minority shareholders, it would be better to have the cumulatively voted directors work as the “watchdog” on the board.⁹⁸

⁹⁸ See “Minority representation on the board could add independent, critical scrutiny of management action and thereby improve corporation decision-making and managerial accountability.” J.N. Gordon, *supra* note 87 at 171.

At the same time, they may bring some fresh air to the board, which might be beneficial to the corporation as a whole.⁹⁹

For the fourth reason, the fiduciary duty that is imposed on directors could again play a significant role. If the director unduly leaks the corporate information, he will be held liable for breach of fiduciary duty. Furthermore, it seems to be more a biased and arbitrary charge than a serious reason. Numerous cases have shown that it is not necessarily more likely that the directors chosen by the minority shareholders will harm the corporation. On the contrary, those elected by the majority shareholders have more opportunities to do so because they are often at more important positions in the corporate politics.

The fifth reason is quite similar to the fourth. Why is it not possible to assert that, in the same pattern, the frequent use of straight voting “tends to be used in practice by persons who are motivated by narrow, selfish interests rather than by the broader interests of the stockholders”? In reality, it is not unusual for majority shareholders to abuse their controlling status and reap the benefits for themselves at the cost of the corporation or the minority shareholders. Despite the likelihood that the process could be used abusively, there is no denying that cumulative voting may well prevent the narrow, selfish interests (of the majority shareholders) from dominating the corporation. To disregard the process of cumulative voting by arguing that it may be used by narrow, selfish interests is an argument that is simply not well-founded.

Last but not least, for the sixth reason, the directors are imposed with the fiduciary duty, which shall hold them liable if they make “each board meeting becomes a skirmish in a continuing battle”. Even though there were some good points in this argument, whether it suffices to negate the very existence of the cumulative voting remains doubtful.

5.2.5 Proposals for Reforms

5.2.5.1 Cumulative Voting: Mandatory or Permissive?

⁹⁹ *Ibid.* at 129: “Cumulative voting in the large public firm can provide a means for virtual representation of majority interests by a well-motivated minority.”

Thanks to its pros, cumulative voting, at least the permissive cumulative voting, has been generally accepted in the main legal systems of the world. For example, in the US, by 1992, only the state of Massachusetts did not permit cumulative voting, forty-four jurisdictions having chosen the permissive form, and six states having maintained mandatory cumulative voting.¹⁰⁰ In Canada, cumulative voting may be authorized by either statute or the corporate constitution, and is not statutorily prohibited in any province.¹⁰¹ As was discussed in the preceding paragraphs, the arguments against the cumulative voting are generally not well-founded. Therefore, it seems that cumulative voting shall not be prohibited, and the question becomes as to whether mandatory cumulative voting or permissive cumulative voting shall be provided for in the Company Law of China.

It would seem preferable that in publicly held corporations, cumulative voting should be permissive, while in closely held corporations, cumulative voting should be mandatory.

The reasons to institute a lower requirement for cumulative voting in publicly held corporations are: first, it would often be prohibitively difficult for publicly held corporations to vote cumulatively and, secondly, because of the widely dispersed capital structure and the popular proxy voting, the effect of cumulative voting would be less obvious than in closely held corporations.

Other reasons as to why mandatory cumulative voting should occur in closely held corporations will be elaborated in the following paragraphs.

First, it is generally agreed that with the aforementioned reasons in support of the cumulative voting, such as the traditional argument that cumulative voting, are just and fair. If you have 100% of shares, you have 100% control; if you have 51% of shares, you have 51% of control. To allow a shareholder with only 51% of shares have complete control while leave nothing to the shareholder with 49% of shares is simply not fair.

Secondly, as discussed in the Section 5.2.4, the aforementioned 6 reasons against the cumulative voting are not well-founded.

¹⁰⁰ *Ibid.* at 146-147.

¹⁰¹ New Brunswick is the only jurisdiction yet to have made cumulative voting compulsory. See Welling, *supra* note 2 at 459.

Thirdly, the reasons for the fall of cumulative voting in the US can serve as valuable reference in deciding the form that cumulative voting will take in China. It is generally held that the reasons for the fall of mandatory cumulative voting are (1) the competition between the states has grown as the economic benefits of having business incorporate in-state have grown;¹⁰² (2) the desire to deal with the threat of hostile takeovers which abounded during the 1970s.¹⁰³ However, there are some deeper reasons behind them. First, “managerial entrenchment motives seem to play the dominant role in the management decision to pursue elimination of cumulative voting.”¹⁰⁴ They defeated the interests of shareholders in their pushing the jurisdictions in order to eliminate mandatory cumulative voting. As for the hostile takeovers, they were quite important during the 1970s and early to mid 1980s. “As events in the late 1980s demonstrated, however, hostile takeovers were not an ideal intervention mechanism.”¹⁰⁵ To a large degree, the concern to deal with hostile takeovers with the elimination of cumulative voting has become unimportant in the business world of today.

In addition, these two reasons do not really fit in with the reality of modern China. First, as a simple state, the power to enact the Company Law is vested in the hands of the central legislature, namely the National People’s Congress (hereinafter referred to as the “NPC”), and the provinces do not have the power to enact competing Company Laws to attract incorporations. Therefore, this reason does not stand in China as a reason to decline cumulative voting. As regards the consideration of hostile takeovers, they have never been an important phenomenon in China, so this would not seem to be a valid reason either.

Fifthly, cumulative voting is specially argued for because the protection for minority shareholders in Chinese Company Law is traditionally weak, and the necessary mechanisms such as derivative action and oppression remedy are all missing. Under these actual circumstances, cumulative voting would be particularly important as a

¹⁰² J.A. Striegel, *supra* note 85 at 1274.

¹⁰³ *Ibid.* at 1276.

¹⁰⁴ J.N. Gordon, *supra* note 87 at 162.

¹⁰⁵ *Ibid.*, at 126. “The transaction costs were high; the associated financial market structure became overextended; the legal rules promoted last dollar auctions that, among other factors, led to bidder overpayment and fragile financial structures; the magnitude of the transactions led to speculation and illegality; and the eventual political reaction produced deal-breaking legal rules that were perversely more protective of managers than ever before.”

protective means for minority shareholders. Therefore, mandatory cumulative voting should be adopted in closely held corporations.

5.2.5.2 Countermeasures Against Minimizing Cumulative Voting

In order to offset the effect of cumulative voting, some mechanisms have been designed, mainly in the US. An introduction to these mechanisms and a discussion in how to deal with them will help to maximize the effect of cumulative voting in the Company Law of China.

5.2.5.2.1 Staggered Terms of Directors

Perhaps the most important device minimizing cumulative voting is the use of staggered terms of directors. “[F]or example, directors serve three year terms but only one-third of the directorships are up for election each year.”¹⁰⁶ The secret of this mechanism can be shown in the aforementioned formula: $X = [(Y \times N) / (N + 1)] + 1$. When the “N” gets smaller, down to 1/3 of the original number when the board is not classified, X gets much larger, which means that the minority shareholders shall have to muster more shares in order to elect their desired representatives into the board. Furthermore, even after a successful hostile takeover, the classification will guarantee that the former members of the board will not be removed immediately.

In *Bohannon v. Corporation Commission*¹⁰⁷, the Corporation Commission held that “a staggered board of directors was conceptually incompatible with the cumulative voting clause of the constitution and the policy favoring minority representation that the clause expresses”. The Supreme Court of Arizona rejected the Commission’s argument and held that, because the cumulative voting system can only function as a crude minority representation device, staggered boards are permitted as long as they merely restrict the effect of the cumulative voting system without destroying the right entirely. The court also spoke about the contribution made by the staggered board system to “corporate

¹⁰⁶ Clark, *supra* note 84 at 365.

¹⁰⁷ 313 P.2d379 (Ariz. 1957).

stability and continuity of experienced management”, and the long history of the use of the staggered board in Arizona.¹⁰⁸ In the case of *Humphrys v. Winous Co.*¹⁰⁹, the court even allowed classification in the board that comprised only three directors, thus completely emasculating the cumulative voting right.

A contrary conclusion was reached in *Wolfson v. Avery*¹¹⁰, in which the Supreme Court of Illinois held that the authorization of the classification of directors was inconsistent with the constitutional right to cumulative voting of a shareholder and should not be sustained.

A customary “justification” for the use of staggered terms puts forth the idea that it ensures “experience of service” on the board, since only one-half or one-third of the board will be elected each year. However, even with the classification of directors, the directors would not necessarily all be replaced at once. Usually, at least some of them can be reelected. Besides, those who are elected as directors usually have accumulated some previous experience in the field, so that the “experience of service” would not be a serious problem. It would seem that the fundamental problem is that this so-called “justification” has never addressed the conflict between the goal of maintaining a certain level of experience on the board and the goal of successful cumulative voting. Therefore, it is logically and methodologically improper to justify the classification and sacrifice the cumulative voting.

Since completely forbidding staggered terms might be an inappropriate interference with the internal affairs of the corporation, one of the solutions to mitigate its encroaching effect is to achieve a certain balance by exercising certain restrictions on such “classifications”. For example, in the US, no listed company is allowed to have a board of directors that is divided into more than three classes. This should be of good reference for the amendment of the Company Law of China. It can be provided that staggered terms may be used, but not to the effect of virtually wiping out the cumulative voting. To classify the board into 3 classes when the board comprises only 3 directors is certainly an abuse of the right, and should not be allowed. Professor Junhai Liu proposes that the board of directors and the board of supervisors shall be elected at the same

¹⁰⁸ Clark, *supra* note 84 at 365.

¹⁰⁹ 165 Ohio St 45.133 NE 2d 780.

¹¹⁰ 6III 2d78, 126 NE 2d 701.

time,¹¹¹ in order that the “N” in the formula gets bigger and the effect of classification can be mitigated. The C.B.C.A. also provides a helpful reference. Staggered terms of directors are allowed in the C.B.C.A.¹¹², but every director can be removed before tenure by a majority vote¹¹³ if and only if “the number of votes cast in favour of the director's removal is greater than the product of the number of directors required by the articles and the number of votes cast against the motion”¹¹⁴. With this special requirement, even though the “classification of directors” is allowed, cumulative voting would not be defeated by an ordinary resolution that would afterwards remove the cumulatively voted directors afterwards. China may well follow suit when amending the Company Law.

5.2.5.2.2 Prior Notice

If a certain shareholder plans to vote cumulatively, he or she should give this intention to other shareholders, so that they may all cumulatively vote accordingly. This requirement is plainly desirable, otherwise it would be unfair to other shareholders and may cause internal chaos by bringing about the unexpected result that the directors chosen by minority shareholders control the board.

There should be no exception in the Chinese Company Law, and an advance notice should be given if the shareholders plan to vote cumulatively.

Despite these proposals to deal with the devices minimizing the cumulative voting, the minimizing devices may often retain the upper hand. Other devices, like class voting, would sometimes be more helpful than cumulative voting.

5.3 Class Voting

5.3.1 Classes of Shares and the Standard to Classify Shares

¹¹¹ Junhai Liu, *supra* note 47 at 193.

¹¹² C.B.C.A., s. 106(4).

¹¹³ C.B.C.A., s. 109(1).

¹¹⁴ C.B.C.A, s. 107 (g). Section 6(4) of the C.B.C.A. is also related: “The articles may not require a greater number of votes of shareholders to remove a director than the number required by section 109”.

5.3.1.1 Introduction

“Another means of assuring representation on the board of directors of different shareholders is to authorize classes of shares and a classified board of directors, so that each class of shares elects its class of directors.”¹¹⁵

It should be noted that class voting is not only applicable to the vote for directors, but is also applicable to other voting circumstances as a protective device for minority shareholders. To understand this better, it would be helpful to first examine the concept of classes of shares and the standard used to classify shares.

“...A class is simply a sub-group of shares to which the corporate constitution has assigned rights and conditions in common which distinguish them from other shares.”¹¹⁶ It should be noted that only the shareholders with voting shares can actually vote for the classified board of directors, no matter which classes these shares belong to. Therefore, preference shares that do not carry voting powers will not participate in the vote for the board of directors. This issue will be discussed in detail in the following paragraphs.

“Common shares” and “preference shares” are the most popular division of classes of shares. Generally speaking, common shares “have no restrictions and...were fully participating as to voting, dividends, and dissolution”,¹¹⁷ while preference shares “carried a long-term, special liquidation preference, had fixed dividend rights which were payable in priority to dividends to other shareholders, and often had either contingent voting rights or no voting rights at all.”¹¹⁸

In fact, “[i]t is important to note at the outset that these are jargon words, not terms with fixed legal meanings.”¹¹⁹ The specific contents of common shares and preference shares may vary considerably. Actually, they can be freely decided by the incorporators in the corporate constitution. Therefore, the discussion of “common shares” and “preference shares” would be difficult and sometimes misleading. It would seem better to instead examine the broader issue of the standard by which to classifying shares.

¹¹⁵ Henn, *supra* note 76, at 719.

¹¹⁶ Welling, *supra* note 2 at 615.

¹¹⁷ *Ibid.* at 612.

¹¹⁸ *Ibid.* at 612.

¹¹⁹ *Ibid.* at 612

Since the “rights, privileges, restrictions and conditions attaching to shares of each class” should generally be stated in the articles of associations, the shareholders should have reached a consensus through voluntary negotiations for the election of classified directors. If the articles of associations provide that a certain class of shares will be able to vote for 1 director out of the 5 directors, this remains true even when such a class only comprises 10 shares while another class has 10000 voting shares.

5.3.1.2 “Series”

Some statutes have subcategorized “classes” into “series”. The “series” are like classes under shares, but they are fundamentally different in their creation. In typical statutes regulating the classes of shares, the “rights, restrictions and conditions attaching to the shares of each class shall be set out in the article.”¹²⁰ While for “series”, the C.B.C.A. provides for two ways to subcategorize a class into them:

“The articles may authorize, subject to any limitations set out in them, the issue of any class of shares in one or more series and may do either or both of the following:

(a) fix the number of shares in, and determine the designation, rights, privileges, restrictions and conditions attaching to the shares of, each series; or

(b) authorize the directors to fix the number of shares in, and determine the designation, rights, privileges, restrictions and conditions attaching to the shares of, each series.”¹²¹

So series can be created either by the shareholders in articles of associations, or by directors under authorization. As a result of the second scenario, “strangely, discrimination within a particular class need only be premeditated in the articles: the details can be supplied from time to time by ordinary directors’ resolutions, without any

¹²⁰ See, for example, C.B.C.A. s. 24 (4) (a).

¹²¹ C.B.C.A. s. 27(1).

shareholder participation at all.”¹²² It would seem improper to confer such power to directors, particular under the current Chinese social context where the lack of a mature director market, among other reasons, has resulted in constant breaches of fiduciary duty and oppression on minority shareholders.

To summarize, it is proposed that in the reforms to the Company Law of China, classes and series should both be allowed, but their “designation, rights, privileges, restrictions and conditions” should both be set up in the corporate constitution by shareholders. This is compatible with the English-model system, which is akin to the model of Chinese Company Law. If the directors wish to change the class structure or create new classes/series, prior approval by shareholders should be acquired. As long as the “designation, rights, privileges, restrictions and conditions” can sufficiently differentiate one group of shares from another, a certain class or series may be created.

5.3.1.3 Classes of Shares in China

In applying the foregoing standard, we will attempt to correctly separate the shares in China into classes.

In the corporate practices of modern China, there are, in reality, several classes of shares, although the Company Law has not formally admitted the process of class voting. These classes include “A” shares, shares that are sold in the stock market within the mainland of China, “B” shares, shares that are sold in some other main stock markets outside China, and “H” shares, shares that are sold in Hong Kong stock market. These three classes of shares are differentiated according to the place they are issued and traded, and are not a good standard by which to classify the shares.

Another popular classification of shares divides them into state shares, shares owned by the state, enterprise shares, shares owned by enterprises, and individual shares, shares owned by individuals. The characteristics of the former two classes are almost the same although the holders are different. Compared to individual shares, they are not transferable in the stock market. One admitted phenomenon is that, due to their

¹²² Welling, *supra* note 2 at 617.

transferability, individual shares are usually evaluated at a higher worth than both state shares and enterprises shares.

This should be the key feature that distinguishing individual shares from state shares and enterprise shares. The transferability of the shares, rather than the owners who happen to hold the shares, should be the standard to classify these shares. Therefore, the Author proposes that the shares be divided into two classes, one is transferable in the stock market and the other is not. The shareholders of these two classes of shares shall be allowed to vote as a separate class.

5.3.2 Class Veto

Class veto is closely related to class voting, or can be regarded as part of class voting. The purpose of class veto is quite similar: to allow a certain class of shares vote separately on certain issues. Welling tends to use another term, “class veto”.¹²³ Professor Welling summarizes the situations in which a class veto is given in the statutes, saying, “[t]hey can be described functionally in three categories:

- (1) proposals that would directly vary class rights;
- (2) proposals that would have the indirect effect of varying class rights;
- (3) a catch-all category which operates unless excluded by the articles.”¹²⁴

Class veto does not really render illegal certain resolutions. “If the class veto is applicable, but the majority of the affected class approves the amendment, the dissenting shareholders in the class may invoke the appraisal remedy in most jurisdictions.”¹²⁵ The appraisal remedy will be discussed in detail in the next chapter.

There is a similar “series veto” in the C.B.C.A.: “If the terms attached to a series are set out in the articles and if it is proposed that those terms be amended, and thus

¹²³ *Ibid.* at 564

¹²⁴ *Ibid.* at 566-567: “It must be kept in mind that, as noted above, the whole section has application only when the proposal is to amend the articles. Situations in which management or other class of shareholders seek to exercise powers already given to them by the articles are not included.”

¹²⁵ *Ibid.* at 571

differentiated from the terms attached to other series in the class, s.176 (1) and (2) of the C.B.C.A. provides for a series veto in exactly the same way as for a class veto.”¹²⁶

Similar devices should be adopted by the Company Law of China to allow for class veto and series veto, which is the substantial value of division of classes of shares. It should be emphasized that the use of class veto does not guarantee the end of certain resolutions, but simply provides an opportunity to exit through appraisal remedy in most cases.

5.4 Restrictions on the Voting of Majority Shareholders

5.4.1 Theoretical Tool: Abuse of Power

“The company is destined to be controlled by certain shareholder or directors.”

¹²⁷ Under such control, the abuse of rights becomes a quite likely consequence.

“...if the majority passes a resolution which no body of reasonable persons could have supposed to be within the scope of the majority’s power, having regard to the contemplated purposes of the company, the resolution is liable to be declared void by a court.”¹²⁸ Professor Ford summarizes the three situations where control of majority’ voting power is appropriate:

The operation of the equitable doctrine of control of majority of voting power is best illustrated in three divisions: (1) majority voting for alteration of articles or memorandum or variation of rights of members; (2) majority unwilling to direct that proceedings be brought by the company where a wrong has been committed as against the company; and (3) majority voting in other cases.¹²⁹

¹²⁶ *Ibid.* at 568-569.

¹²⁷ Ping Jiang et. al, *A New Textbook for Company Law*, (Beijing: Press of Law, 1994) 201.

¹²⁸ HAJ Ford & RP Austin, *Ford’s Principles of Corporations Law*, 6th ed. (Sydney: Butterworths, 1992) at 591.

¹²⁹ *Ibid.*, at 592.

In order to keep such abuse of rights from occurring, it would be necessary to consider imposing certain restrictions on the voting rights of the majority shareholders. The concept of restriction in the doctrine of abuse of power will be undoubtedly helpful, and a similar effect may also be achieved by adhering to such general principles as good faith, honesty or credibility. A bolder use of the concepts of abuse of power and good faith doctrine by Chinese judges would be necessary in China.

5.4.2 Decreasing the Voting Power of Majority Shareholders

Decreasing the voting powers of majority shareholders is perhaps one of the simplest, yet very useful methods that prevents the abuse of right.

In general, civil law traditions tend to impose such restrictions more often. For example, the Commercial Code of Italy provides that shareholders with fewer than 100 shares can only have one vote for every five shares, while those with more than 100 shares can only have one vote for every twenty shares.¹³⁰ Article 179 of the Company Law of Taiwan Province provides that the articles of associations shall impose restrictions on the voting powers of shareholders that retain more than 30% of issued shares, except for special shareholders.¹³¹ Belgium Company Law provides that a single shareholder shall not have more than 20% of the voting power of the corporation, nor shall he have more than 40% of the voting power present at the shareholders' general meeting.¹³²

On the other hand, common law traditions tend to not decrease the voting power in the same pattern, trying instead to restrict it with rules such as the fiduciary duty of shareholders and the business judgment rule.

Our preference lies with the method of the common law tradition, as devaluing the voting power of majority shareholders is not seen as wise. In fact, it would be going beyond the protection of minority shareholders or the corporation. To put the restrictions in effect would be to unfairly harming the lawful rights and the legitimate expectations of the majority shareholders. After all, it would be the majority shareholders who are taking a bigger risk in the investment, and they deserve the proportional participation in the

¹³⁰ Feng Guo, *supra* note 23.

¹³¹ The Company Law of Taiwan Province, Article 179.

¹³² Bin. Qi, *supra* note 30 at 627.

corporation. Minority protection should not mean majority infringement. In the broader social context, such a restriction would also discourage economic investments in the society and, therefore, reduce the general welfare. Professor Hongsong Song has proposed that such a restriction should not be statutorily mandatory, but be allowed by the articles of associations.¹³³ This proposal seems to be logical and useful.

5.5 Chapter Conclusion

In this chapter, the fiduciary duty of majority shareholders toward the minority shareholders was first discussed, thus proposing an important principle and laying the foundation for discussions in the following parts. It is held that the Company Law of China should impose a fiduciary duty on majority shareholders towards minority shareholders. Adopting the *Donahue* approach that imposes a heightened fiduciary duty serves to reinforce the argument.

Much significance was then attached to cumulative voting, and it was argued that China should provide for mandatory cumulative voting in closely held corporations, and permissive cumulative voting in publicly held corporations.

Next, class voting was discussed, and it was argued that the Company Law of China should disregard the classification of state shares, enterprise shares and individual shares, and instead divide the shares into two classes according to the transferability. Class (series) veto should be exercised.

The imposition of restrictions on the voting powers of majority shareholders was then discussed. It is held that potential abuse of the voting power by majority shareholders shall not be dealt with by decreasing the voting powers attached to the shares, but by checking the abuses with such mechanisms as fiduciary duty, the abuse of power theory, or the good faith requirement.

With the proposed fiduciary duty, cumulative voting, class voting, and various restrictions on majority shareholders, it can be expected that a more healthy relationship

¹³³ Hongsong Song, "The Minority Shareholders' Rights and the Protection by the Company Law", (2000) 13:4 Journal of Yantai University (Social Science) 401 at 406.

between minority shareholders and majority shareholders will be created. It is hoped that the situation would no longer be “minority shareholders vs. majority shareholders” any more, but one of “minority shareholders harmonious with majority shareholders.”

6.0 Shareholder Remedies: Proposals for Reforms

6.1 General Remarks: the “Remedy Approach”

After examining the defects in the protection of minority shareholders and discussing some *preventive* measures, it would now be appropriate to discuss some *remedial* mechanisms to protect minority shareholders *ex post facto*.

Professor Welling has argued for a “remedy” approach and discarded the “right” approach for minority shareholders protection. Since in many cases, the majority shareholders or directors are following the majority rule, which is totally legitimate, Professor Welling holds that the dispute “is more analogous to religious discrimination than to the kind of issue western democracies traditionally leave to be decided by majority rule.”¹³⁴ Since the major premises of corporate personality and majority rule are not likely to be discarded, “it is difficult to create minority ‘rights’ that can be asserted against the majority.”¹³⁵

In a nutshell, I suggest that a ‘rights’ approach is the wrong way to protect minority shareholders. What is needed—and what we find in most Canadian jurisdictions—is a system of procedural *remedies* whereby:

the majority can be forced to conform to the rules set out in the corporate constitution; and

in some (but not all) cases where the dispute is about underlying policy rather than about flouting of rules, either

¹³⁴ Welling, *supra* note 2 at 510.

¹³⁵ *Ibid.*, at 510.

- (i) a compromise can be worked out,
- (ii) a discretionary solution can be imposed, or
- (iii) the disgruntled minority can be bought out for a judicially determined 'fair' price.¹³⁶

The argument and the approach proposed by Professor Welling makes much sense, and this approach will be followed when discussing the protection for minority shareholders.

Generally speaking, typical *ex post facto* mechanisms such personal suit, derivative action, oppression remedy, compliance and restraining orders, appraisal remedy, and "just and equitable" wind-up. The major mechanisms will be discussed and opinions offered on how to adapt them for the Company Law of China.

6.2 Personal Suit

6.2.1 General Remarks

"The personal action is an ordinary civil suit initiated by a shareholder to seek relief for some injury caused directly to her rights as a shareholder, such as the failure to receive notice of a meeting to which she was entitled."¹³⁷ Professor Stanley M. Beck emphasized "personal wrong" as the one of the principal criteria by which to bring a personal suit:

Where a legal wrong is done to shareholders by directors or other shareholders, the injured shareholders suffer a personal wrong, and may seek redress for it in a personal action. That personal action may be by one shareholder alone, or (as will usually be the case) by a class action in which he sues on behalf of himself and all other shareholders in the same interest

¹³⁶ *Ibid.* at 510

¹³⁷ J. A. Vanduzer, *The Law of Partnerships and Corporations*, (Ontario: Irwin Law, 1997) at 250.

(usually, all other shareholders save the wrongdoers). Such a class action is nevertheless a personal action.¹³⁸

Professor Clark further emphasizes that in a personal suit, “Recovery in these individual or class actions goes to the suing shareholders, not their corporation.”¹³⁹

When the personal rights of shareholders are infringed, a personal suit would be the most suitable suit to assure legal protection as a fundamental legal rule.

In modern company laws of the major legal systems, personal suits are generally recognized. For example, in Canadian corporate legal practices, although “the courts have traditionally been reluctant to grant a wide scope to the personal action”¹⁴⁰, “...the courts began to allow personal actions in a wider range of circumstances. Personal actions were permitted so long as breach of a personal right was alleged. It was irrelevant if the same breach might constitute a breach of fiduciary duty [to the corporation] as well.”¹⁴¹

As was discussed in Section 3.4.2.1, although the problem in the enforcement of law is also an important reason for the difficulties in bringing personal suits in China, discussions aimed at legislation are undoubtedly helpful and consistent with the topic of this thesis.

In his book *Corporate Law*, Professor Clark has held that “[b]ecause these kinds of actions, unlike derivative suits, do not raise procedural issues that are dramatically special to the corporate context, they are left for books and courses on civil procedure.”¹⁴² For the same reason, we will not discuss in detail the direct action in this thesis, and concentrate instead on proposals to amend Articles 63 and 111 of the Company Law as well as the “Misrepresentation Notice”, the major provisions that are related to direct action in Chinese corporate law.

6.2.2 Reforming Articles 63 and 111 of the Company Law

¹³⁸ Stanley M. Beck, “The Shareholders’ Derivative Action”, (1974) 52 Can. Bar Rev. 159 at 185-186.

¹³⁹ Clark, *supra* note 84 at 640.

¹⁴⁰ Vanduzer, *supra* note 136 at 251.

¹⁴¹ *Ibid.* at 252.

¹⁴² Clark, *supra* note 84 at 640.

Article 63 provides that a director, supervisor or manager “shall be liable for damages” if his or her violation of the law, administrative regulations or the articles of association results in harm to the company. Theoretically, this should be manageable, but realistically, it is not feasible because it is too abstract. Therefore, the improvement of this article should aim to add more detailed regulations as to the feasibility of the provision. For example, the shareholders shall be explicitly given the right to raise the lawsuits, so that they do not have to rely on the mercy of judges in order to have the trial heard.

Article 111 of the Company Law of China is the most relevant and important provision regarding shareholders’ right to raise personal suit:

If any resolution adopted by a shareholders' general meeting or the board of directors violates any *law or administrative regulation* or infringes the lawful rights and interests of shareholders, shareholders have the right to initiate proceedings in the people's court to *require that* such acts of violation or infringement be *stopped*. (emphasis added by the Author)¹⁴³

In view of the defects of Article 111 that were discussed in Section 3.4.2.1, the following efforts for improvements should be made.

First, since the assurance that the management or the majority shareholders would obey the articles of association is essential for the security of investments of shareholders, it is suggested that the provision shall apply, not only when “law or administrative regulation” is violated, but also when the “articles of associations are violated. The articles of association can be regarded as either shareholders’ agreements or statutory contracts, so they should be enforceable.

Secondly, shareholders shall not only have the right to sue “to require that such acts of violation or infringement be *stopped*” (injunction), but also, more importantly, the right to sue for civil *recoveries* (compensation). Although one is more likely to obtain an injunction or declaration remedy, there is no denying that there are indeed some cases in

¹⁴³ The Company Law, Article 111.

which compensation is the most proper form of remedies.¹⁴⁴ The causes of such an action could be either the breach of contract or tort, and the rules to follow would not be very different from the ordinary civil procedural laws so they will not be discussed in detail in this thesis.

Thirdly, when some of the conducts of the directors or the majority shareholders are technically lawful, i.e., are not “violating any law or administrative regulation or infringing the lawful rights and interests of shareholders”, but equitably oppressive, remedies should also be granted. This will be discussed in detail later in the section of “oppression remedy”.

Fourthly, Article 111 should not only apply to cases in which the interests of minority shareholders are harmed at the shareholders’ general meeting or the meeting of directors, but also to other harms that occur outside these meetings. This is consistent with the fiduciary duty of directors and the proposed fiduciary duty for majority shareholders.

6.2.3 Reforming the “Notice 406” and the “Misrepresentation Notice”

The defects of the “Notice 406” and the “Misrepresentation Notice” have been discussed in depth in Chapter 3 under “The Notice by the Supreme Court”. Although they are only applicable to publicly listed corporations, they should not be neglected in our discussions as shareholders in these public corporations also have the issue of personal suits.

Above all, “Notice 406” of September 2001 should be annulled. In this notice, the Supreme Court provided that the cases for civil recoveries concerning insider trading, fraud, and market manipulation in the publicly listed corporations shall temporarily not be heard by the courts. Its absurdity and arguable illegality have been discussed in Chapter 3 under “The Notice by the Supreme Court”. In order for minority shareholders to raise direct suits for civil recoveries, the first step would be to remove the barrier caused by Notice 406.

¹⁴⁴ Besides, because the minority shareholders seldom have opportunities to participate in the management of the corporations, it is often impossible for them to “stop” these resolutions, and the remedy has to be the *ex post facto* compensation.

More amendments are needed for the “Misrepresentation Notice”, in which the Supreme Court has allowed cases of misrepresentation to be heard by courts in January 2002.

First, and probably most importantly, the Misrepresentation Notice should not have only covered cases of misrepresentations and excluded others, such as those of insider trading or market manipulation from trial. This is not only unfair to the minority shareholders, but also inconsistent with the requirements of the Securities Law to ban such acts. Although the provisions in the Company Law and the Securities Law lack details, the principle to forbid such acts is explicit.

Secondly, the Misrepresentation Notice should allow class suits, which could save a considerable amount of time and money for the victims, as well as judicial resources for the society thanks to its expanding effect. Probably, the rationale of the Supreme Court in choosing not to allow the class suit were for reasons of so-called “social stability”: they were fearful that the class suit, more companies would become bankrupt because of the compensations, and more suits would flood to the courts in an overwhelming manner. However, the sacrifice of shareholders’ legitimate interests out of these considerations is not only legally unacceptable, but also moving further away from the goal of “social stability”. When people fail to get the appropriate judicial remedy, the likelihood that they would take improper action for private remedies will greatly increase, making the society much more instable. As for the concern of overwhelming workload brought by the advent of the class suit, it is unfounded because such a suit would generally greatly reduce the workload of the courts with its expanding effect, contrary to their concerns.

Thirdly, the requirement to set effective administrative investigation as the prerequisite of personal suit should be removed. This requirement is not only unfair to shareholders, but also unduly intrudes in the domain of judicial independence. According to this notice, the administrative agency, the CSRC, is unduly empowered to decide as to whether a person can raise a suit and whether courts may hear such cases even before the cases can go to the court. Although more constitutional, jurisprudential or civil

procedural issues may arise from further discussions, for this Thesis it should suffice to propose that this requirement should be removed.¹⁴⁵

6.2.4 Concluding Remarks

Personal suit is certainly one of the most important channels by which to protect minority shareholders. If even the personal rights of shareholders cannot be protected through lawsuits, it could hardly be said that there does exist any protection for minority shareholders. If China really wants to improve the protection of minority shareholders, personal suits would be an ideal starting point.

6.3 Derivative action

6.3.1 General Remarks

Derivative action, or “representative action” as is argued for by Professor Bruce Welling,¹⁴⁶ is essentially “a claim asserted by a shareholder on behalf of the corporation. In a shareholder derivative suit the law recognizes that corporate directors may not be acting in the best interests of the corporation when they refuse to assert the corporation's legal right to enforce the directors' fiduciary duty to the corporation.”¹⁴⁷

¹⁴⁵ Plus, since the conclusion of administrative investigation should be final in or for civil proceedings to be initiated, the process can be painfully long because very often, procedures such as administrative review and administrative lawsuits are necessary to reach the final conclusion. The victims will have to wait until all these procedures are finished, and the wrongdoers may well use administrative review or administrative suits as a tactic to prolong the civil proceedings.

¹⁴⁶ Welling, *supra* note 2, at 544-545. Professor Welling argues that the term “derivative action” should not be used at all, and “statutory representative action” should be used instead. However, the Author would still stick to the term “derivative action” mainly for the following reasons. (1) “Derivative action” is already generally accepted, so from the aspect of linguistics, it should not be replaced unless for compelling reasons, but the arguments by Professor Welling on this issue are not so “compelling”. (2) Under the background of introducing derivative action into China, the term “derivative action” would be better because the Chinese alternative for “representative action” would be very likely to get mixed up with that of the “direct suit representing certain group of shareholders”.

¹⁴⁷ E.C. Lashbrooke, Jr, “The Divergence of Corporate Finance and Law In Corporate Governance” (1995) 46 S.C. L. Rev. 449 at 449.

Derivative action is “the minority shareholder’s sword to the majority’s twin shields of corporate personality and majority rule.”¹⁴⁸ With the derivative action, minority shareholders might have some chance to hold the wrongdoers—often directors or majority shareholders—liable. If shareholders are not allowed by statute to raise derivative action, such as is the case of the Company Law of China, the power to reach the corporate decision to sue would completely fall into the hands of the directors or the controlling shareholders, who would, as expected, not make the decision to sue themselves.

Since derivative action is almost universally established in the major legal systems, and much of its content is more or less the same, a comprehensive system of derivative action will not be built up in this thesis. We will instead only concentrate on discussing the issues inviting more disputes and differences. After some comparative and analytic work, proposals for the establishment of derivative action in the Company Law of China will be offered.

6.3.2 Derivative Action and Personal Action Distinguished

Because the shareholders, and not the corporation itself in ordinary cases, are raising the derivative action on behalf of the corporation, it would first be necessary to impose certain special requirements on the derivative action. The first step by which to do so is to first distinguish derivative actions and personal actions. In fact, “judicial permission to proceed should not be given where...the claim presented insufficiently distinguishes between corporate claims and rights of action personal to the shareholder.”¹⁴⁹ In addition, in order to introduce derivative action into the Company Law of China, it would first be necessary to harmonize it with the current legal systems, and properly distinguishing it from direct action is an important step towards this harmonization.

A general criterion that would serve to distinguish direct action from derivative action is that “a derivative suit is called for when the wrong complained of primarily

¹⁴⁸ Welling, *supra* note 2 at 526. For the reasons discussed in footnote 1, the Author used the term “derivative action” although he is often citing Professor Welling’s views.

¹⁴⁹ *Ibid.* 537

constituted an injury to the corporation, whereas a direct suit is appropriate when the injury was primarily to the shareholder(s) as such.”¹⁵⁰ Professor Clark further held that “[t]he kinds of suits that are derivative in nature include most cases based on breach of the fiduciary duties of care and loyalty. These include, for example, suits based on gross negligence, waste of corporate assets, basic self-dealing, excessive compensation, or usurpation of a corporate opportunity.”¹⁵¹

Professor Harry G. Henn has provided some specific circumstances in which each kind of lawsuit is appropriate.

The following have been held to be direct actions by the shareholder:

- (a) to compel payment of lawfully declared dividends or of mandatory dividends;
- (b) to enforce the right to inspect corporate books and records;
- (c) to protect preemptive rights and possibly otherwise prevent fraudulent dilution of one’s proportionate interests;
- (d) to enforce the right to vote;
- (e) to proceed against voting trustees;
- (f) to enjoin an *ultra vires* act or other threatened wrong before its consummation;
- (g) to recover from insider who purchased shareholders’ shares without proper disclosure;
- (h) to recover from controlling shareholder for wrongful redemption;
- (i) to sue for breach of a preincorporation agreement;
- (j) to sue for breach of a shareholder agreement;
- (k) to compel corporate dissolution.

On the other hand, the following have been held to be wrongs to the corporation which give rise to derivative actions:

¹⁵⁰ Clark, *supra* note 84 at 662.

¹⁵¹ *Ibid.*, 663.

- (a) to recover damages resulting from a consummated ultra vires act;
- (b) to enjoin directors, officers, and controlling shareholders from breaching their fiduciary duty to the corporation, or to recover damages or profits for breach of duty to the corporation, e.g., mismanagement of the business by directors or officers, or misappropriation of corporate assets, or opportunities, or sale of control;
- (c) to enjoin issue of share options for inadequate consideration;
- (d) to recover improper dividends;
- (e) to enjoin outsiders from wronging the corporation or to recover for such wrong.¹⁵²

At times, the actual facts of the case can be more complicated than most of the above examples. Viewed from different angles, the same conduct may be the cause of action for either direct suits or derivative suits, so that a transformation between these two suits may take place in some cases, and some parties may intentionally choose or avoid a certain form of suit in order to maximize their interests in the suit. Professor Clark has given some examples that would create such a transformation.

A corporation bought property owned by its majority shareholder. The shareholders, including the majority shareholder, voted to approve the deal; a majority of the outstanding shares were cast in favor of it. But plaintiff thinks the price paid was excessive and sues to rescind. He alleges not that there was unfair self-dealing (a derivative injury), but that his *voting rights* were impaired (a direct injury)!¹⁵³

¹⁵² Henn, *supra* note 76 at 1048-1050. Sometimes the direct suits and derivative suits may be transformed into each other for various purposes. Professor Clark gave some examples for such transformation. See Clark, *supra* note 84 at 663-664.

¹⁵³ Clark, *supra* note 84 at 663-664. The theoretic foundation of this choice is that the voting rights devalued because of the majority shareholders' wrongful participation in the voting.

The other example, in which the defendant would like to sue in his or her name, occurs roughly in this manner: when, in certain cases, directors are to be held liable for paying themselves excessive salaries which were ratified by majority rule, they have tried to argue that the suit was a personal one instead of a derivative one so that their damages should be paid only to the shareholders who did not vote to ratify and in proportion to their interest in the corporation.¹⁵⁴

To summarize, the examples shown by Professor Henn have demonstrated excellent hints distinguish derivative action from direct action, and can serve as excellent reference when China adopts derivative action. It should, however, also be kept in mind that the distinction is not absolute, and that a transformation of the form of suit may take place, which would leave room for the parties to make limited choices.

6.3.3 The Rule in *Foss v. Harbottle* and its Exceptions

Before the recognition of derivative action, the general rule governing the shareholders' suit had been developed in an old British case called *Foss v. Harbottle*¹⁵⁵. The gist of the decision was that only a corporation may sue for an injury to it, based on the notion that "since the shareholders could approve or ratify breaches of duty to the corporation, it would be an inappropriate interference with majority rule for courts to permit actions by minority shareholders where the action had been or could be ratified by the majority."¹⁵⁶

Although the rule in *Foss v. Harbottle* could efficiently block a multiplicity of suits against companies and block wasted litigation, it in many ways neglects the interests of minority shareholders and, ultimately, the corporation. For this, it has incurred vigorous criticism. "It has been said to restrict too narrowly the individual shareholder's power to enforce the company's rights; to have resulted in an overly complex body of rules; to pursue inconsistent policies; and to have been extended beyond its proper

¹⁵⁴ See *Ibid*, 663-664.

¹⁵⁵ [1843], 2 Hare 461, 67 E.R. 189 (Eng.).

¹⁵⁶ J.A. Vanduzer, *supra* note 136 at 252-253.

scope.”¹⁵⁷ Therefore, although the rule in *Foss v. Harbottle* was once quite influential, some exceptions were made to mitigate it. These exceptions are summarized as follows:

The rule does not extend to a case where the act complained of is either illegal or ultra vires, or is a fraud upon the minority, and there is also an exception in cases where the act done, although regular in form, is unfair and oppressive as against the minority...It does not apply to a case where the matter in question requires, by virtue of provision either in the Companies Act 1985 or in a company’s memorandum or articles, a special or extraordinary resolution...A single shareholder may sue in his own name to restrain an act which is an infringement of his individual rights...¹⁵⁸

Therefore, under limited circumstances in which these exceptions would apply, minority shareholders have the possibility of raising the suit on behalf of the company. After examining a series of cases, Professor Gower has summarized the conditions for access to the derivative action as follows:

First, the individual shareholder may not sue to enforce the company’s rights if the wrong in question is one which is ratifiable by the company in general meeting by ordinary resolution. Secondly, even if the wrong is not ratifiable as being a ‘fraud on the minority’, the derivative action may not be brought unless the wrongdoers are in control of the company and (possibly) may not be brought in the case of any non-ratifiable wrong unless the majority of the independent shareholders support the bringing of the action.¹⁵⁹

Although derivative action has been allowed under certain circumstances, these rules were still too restrictive and complicated. Later developments in modern company

¹⁵⁷ Gower, *supra* note 64 at 659-660.

¹⁵⁸ John Birds et.al., *Boyle & Birds’ Company Law*, 3rd ed., (Bristol: Jordan Publishing Limited, 1995) at, 493-494.

¹⁵⁹ Gower, *supra* note 64 at 670.

laws have generally allowed for more flexibility for the minority shareholders, so that they could bring derivative actions.

6.3.4 Qualification of Shareholders to Bring Derivative Action

6.3.4.1 The “Complainant” in the C.B.C.A.

An issue of key significance for the notion of derivative action would be the shareholders’ qualifications to bring the derivative action to court. Regarding this issue, the reformed Canadian corporate statutes have generally held a much more lenient attitude toward minority shareholders than the British common law derivative action—actually, it is almost the most open-minded in the world. In the C.B.C.A., the notion of a qualified “complainant” who can apply to the court for a leave to bring a derivative action include:

- (a) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates...
- (b) a director or an officer or a former director or officer of a corporation or any of its affiliates,
- (c) the Director, or
- (d) any other person who, in the discretion of a court, is a proper person to make an application under this Section¹⁶⁰

The C.B.C.A. virtually did not set any substantial restriction on shareholders to raise the derivative action, and as “complainants” for some other remedies. There are no requirements as to the number of shares that they shall hold, or requirements as to the period of time during which they have held the shares. In fact, even a *former* shareholder

¹⁶⁰ C.B.C.A., section 238.

qualifies.¹⁶¹ It would be of academic significance to compare this loose requirement with the much more stringent “Contemporaneous Ownership Rule”, which is required in the majority of American jurisdictions.

6.3.4.2 The Contemporaneous Ownership Rule

The contemporaneous ownership rule was first set forth in an old American case, *Hawes v. Oakland*¹⁶², and later carried into the Federal Equity Rule 94 and, finally, then the Federal Rule of Civil Procedure 23.1.

Under the Federal Rule of Civil Procedure 23.1, the plaintiff must prove that he or she had been a shareholder at the time of the transaction of which the plaintiff complains, or that the plaintiff’s share thereafter devolved on him or her by operation of law. Nowadays “a majority of jurisdictions, whether by statute, court rule, or judicial decision, still have the contemporaneous ownership rule”.¹⁶³ The reason for this rule is now mainly to prevent a subsequent purchaser of shares from “speculating in litigation” or “litigating purchased grievances”.¹⁶⁴

This rule has generated much debate and created many disputes:

Nowadays one may attempt to rationalize the rule as applied by state courts, by arguing that it prevents the buying of shares by litigious persons who might bring frivolous suits. But it is easy, of course, to argue the opposing view that a cause of action for wrongdoing by directors and officers is part of the assets in which a shareholder has a transferable interest... Thus, it is difficult to justify the continued existence of the contemporaneous ownership rule.¹⁶⁵

¹⁶¹ This is not to say that there is absolutely no restriction. In order for approval to bring a derivative action to be given by the court, the following three conditions need to be met: (a) the shareholder gives reasonable notice to the directors of the corporation of her intention to apply for leave to bring an action if the directors do not; (b) the shareholder is acting in good faith; and (c) the action proposed to be initiated by the shareholder appears to be in the interests of the corporation. See Vanduzer *supra* note 136 at 253.

¹⁶² 104 US 450, 26 L. Ed. 827 (1882).

¹⁶³ Clark, *supra* note 84 at 650.

¹⁶⁴ See Henn, *supra* note 76 at 1060-1061.

¹⁶⁵ Clark, *supra* note 84 at 651.

The continuing-wrong doctrine serves as the most important exception to the contemporaneous ownership rule. According to this doctrine, “[i]f the alleged misconduct can be construed as having ‘continued’ until plaintiff acquired his shares, the plaintiff does not run afoul of the contemporaneous ownership rule.”¹⁶⁶ Professor Henn has also discussed an interesting “converse ‘contemporaneous ownership rule’ requirement problem”: “If all the shareholders are barred from suing derivatively because of the contemporaneous-share-ownership rule, may the corporation then bring a direct action to recover on the claim that could not be enforced derivatively?”¹⁶⁷ The answer given by Professor Henn, through a discussion of several key cases seems to be “no”. In general, the continuing-wrong doctrine can serve to provide some remedies to minority shareholders, but it cannot answer the question as to whether the right to sue is part of the assets of the interests to shareholders. Therefore, it cannot completely solve the problem in the contemporaneous ownership rule.

Although the contemporaneous ownership rule is popular in many US jurisdictions, the open-mindedness in the C.B.C.A. is preferred, and shareholders should be given the power to bring the derivative action.¹⁶⁸

Some civil law corporate codes tend to require that the shareholders should have been holding their shares for a certain period in order to bring the derivative action. For example, the Commercial Code of Japan provides that a shareholder should have been continuously holding the shares during the 6 months prior to the action.¹⁶⁹ The Company Law of Taiwan Region is even stricter: the plaintiff should have held above 10% of shares continuously for over one year prior to the action.¹⁷⁰ These requirements have been criticized as too strict and burdensome.¹⁷¹ They are also one of the reasons why “the

¹⁶⁶ *Ibid.* 651.

¹⁶⁷ Henn, *supra* note 76 at 1063.

¹⁶⁸ In some cases, the court’s power to decide whether certain cases would be placed on the file for trial is abused, causing additional difficulty for shareholders to raise the suits. This may also need to be reformed, but that is related to another wide issue of reform in the civil procedures. A detailed discussion on that topic would obviously go beyond the reasonable boundary of this thesis, and the Author would refrain from doing that.

¹⁶⁹ The Commercial Code of Japan, s. 267.

¹⁷⁰ The Company Law of Taiwan Region. s. 214.

¹⁷¹ Yong Wan, “Shareholders’ Representative Action and the Protection for Minority shareholders”, (2001) 23:5 *Journal of Shanxi Finance and Economics University* 108 at 109.

derivative action is generally not a successful mechanism in Taiwan Region and Japan”.¹⁷² This criticism seems quite valid and, once again, the C.B.C.A. approach would be preferred.

6.3.4.3 Internal Notice/Demand Before Bringing the Suit

Again, on the issue of requirements for bringing a suit, in the C.B.C.A. and the US approach differ considerably.

According to section 239 (2) of the C.B.C.A., the complainant shall have “given notice to the directors of the corporation or its subsidiary of the complainant’s intention to apply to the court...” (emphasis added by the Author) “The courts are not likely to require much formality in the notice requirement.”¹⁷³ In *Armstrong v. Gardner*¹⁷⁴, Cory J. held that “although the letters requesting action were not framed with great particularity as to the cause of action to be brought, they were directed to a solicitor. I think that there was a sufficient demand made to bring an appropriate action...I do not think that this section of the Business Corporations Act ought to be construed in an unduly technical or restricted manner.”

The case in the US is more complicated. First, “the general rule in virtually all United States jurisdictions is that before bringing a derivative suit a shareholder must first make a demand on the corporation’s board of directors to act so as to remedy the situation about which the shareholder complains.”¹⁷⁵ When the demand on the directors would prove to be futile, it would often be excused. “Typically, demand is considered futile where the alleged wrongdoers *comprise* or *control* a majority of the directors.”¹⁷⁶ If the board of directors refuses the demand, a shareholder may or may not be able to proceed with his derivative action. “A standard formulation of the rule for this common context is that when the directors have refused to sue, the shareholder can maintain a derivative action if he can allege and prove that the directors are ‘personally involved or interested

¹⁷² Song Hongsong, *supra* note 133 at 408.

¹⁷³ Bruce Welling et al., *Canadian Corporate Law Cases, Notes & Materials*, 2nd ed., (Toronto: Butterworths, 2001) at 455. (hereinafter “Welling Casebook”)

¹⁷⁴ [1978], 20 O.R. (2d) 648 (H.C.)

¹⁷⁵ Clark, *supra* note 84 at 640.

¹⁷⁶ *Ibid.*, at 641.

in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way.”¹⁷⁷ Secondly, there is the possibility of such a demand on shareholders in certain jurisdictions, although in some important jurisdictions this requirement does not exist. There are reasons both for and against the demand on shareholders, but “[o]n balance, it seems unwise that there should be any demand on shareholders requirement in a derivative suit brought on behalf of a public corporation.”¹⁷⁸ Unfortunately, this does not completely eradicate the possibility of such a demand on shareholders, especially in closely held corporations in certain jurisdictions.

After weighing the advantages and disadvantages of the requirement of notice/demand in Canada and the US against Chinese social reality, the C.B.C.A. approach is again preferred. In the proposed amendments for the Company Law of China, a prior notice to the management (in this case, it should be the board of supervisors because Chinese Company Law has traditionally established the board of supervisors, whose role is supposed to be supervising directors) would suffice as the prerequisite for bringing a derivative action. The reasons for this include: (1) due to the aggressive oppression of minority shareholders in Chinese corporate practices, the guiding principle would be to facilitate the protection of these shareholders by lowering the prerequisites; (2) the risk of strike-suits may be efficiently prevented by demanding that the malicious plaintiff pay the legal fees; (3) the US approach implies that if the alleged wrongdoers are not *comprising* or *controlling* a majority of the directors, their refusal of the shareholders’ demand would be considered as an impartial business judgment and would not be subject to judicial intervention. Unfortunately, this could not be held to be true in China. Because of both the lack of a mature manager market and the prevalent undue influence from the governments, it is often unrealistic to expect the directors to make decisions that are fair to the corporation or the minority shareholders, even in the cases in which they are themselves not personally involved or interested in the alleged wrongs. (4) such a demand on shareholders would not be appropriate not only in publicly held corporations, but also in closely held corporations, since the majority shareholders “should not be

¹⁷⁷ *Ibid.* at 644.

¹⁷⁸ *Ibid.* at 650

allowed to ratify a fraud over the objection of the minority, any more than they can vote to give away corporate assets over the protests of the minority.”¹⁷⁹

Therefore, the C.B.C.A. approach is again preferred as it is more lenient to derivative action.

6.3.5 Special Litigation Committee

Special litigation committee is a common defensive tactic in the US to respond to the shareholders’ attempts to bring derivative action. “After the derivative suit was filed, the board of directors would set up a committee of supposedly disinterested directors to investigate the plaintiff’s claims and recommend action with respect to them.”¹⁸⁰ If the committee’s report agrees that the action is in the corporation’s interest, “either the board would resolve to have the corporation sue...or the report would disappear.”¹⁸¹ If it is not, “it will be filed with the court as evidence against the proposed action.”¹⁸²

In the case of *Auerbach v. Bennett*¹⁸³, “Jones J. has analogized the ‘special litigation committee’ to an administrative tribunal...So long as the committee proceeded according to a formal process appropriate to its decision-making role, its conclusions are beyond judicial review.”¹⁸⁴

In *Zapata Corporation v. Maldonado*,¹⁸⁵ however, Quillen J. used an “expert witness” approach and analyzed the judicial review of the committee’s decision as a two-step process: “If...the Court is satisfied...that the committee was independent and showed reasonable bases for good faith findings and recommendations [step 1], the court may proceed [to step 2 and]...determine, applying its own independent business judgment, whether the motion should be granted...”¹⁸⁶

¹⁷⁹ *Ibid.* at 649.

¹⁸⁰ *Ibid.* at 645.

¹⁸¹ Welling, *supra* note 2 at 530.

¹⁸² *Ibid.*, at 530.

¹⁸³ 393N.E. 2d 994 (N.Y.C.A., 1979)

¹⁸⁴ Welling, *supra* note 2 at 531.

¹⁸⁵ 430 A. 2d 779 (Del., 1981)

¹⁸⁶ This is a passage edited by Professor Welling. See Welling, *supra* note 2 at 532-533.

Professor Welling has suggested that the approach in *Zapata Corporation v. Maldonado*, the “‘expert witness’ analogy is the better approach”¹⁸⁷ when compared with the administrative tribunal approach in *Auerbach v. Bennett*.

Nevertheless, we believe that the special litigation committee simply should not be allowed to be used as a defensive tactic against the derivative action in China, and it is logically unnecessary to discuss the judicial review of the committee’s decision. The reasons for this include the following:

First, “when the members of the ‘independent’ committee are selected by or under the influence of the defendant directors, the almost inevitable result in practice is that the committee will make a recommendation that favors the defendants’ interest...Subjective good faith simply does not insure lack of bias in an objective sense.”¹⁸⁸

Secondly, a commentator objects to the adoption of special litigation committee with the unsatisfactory performance of the directors in general:

In Chinese corporate practices, because the boards of directors in most corporations pass the motions without any dissent, and because it is not very common for directors to be able to express their independent opinions without undue influence, the likelihood of the committee to make fair decisions with regard to the derivative action is very low. Therefore, China should not adopt the special litigation committee.¹⁸⁹

Thirdly, even in the US, a country in which where the protection of the shareholders’ and the company’s interests is much more comprehensive and effective, “the system of the special litigation committee is not playing an important role”.¹⁹⁰ Some commentators have argued that although it is already accepted by American courts, “the litigation committee device ought not to commend itself to Australia or the other

¹⁸⁷ *Ibid.* at 533.

¹⁸⁸ Clark, *supra* note 84 at 648.

¹⁸⁹ Jun Xu, “Legal Remedies for the Rights and Interests of Minority Shareholders”, (2001) online: Allbright Law Firm Homepage <http://www.allbrightlaw.com.cn/1vbbs/xujun3.htm> (last accessed: 28 August 2003)

¹⁹⁰ Min’an Zhang, *supra* note 18 at 153.

Commonwealth jurisdictions.”¹⁹¹ If this would be true, to not introduce it to Australia or other Commonwealth jurisdictions, there would be even less justification to introduce it into the Company Law of China, where the legal system and culture is much more different from that of the US than Australia and other Commonwealth countries.

6.3.6 A *Pro Rata* Recovery

Since the derivative action is put forth on behalf of the corporation, the recovery, if any, should normally be made to the corporation and not personally to the plaintiff shareholders. “In sum, if no unusual circumstances intervene and the complainant’s claim is meritorious, the result would be a judgment in favor of the corporation against the named defendants; the complainant, the nominal plaintiff, would, of course, receive nothing other than his expenses.”¹⁹²

This theory is consistent with the concept of the derivative action and it is universally accepted. It should also hold true in the inclusion of the proposed derivative action in the Company Law of China. At the same time, some exceptions that fall under the US law on this issue are worthwhile to be considered for the case of China.

“...in limited instances courts have allowed individual shareholders to recover in derivative actions...A *pro rata* recovery by shareholders has been permitted in three situations:

- a. Where the derivative action is against insiders who have misappropriated corporate assets; here an individual *pro rata* recovery prevents the funds from reverting to the control of the wrongdoers;
- b. Where there are both “innocent” and “guilty” shareholders; hence a *pro rata* recovery may be limited to the “innocent” ones;

¹⁹¹ D.A. Demott, ‘Shareholder Litigation in Australia and the United States: Common Problem, Uncommon Solutions’, (1987) 11 Sydney Law Review 259 at 279.

¹⁹² Welling, *supra* note 2 at 542.

c. Where the corporation is no longer a going concern; here individual awards facilitate distribution of funds.”¹⁹³

Section 240 (c) of the C.B.C.A. may achieve the similar effect, except that it is not as specific as the above reasoning. According to this section, the court may make “an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary instead of to the corporation or its subsidiary...”. If the C.B.C.A. was more specific in prescribing the situations in which such order will be made, it would be even better.

These above three exceptions in the US corporate law are thus more helpful for Chinese judges. Since these exceptions are not country-specific, China may well follow suit in allowing for *pro rata* recovery in certain circumstances of the derivative action.

6.3.7 Security for Expenses

In the US, “[a]bout a third of the states have enacted statutes under which derivative suit plaintiffs may be required to post security for the expenses of the defendants.”¹⁹⁴ New York Section 627 and California statute Section 800(c)-(f) represent two models of security for expenses. Generally speaking, the former model was much more demanding of the plaintiff shareholders. For example, according to the New York statute, the defendants were “entitled” to require security, while the California statute provided that defendants may only move the court for an order requiring security.

The original cause of the requirement for the security for expenses was that, during the Great Depression, only a small number of the derivative actions had produced corporate recoveries. This requirement was thus made in order to reduce “strike suiters”—“plaintiffs with minor interests in the corporation who brought unmeritorious

¹⁹³ Henn, *supra* note 76 at 1096-1097. Apart from these three exceptional situations of *pro rata* recovery, there is something else worth mentioning here about a *pro rata* recovery. First, “As a general rule, a *pro rata* recovery by shareholders is not allowed when the rights of creditors are involved.” Secondly, “Where a *pro rata* recovery by the plaintiff-shareholder is allowed, the probable rule is that other shareholders who later sue for a similar award of their proportionate share of the damages are not barred by the plaintiff-shareholder’s recovery.” *Ibid.* at 1098.

¹⁹⁴ Clark, *supra* note 84 at 652.

claims for the purpose of harassing the corporation and being bought off by it, and who suffered little if the corporation suffered because of their activity”.¹⁹⁵

The security for expenses in derivative actions has been the target of fierce criticism, one of the most powerful criticisms being that the extortionate secret settlement with a frivolous plaintiff could have been solved by simply requiring that once a plaintiff has filed a derivative suit, it may not be dismissed, discontinued, or settled without the approval of the court.¹⁹⁶ This argument has undermined the theoretical and practical foundations of security for expenses and has found coherence in some modern corporate statutes, such as the C.B.C.A. Section 242 (2):

(2) An application made or an action brought or intervened in under this Section shall not be stayed, discontinued, settled or dismissed for want of prosecution without the approval of the court given on such terms as the court thinks fit and, if the court determines that the interests of any complainant may be substantially affected by such stay, discontinuance, settlement or dismissal, the court may order any party to the application or action to give notice to the complainant.

(3) A complainant is not required to give security for costs in any application made or action brought or intervened in Under this part.

This provision can not only end the requirement of security for expenses, but could help to “ensure that the interests of the corporation (the true plaintiff) are adequately protected.”¹⁹⁷ In the C.B.C.A., “the exemption in the case of derivative actions is intended to assist an impecunious shareholder to take actions in the corporation’s interest.”¹⁹⁸ This is a reasonable consideration, especially if we remember that the recovery would normally be extended to the corporation instead of the shareholder plaintiffs, the latter who take the risk of paying fees but who would receive nothing other than his expenses.

¹⁹⁵ See *Ibid.* at 654-654

¹⁹⁶ *Ibid.*, at 654.

¹⁹⁷ Welling, *supra* note 2 at 543.

¹⁹⁸ Vanduzer, *supra* note 136 at 255.

Therefore, it is proposed that the Company Law of China should not require security for expenses when allowing the derivative action, an argument that has already been eloquently put forth by Mr. Bin Qi.¹⁹⁹

6.3.8 Summary

After examining some issues of derivative action in detail, a summary of opinions and proposals concerning derivative action as proposals are now put forth. Some of the proposals are summaries of previous paragraphs, while some others are commonly accepted provisions around which there should not be much debate.

First of all, the facilitating and the encouraging derivative action should be the guiding principle in the social context in China, a country in which the where oppression of minority shareholders is quite prevalent.

In order for them to be allowed to bring derivative action, the plaintiff shareholders should have to meet certain conditions. It is believed that the person putting forth the action can be any shareholder, regardless of the number of shares that they hold and the length of time that they have been holding such shares. The contemporaneous ownership rule prevalent in US corporate law should not be followed.

A certain notice to directors should be made before the derivative action is brought. The notice requirement can be waived if the alleged wrongdoers comprise or control a majority of the directors. A special litigation committee should not be adopted in the Company Law as a defensive tactic to derivative action.

The recovery shall normally go to the corporation, except in several exceptional circumstances.

Security for expense should not be required. Judicial power should be allowed to intervene in order to preclude any unjust settlement of the action.

With derivative action as one of their most powerful weapons, minority shareholders in China may well expect a better system of protection.

¹⁹⁹ Bin Qi, *supra* note 30 at 640.

6.4 Oppression Remedy

6.4.1 Introduction

In corporate practices, there may be some circumstances in which certain acts are undertaken, usually by majority shareholders or directors, that are technically lawful but can also be considered unfair either in the acts themselves or in their consequences. It is difficult to assert that a party is doing anything *unlawful* or is infringing upon any person's explicit right. To do nothing, however, before such an unfair conduct or consequence is clearly against the legal spirit of the modern civil law. This is where the oppression remedy can be expected to play a significant role in common law systems.

China, under the strong influence of the civil law tradition, has traditionally turned to the doctrine of honesty and credibility. When a case that is similar to a petition for oppression remedy in common law systems is brought before a Chinese court, the only applicable recourse is to such abstract legal doctrines. For example, Article 4 provides that “[i]n civil activities, the principles of voluntariness, fairness, making compensation for equal value, *honesty and credibility* shall be observed.” (*emphasis added*) Article 6 of the Contract Law provides for the requirement of “good faith”: “The parties shall abide by the principle of *good faith* in exercising their rights and performing their obligations.” (*emphasis added*) In rare and extreme cases, there is a theoretical possibility for the court to adopt such principles for remedial purposes. According to Article 5 of the GPCL, “[t]he lawful civil rights and interests of citizens and legal persons shall be protected by law; no organization or individual may infringe upon them.” This may also be invoked in support of the argument that the rights and interests of the minority shareholders and the company shall not be infringed upon by the majority shareholders or the directors, even in the case that the latter were not doing anything technically illegal.²⁰⁰

²⁰⁰ Besides, Article 7 of the GPCL, although arguably more remote from the situation, might be invoked as well: “Civil activities shall have respect for social ethics and shall not harm the public interest...”. To infringe upon the rights or interests of the minority shareholders may attract criticism that such infringements are not having “respect for social ethics”. In addition, a constitutional provision might also be relevant. Article 51 of “Constitution of People’s Republic of China” (hereinafter referred to as the “Constitution”) provides: “Citizens of the People’s Republic of China, in exercising their freedoms and rights, may not infringe upon the interests of the state, of society or of the collective, or upon the lawful freedoms and rights of other citizens.” Therefore this provision might be arguably invoked when the

However, the Chinese courts are usually extremely reluctant to invoke such abstract or vague provisions.²⁰¹ Restricted by the civil law traditions and various other limitations, they are not as active in trial as their common law colleagues. Moreover, as will be discussed in following chapters, these abstract doctrines cannot fully replace oppression remedy for the following reason: “[a]rguments that the conduct complained of had to be ‘harsh, burdensome and wrongful’ or be in violation of a specific legal right were rejected...the effect on the complainant of the actions taken, not the good or bad faith of the respondents, was the relevant consideration...”²⁰²

Therefore, introducing the oppression remedy into the Company Law of China might be necessary and beneficial in order to establish the complete protection of minority shareholders. More explicit statutory provisions of oppression remedy will give the judges more specific directives and much more confidence in their judicial intervention, when it would become necessary.

6.4.2 The “Complainant”

The oppression remedy is one of the most important achievements of the post-1970 legislative reforms in Canada. It was appraised as “...beyond question, the broadest, most comprehensive and most open-ended shareholder remedy in the common law world...unprecedented in its scope.”²⁰³ One of the reasons for it to win such high praises is its generous grant to the status of complainant.

In the C.B.C.A., the oppression remedy is not just a remedy for minority shareholders.. Like the derivative action, it is a “Complainant” remedy. A qualified “complainant”, as is defined by Section 238 is the same as those who can bring a

majority shareholders or directors are infringing upon the rights of the minority shareholders in exercising their rights as majority shareholders or directors. The weakness in this provision is that the “rights” in the Constitution are usually narrower than what should be protected under the oppression remedy, and it might be too remote from the actual corporate case.

²⁰¹ For example, the Author has conducted extensive research in search of cases that are heard solely based on such abstract principles, but not a single such case was found in the area of corporate law.

²⁰² John J. Chapman, “Corporate Oppression: Structuring Judicial Discretion”, (1996) 18 *Advocates’ Quarterly* 170, at 181. Also, “The primary importance of the decision of the House of Lords in *Westbourne* is to reject the view of the Court of Appeal in that case that the petitioner must prove that the exclusion was not bona fide in the interests of the company or such that no reasonable man could consider it to be in the interests of the company.”

²⁰³ S. Beck, “Minority Shareholders’ Rights in the 1980’s” [1982] *Spec. Lect. L.S.U.C.* 311 at 312.

derivative action or sue for other forms of remedies such as the appraisal remedy, compliance and restraining order. Again, the range of “complainant” is very broad, covering even creditors, former shareholders, persons with contractual claims to be issued shares, directors, and dismissed employees.

Although the wide range of complainants seems to be working fine in the jurisdictions following the C.B.C.A., it may raise an even more disputable issue in China. We suggest that in the proposed oppression remedy provisions in the Company Law of China, the qualified complainants should only include current shareholders or former shareholders, excluding directors, officers, creditors or other security holders. In order to deal with exceptional cases, a residual power to grant discretionary complainants shall be given to the court. The reason for this “conservative attitude” is that a broad range of complainants might raise more problems in China. In remembering that the oppression remedy is almost a “revolution” in Canada, a country that is characterized by a long common law tradition with active and highly-qualified judges, the legislators in China should be more cautious in deciding the complainants. If the range of complainants is too broad, it may well create theoretic confusion and judicial chaos, and the predictability of civil activities may well be impaired. Besides, other domains of laws, such as contract law, serve to protect other complainants such as creditors, and the court has the residual power to discretionally grant complainant status. Therefore, people do not need to worry about the range of complainants being too narrow—actually although the range of complainants in the C.B.C.A. is quite wide, most of the complainants for oppression remedy are still shareholders.

6.4.3 “Oppression”

6.4.3.1 “Oppression” in the C.B.C.A.

241. (1) A complainant may apply to a court for an order under this section.

(2) If, on an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates

(a) any act or omission of the corporation or any of its affiliates effects a result,

(b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or

(c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner

that is *oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer*, the court may make an order to rectify the matters complained of. (*emphasis added*)

6.4.3.2 “Oppression” in Case Law

The definition of “Oppression” in *Scottish Co-operative Wholesale Society Ltd v. Meyer*²⁰⁴ was once very influential:

‘[The society] had the majority power and [it] exercised [its] authority in a manner *‘burdensome, harsh and wrongful’*—I take the dictionary meaning of the word. [Viscount Simonds]

Oppression under section 210 may take various forms. It suggests, to my mind...*a lack of probity and fair dealing* in the affairs of a company to the prejudice of some portion of its members. [Lord Keith of Avonholm]²⁰⁵ (*emphasis added*)

²⁰⁴ [1959] A.C.324, [1958] 3 All E.R. 66 (Scot., H.L.), at pp.342, 363 and 364

²⁰⁵ Some cases have provided for a helpful indicative list of the oppressive acts. “Although the highly fact-specific nature of the oppression remedy precludes anything like an exhaustive list of the factors suggesting oppression, Mr. Justice Austin in *Arthur v. Signum Communications Ltd.* Set out the following helpful catalogue: lack of a valid corporate purpose for the transaction; failure on the part of the corporation and its controlling shareholders to take reasonable steps to simulate an arm’s-length transaction; lack of good faith on the part of the directors of the corporation; discrimination among shareholders, with the effect of benefiting the majority shareholder to the exclusion or the detriment of minority shareholders; lack of adequate and appropriate disclosure of material information to minority shareholders; and a plan or design to eliminate a minority shareholders. See *Vanduzer supra* note 136 at 273-274.

However, the law has changed now. The Ontario Court of Appeal in *Brant Investments Ltd. v. Keeprite Inc.*²⁰⁶ specifically rejected lack of bona fides as the standard of oppression:

[A] requirement of lack of bona fides would unnecessarily complicate the application of the provision and add a judicial gloss that is inappropriate given the clarity of the words used.

[T]here will be few cases where there has not been some ‘want of probity’ on the part of the corporate actor where a remedy pursuant to [the oppression remedy section] will be appropriate. However, given the wording of the section...I do not consider it necessary that a finding of want of bona fides be made in every case where the court is disposed to grant a remedy.

Lord Wilberforce, in *Ebrahimi v. Westbourne Galleries*²⁰⁷, expressed a similar view. As was commented by Professor Boyle: “[t]he primary importance of the decision of the House of Lords in *Westbourne* is to reject the view of the Court of Appeal in that case that the petitioner must prove that the exclusion was not *bona fide* in the interests of the company or such that no reasonable man could consider it to be in the interests of the company.”²⁰⁸

Professor Welling emphasizes the consequence of the act as the standard by which to judge oppression: “...the oppression remedy sections are worded in terms of the consequences to the oppressed, not in terms of the character of the oppressors whose behavior brought about the consequences. This is consistent with the theory that shareholder expectations are the guiding principle of statute-based judicial intervention.”²⁰⁹

Similarly, according to another commentator, “arguments that the conduct complained of had to be ‘harsh, burdensome and wrongful’ or be in violation of a specific

²⁰⁶ [1991], 80 D.L.R. (4th) 161 (Ont. C.A.).

²⁰⁷ [1972] 2 All E.R. 492.

²⁰⁸ A.J. Boyle, *Minority Shareholders’ Remedies*, (Cambridge: Cambridge University Press, 2002) at 93.

²⁰⁹ Welling, *supra* note 2 at 557.

legal right were rejected...The *effect* on the complainant of the actions taken, *not the good or bad faith* of the respondents, was the relevant consideration...”²¹⁰.

6.4.3.3 Indicia of Oppressive Conduct

An indicative list of indicia of oppressive conduct would be very beneficial to the optimal application of the oppression remedy because (1) the legal community of China has traditionally stuck to the civil law tradition characterized by explicit statutory provisions and is not used to the more active role of a judge in trial; (2) the oppression remedy would be a completely new mechanism that might well cause much confusion and difficulty.

Although the highly fact-specific nature of the oppression remedy precludes anything like an exhaustive list of the factors suggesting oppression, Mr. Justice Austin in *Arthur v. Signum Communications Ltd.*²¹¹ Set out the following helpful catalogue:

- lack of a valid corporate purpose for the transaction;
- failure on the part of the corporation and its controlling shareholders to take reasonable steps to simulate an arm’s-length transaction;
- lack of good faith on the part of the directors of the corporation;
- discrimination among shareholders, with the effect of benefiting the majority shareholder to the exclusion or the detriment of minority shareholders;
- lack of adequate and appropriate disclosure of material information to minority shareholders; and
- a plan or design to eliminate a minority shareholders.”²¹²

²¹⁰ Chapman, *supra* note 201 at 181. It should be noted that although evidence of bad faith or want of probity is not essential to ground a finding of oppression, it can be an indicia of oppressive conduct. J.G. MacIntosh, “Bad Faith and the Oppression Remedy: Uneasy Marriage, or Amicable Divorce?” (1990), 69 Can. Bar Rev.276, discusses the issue in detail.

²¹¹ (1991), 2 C.P.C. (3d) 74 (Ont. Gen. Div.), aff’d [1993] O.J. No. 1928 (Div. Ct.) (QL)

²¹² Vanduzer, *supra* note 126 at 273-274.

Another useful hint, although not absolute, is that the oppressive conduct is often connected to the breach of the fiduciary duty by majority shareholders or directors. It is hoped that this hint and the indicia will help Chinese courts to more accurately judge oppressive conduct.

6.4.4 “Unfairly Prejudicial”

In Canadian corporate law, “[a]s to what “unfairly prejudicial” means, no one seems inclined to give particulars.”²¹³ In contrast, the English statutes and cases may provide more information for deciding “unfairly prejudicial”.

Section 459 (1) of the UK Companies Act 1985 allows a member to apply to the court by petition for an order when the company’s affairs are being conducted in a manner which is unfairly prejudicial to the interests of its members generally, or of a certain group of its members (including at least the petitioner), or that any actual or proposed act or omission on its behalf would be so prejudicial.

In an unreported case in 1981, Slade J.²¹⁴ gave this explanation of the term ‘unfair prejudice’:

Without prejudice to the generality of the wording of the section...a member of a company will be able to bring himself within the section if he can show that the value of his shareholding in the company has been seriously diminished or at least seriously jeopardized by reason of a course of conduct on the part of those persons who have had *de facto* control of the company, which is unfair to the members concerned. The test of fairness must, I think, be an objective, not a subjective one.

Again, the expressions “bad faith” and “lack of probity” were irrelevant, and the term “unfair prejudice” is seen to be an objective one.

²¹³ Welling, *supra* note 2 at 556.

²¹⁴ *Re Bovey Hotels*, unreported, 31 July 1981. Later cited with approval by Nourse J in *Re RA Noble (Clothing) Ltd*, [1983] BCLC 273 at 290-1.

Lord Hoffmann, in *O'Neill and Another v. Phillips and Others*²¹⁵, expressed his view of unfair prejudice:

In section 459 Parliament has chosen fairness...to free the court from technical considerations of legal right and to confer a wide power to do what appeared just and equitable. But this does not mean that the court can do whatever the individual judge happens to think fair. The concept of fairness must be applied judicially and the content which it is given by the courts must be based upon rational principles. As Warner J said in *In re JE Cade & Son Ltd* [1992] BCLC 213, 227: 'The court . . . has a very wide discretion, but it does not sit under a palm tree.'

Based on the fact that a company is an association of persons with the terms of this association contained in the articles of association or, sometimes, in collateral agreements between the shareholders, Lord Hoffmann concluded that "a member of a company will not ordinarily be entitled to complain of unfairness unless there has been some breach of the terms on which he agreed that the affairs of the company should be conducted." At the same time, Lord Hoffmann has also admitted that "[t]here will be cases in which equitable considerations make it unfair for those conducting the affairs of the company to rely upon their strict legal powers. Thus unfairness may consist in a breach of the rules or in using the rules in a manner which equity would regard as contrary to good faith." Therefore, Lord Hoffmann's view is strongly relying on Lord Wilberforce's *locus classicus* in *Ebrahimi v. Westbourne Galleries*.

Perhaps one word could be said here about the phrase "unfairly disregard the interest", although it would not be addressed in a separate section as it is less contentious. After the discussion of "oppression" and "unfair prejudicial", this concept should be easier to understand. One case interprets "Unfairly disregards the interests of" as "unjustly or without cause...pay no attention to, ignore or treat as of no importance the

²¹⁵ [1999] 1 WLR 1092, [1999] 2 BCLC 1

interests of [one of the people named]”.²¹⁶ It is also important to note the difference in the burden of proof: “the burden of proof of unfair prejudice or disregard is less rigorous than the burden of proof of oppression because, as stated, what is at issue is the unfair result not a state of mind. In a sense, these broader grounds have absorbed the oppression ground.”²¹⁷

For China to adopt the oppression remedy, the foregoing discussions might be helpful. Chinese judges can also use the general principle of fairness, or honesty and credibility that they are more used to.²¹⁸ In order to achieve a similar effect, they will need to understand such principles as “fairness”, not only from the conducts, but also from the consequences.

6.4.5 Reasonable Shareholder Expectations

While discussing the term “oppression”, the notion of “unfair prejudice” may provide useful hints, although a more helpful approach would be the “reasonable shareholder expectation”—which is also connected to the concept of “oppression” and “unfair prejudice”.

There has been ample judicial analysis of reasonable shareholder expectations. As was commented by Professor Welling, “[a] strong theme running through the authorities dealing with the oppression remedy is its emphasis on the protection of reasonable shareholders' expectations in the context of the shareholders' corporate relationship.”²¹⁹

In *Elrahimi v. Westbourne Galleries Ltd.*, Lord Wilberforce interpreted shareholder expectations as the following:

“Acts which, in law, are valid exercises of powers conferred by the articles may nevertheless be entirely outside what can fairly be regarded as having been in the contemplation of the parties when they became members of the company...[The statutory remedy], as equity always does, enable the

²¹⁶ *Stech v. Davies*, [1987] 5 W.W.R. 563 (Alta. Q.B.) at p. 569.

²¹⁷ Welling, *supra* note 172 at 483.

²¹⁸ This is the approach Lord Hoffmann mentioned in *O'Neill v. Phillips*: “Or one might, as in Continental systems, achieve the same result by introducing a general requirement of good faith into contractual performance.”

²¹⁹ Welling, *supra* note 172 at 479.

court to subject the exercise of legal rights to equitable considerations; considerations, that is, of a personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way.”²²⁰

Kerans J.A. emphasized on the interactive characteristic of the reasonable expectations in *Westfair Foods Ltd. v. Watt*: “One clear principle that emerges is that we regulate voluntary relations by regard to the expectations raised in the mind of a party *by the word or deed of the other*, and which the first party ordinarily would *realize* it was encouraging by its words or deeds. This is what we call reasonable expectations, or expectations deserving of protection.”²²¹

A similar view was expressed by Mr. Justice Farley in *Harold Ballard*.²²²

“Shareholder interests would appear to be intertwined with shareholder expectations. It does not appear to me that the shareholder expectations which are to be considered are those that a shareholder has as his own individual ‘wish list’. They must be expectations which could be said to have been (or ought to have been considered as) part of the compact of the shareholders.”²²³

There are sometimes, however, competing or conflicting expectations among the shareholders. Whose expectations shall prevail? In *820099 Ontario Inc. v. Harold E. Ballard Ltd.*²²⁴, three guidelines were posited by the trial judge for deciding the expectation to be protected and the remedy to be granted.

First, was the proposition that the oppression remedy had to be interpreted and applied in light of the other provisions of the OBCA and the law generally. Second, it was held that an expectation deserving of protection

²²⁰ *Ebrahimi*, at 379.

²²¹ [1991], 5 B.L.R. (2d) 160 (Alta. C.A.).

²²² [1991] 3 B.L.R. (2d) 113 at 185.

²²³ *Welling Casebook supra* note 173 at 479.

²²⁴ [1991], 3 B.L.R. (2d) 113 (Div. Ct.)

under the oppression remedy had to be more than the complainant's wish. In the phrasing used, the expectation had to be part of the 'compact' between the shareholders. Third, the court should interfere as little as possible and only to the extent necessary to redress the unfairness.²²⁵

The discussion on the reasonable shareholders' expectations culminated with Professor Welling's *Corporate Law in Canada: the Governing Principles*, in which he states the following opinion:

Thwarted shareholder expectation is what the oppression remedy is all about. Each shareholder buys his [or her] shares with certain expectations. Some of these are outlandish. But some of them, particularly in a small corporation with few shareholders, are quite reasonable expectations in the circumstances. It is not unusual for three or four individuals to go into business together with shared expectations of mutual profits, to use a corporate form as a convenient organizing vehicle, and to have a subsequent falling out. Individuals in such a situation are like the parties to a decaying marriage relationship: they cannot be expected to operate by friendly compromise in search of mutually satisfactory or 'fair' settlements of the many routine disagreements that can arise. The corporate vehicle that was once a convenience now becomes a prison with rigid rules for bars, a frame of reference for bad-tempered dispute settlement. The rules in a corporate constitution, like all legalistic rules, can become practical tools for dictatorship of the majority and oppression of the minority.

When this occurs, some measure of disinterested judicial activism can be useful. As the situation will usually (though not always) arise in smaller corporations one assumes that the oppression remedy was essentially designed for these corporations, where legitimate shareholder expectations are highly likely to exist, are unlikely to be set out on paper, yet are, because of

²²⁵ Summarized by Chapman. See Chapman, *supra* note 201 at 193-194.

the few parties involved, susceptible of objective proof in the usual legal manner. This, I suggest, is the place for the oppression remedy.²²⁶

After continuous judicial interpretations, the shareholder expectation as a guideline in determining oppression has been well established and clearly explained. The comments made by Professor Welling are excellent, and they can be used as a reference when China enacts for her own oppression remedy. The emphasis needed is: first, the “reasonable expectation” is not simply what a reasonable person may expect as a shareholder, and it should be “in the context of the shareholders’ corporate relationship”; secondly, the protection of reasonable shareholders’ expectations is more frequently required at closely held corporations, but publicly held corporations are not excluded—this deserves special mention because oppression on minority shareholders in the publicly held corporations in China is quite prevalent and it needs to be rectified urgently.

6.4.6 Remedies

6.4.6.1 General Remarks

“One of the most innovative features of the oppression remedy provisions is the unlimited flexibility granted to the court to fashion remedies.”²²⁷ Section 241 (3) of the C.B.C.A. provides:

In connection with an application under this section, the court may make any interim or final order it thinks fit including, without limiting the generality of the foregoing,

- (a) an order restraining the conduct complained of;
- (b) an order appointing a receiver or receiver-manager;
- (c) an order to regulate a corporation's affairs by amending the articles or bylaws or creating or amending a unanimous shareholder agreement;

²²⁶ Welling, *supra* note 2 at 564.

²²⁷ Vanduzer, *supra* note 126 at 278-279.

- (d) an order directing an issue or exchange of securities;
 - (e) an order appointing directors in place of or in addition to all or any of the directors then in office;
 - (f) an order directing a corporation, subject to subsection (6), or any other person, to purchase securities of a security holder;
 - (g) an order directing a corporation, subject to subsection (6), or any other person, to pay a security holder any part of the monies that the security holder paid for securities;
 - (h) an order varying or setting aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract;
 - (i) an order requiring a corporation, within a time specified by the court, to produce to the court or an interested person financial statements in the form required by section 155 or an accounting in such other form as the court may determine;
 - (j) an order compensating an aggrieved person;
 - (k) an order directing rectification of the registers or other records of a corporation under section 243;
 - (l) an order liquidating and dissolving the corporation;
 - (m) an order directing an investigation under Section XIX to be made;
- and
- (n) an order requiring the trial of any issue.

Professor Welling has grouped these broad remedies into four distinct categories:

1. Orders assisting the complainant in self-help within the existing power structure and ground rules.
2. Powers bailing out either the complainant or the corporation from a particular situation, but leaving intact the intra-corporate power structure and ground rules.

3. Orders realigning the power structure established in the corporate constitution.

4. Orders changing the ground rules themselves.²²⁸

Category 1 and 2 are more moderate measures and are applied more often. For example, the buy-out remedy, which is found in Category 2, is one of the most widely used remedies. Category 3 and 4 are more violent and extreme and are used only in rare cases.

The statutory language has clearly shown that “the oppression remedy also overlaps other minority protection devices, notably the compliance and restraining orders, statutory representative actions and “just and equitable” wind-ups.”²²⁹ In granting these various remedies, one general principle that is applicable is that in a petition for oppression remedy, the purpose is to “rectify” and not to “punish”.²³⁰ “The courts should be careful that any remedy granted did no more than redress any unfairness found.”²³¹ In the following paragraphs, the discussion will be concentrated on several issues that will certainly stimulate the need for more research, especially on the notions of “share purchase”, “compliance and restraining order” and “liquidation and dissolution”.

6.4.6.2 Share Purchase as the Main Remedy

“By far the most common remedy requested in oppression actions is the purchase by a corporation or a majority shareholder of the applicant’s shares. This remedy has been found to be appropriate where the parties have lost confidence in each other and their relationship has become unworkable.”²³²

²²⁸ Welling, *supra* note 2 at 559-560.

²²⁹ It should be noted that although the oppression remedy may overlap the derivative action (or the “statutory representative action” as is held by Professor Welling), it is brought in the name of the complainant and is a personal action. For more detailed discussions in this issue, see J.G. Macintosh, “The Oppression remedy: Personal or Derivative?” (1991), 70 Can. Bar Rev. 29.

²³⁰ *Nanef v. Con-Crete Holdings Ltd.* (1995), 23 O.R. (3d) 481 (C.A.)

²³¹ Chapman, *supra* note 201 at 189-190.

²³² Vanduzer, *supra* note 126 at 279, *Redekop v. Robco Construction Ltd.* (1978), 5 B.L.R. 58 (B.C.S.C).

Share purchase is not only an economic remedy, but also a moral one, as when the trust relationship among the shareholders has broken up like a decaying marriage, the most appropriate solution would be to give them the opportunity to peacefully part instead of binding them together. It is also particularly beneficial to deal with deadlocks or freeze-outs, in which the corporation is precluded from operating normally or where the minority shareholders in closely held corporations are excluded from reasonable participation in the management of the business and their economic value of the shares.

In granting the remedy for share purchase remedy, one of the issues that need to be considered is the “minority discount”, i.e., whether the shares of the aggrieved minority shareholders should be discounted because of their unfavorable status as minority shareholders. Boyle has provided some hints as to this issue:

In practice, the *pro rata* basis will be employed where the shares have been acquired on the incorporation of a quasi-partnership and it was expected the minority shareholders would participate in the conduct of the affairs of the company. The valuation will be on the discounted basis in such a company, where, in an exceptional case, the minority had acted so as to deserve exclusion. The valuation is naturally on a discounted basis where the shares are allotted or later acquired as an investment.²³³

This approach seems to be appropriate. It would be betraying the ultimate goal of minority protection if the shares of an aggrieved minority shareholder are discounted when nothing was done which deserved exclusion. This would constitute another form of oppression of minority shareholders. In the oppression remedy of China, the forgoing approach by Boyle should be followed.

Another cautious note might be appropriate: “The reliance interest is protected by protecting past contributions to value. No compensation is given for loss of future income or the loss of the expectation of future employment.”²³⁴ For example, if a minority shareholder who is also an employee is bought out, his or her request demand to

²³³ Boyle, *supra* note 207 at 108.

²³⁴ Chapman, *supra* note 201 at 202.

get compensations for the loss of income from the job for the remaining life should not be supported.

A more interesting issue, that of the valuation of the shares, will be discussed in detail in the next chapter: appraisal remedy.

6.4.6.3 Compliance and Restraining Order

In certain circumstances in which the oppression occurs because of the failure of the directors or the majority shareholders to perform what they are required to by statutes, a compliance and restraining order will be a simple and direct remedy. “In several cases, where there was a failure to prepare and distribute annual financial statements, hold annual meetings, or act in some other way required by the governing corporate statute, all of which effectively excluded a shareholder from a corporation, compliance with the statute was ordered.”²³⁵.

The compliance and restraining order can also be triggered by Section 247 of the C.B.C.A. “The C.B.C.A. and most other modern corporate statutes allow a complainant or a creditor to apply for a court order requiring compliance with or restraining a breach of the Act, the regulations, the corporation’s articles or by-laws, or a unanimous shareholder agreement. (C.B.C.A. Section 247)”²³⁶ This is also an indication of the overlap between the oppression remedy and the compliance and restraining order.

In the Company Law of China, the compliance and restraining order could largely be replaced by a suit for an injunction or declaration. This issue has been touched in Section 3.4.2.1 when discussing Article 111 of the Company Law. Since the suit for an injunction is generally not contentious or problematic, there seems to be no need to discuss it in detail. Actually, it is not advanced that this concept should be adopted because, in a legal transplant, it is generally not preferable to introduce a new concept when an indigenous one that can achieve the same effect is functioning well.

²³⁵ Vanduzer, *supra* note 126 at 280-281.

²³⁶ Vanduzer, *supra* note 126 at 282. Apart from compliance and restraining order under section 247, the court may also grant compliance as a remedy for oppression.

6.4.6.4 Liquidation and Dissolution

“...[W]here the parties’ relationship has completely broken down, liquidation and dissolution of the corporation may be the only remedy.”²³⁷ This remedy largely overlaps the “winding up” remedy provided in Sections 213 and 214, so they will be discussed together.

Because this is the most extreme remedy, the court will generally avoid using it: “[w]henver possible it would seem, a winding unfair prejudice order with all its potential for the destruction of an otherwise viable business and with harsh consequences for the innocent employees will be denied whenever a viable alternative remedy is available.”²³⁸

Liquidation and dissolution may also be triggered by an order of share purchase: “[a] share purchase may not be appropriate if neither the corporation nor the controlling shareholders are in a financial position to purchase the applicant’s shares. In such circumstances, where the parties’ relationship has completely broken down, liquidation and dissolution may be appropriate.”²³⁹

Liquidation and dissolution is the most powerful and extreme remedy. It is like a death sentence to a corporation, so it should be exercised only in situations in which there is not any other remedy that is appropriate for rectification. A cautious attitude is needed in granting this remedy.

6.4.7 Concluding Remarks

If the oppression remedy has been a “legislative revolution” in Canada, it may well bring about a judicial “earthquake” in China. On one hand, the oppression remedy is definitely beneficial and necessary; on the other hand, there should still be an awareness that the judicial and social challenges it will raise should not be underestimated. The

²³⁷ *Ibid.* at 280.

²³⁸ Boyle, *supra* note 207 at 104.

²³⁹ Vanduzer, *supra* note 126 at 279.

oppression remedy will require a constant balancing between fairness and judicial predictability. The judges will stand on the frontier of these challenges.

In view of the prevalent oppression of minority shareholders in the Chinese market and the benefits of the oppression remedy, it is clear that the oppression remedy should be enacted in China—even though it might bring about some problems, things could not become worse than they are now. After a short transitional period, a clear progress should be detected in the corporate governance and the judicial justice in general in China.

6.5 Appraisal Remedy

6.5.1 General Remarks

The appraisal remedy considerably overlaps the “share purchase” in the oppression remedy, so it is appropriate to discuss it following the oppression remedy.

According to Section 190 of the C.B.C.A., the dissenting minorities can sometimes force the corporation to buy their shares at either a mutually satisfactory or a judicially set “fair” price. Generally speaking, the holder of shares of any class may dissent if the corporation is subject to an order under paragraph 192(4)(d) that affects the holder or if the corporation resolves to:

- (a) amend its articles under section 173 or 174 to add, change or remove any provisions restricting or constraining the issue, transfer or ownership of shares of that class;
- (b) amend its articles under section 173 to add, change or remove any restriction on the business or businesses that the corporation may carry on;
- (c) amalgamate otherwise than under section 184;
- (d) be continued under section 188;
- (e) sell, lease or exchange all or substantially all its property under subsection 189(3); or

(f) out a going-private transaction or a squeeze-out transaction.

One general principle is that anything that can trigger a class vote under Section 176 also automatically triggers a right to dissent for the plaintiff in that class. This is the usual result of class veto in cases in which the majority of the affected class approves the amendment.

Among the situations listed in Section 190 of the C.B.C.A., most of them should be applicable when China enacts the oppression remedy. It should be noted that these changes should be coordinated with the enactment for classification of shares and class voting, otherwise the appraisal remedy would be unfounded.

For the “emigration” of corporations, it would usually not be a problem in China as a unitary state, except when the corporation resolves to emigrate overseas.

It can be found from the statutes that an “oppression” or “unfair prejudice” or “unfair disregard of interests” does not necessarily lead to the appraisal remedy, which can be triggered merely when the shareholders have different opinions on the fundamental issues. Therefore, “the appraisal remedy rarely is triggered unless a proposal is made to amend the corporate constitution.”²⁴⁰

In order to prevent the abusive use of the appraisal remedy, certain procedures must be followed. These include above all, a formal written objection by the dissenting shareholders to the resolutions that will bring fundamental changes to the corporation, and then the following correspondences and judicial procedures.²⁴¹

6.5.2 “Fair Value”

A more legally interesting topic would be the decision of “fair value” in granting the appraisal remedy.

²⁴⁰ Welling, *supra* note 2 at 575.

²⁴¹ In *Jepson v. Canadian Salt Col Ltd.* [1979] 4 W.W.R. 35, 99 D.L.R. (3d) 513 (Alta. S.C.), Laycraft J. offered an excellent summary of the procedures to trigger an appraisal remedy in the C.B.C.A.

6.5.2.1 Valuation Date

The first problem to determine is which day should be used as the valuation date.

Three possibilities were considered in *Re Whitehorse Copper Mines Ltd.; Hudson Bay Mining and Smelting Co. Ltd. v. Lueck*.²⁴²

- (I) The date of the takeover bid;
- (II) The last possible day to accept the offer price;
- (III) The date of the hearing.

The second possibility was chosen. The third was rejected because it was always uncertain in relation to the events involved, while the first was rejected because an offer could drag on for quite some time.²⁴³

For the same reasons, we agree with this approach by choosing “the last possible day to accept the offer price.”

6.5.2.2 Principles of Valuation

Professor Welling has examined the four conventional methods of assessing “fair value” in Canada: (1) net asset value; (2) market value; (3) investment or earning value; (4) some combination of the preceding three approaches.²⁴⁴

Professor Welling does not agree to the net asset value, saying,

The net asset value does not take into account the profit-making value of the corporation as a going concern. The figure arrived at will be unrealistic and may be too low. On the other hand it is arguable that net asset value gives a minimum figure at least, since the assets can always be sold off.²⁴⁵

²⁴² [1980], 10 B.L.R. 113 (B.C.S.C.), a buy-out action under s. 199(15) of the C.B.C.A.

²⁴³ Welling, *supra* note 2 at 581.

²⁴⁴ *Ibid.* at 582-589.

²⁴⁵ *Ibid.* at 583.

Generally, we agree with Professor Welling.

Professor Welling holds that market value is the simplest method and is good for large corporations whose shares are actively traded. In *Re Montgomery and Shell Canada Ltd.*,²⁴⁶ Estey J. held that the market value, instead of the asset value, of a common share should be used when a corporation is to continue as a going concern. This is certainly true before the facts of that particular case.

However, the market price is not universally applicable. In *LoCicero and Ravin v. B.A.C.M. Industries*²⁴⁷ O’Sullivan J.A. held that the market value was not the fair value in the case:

“What is to be valued is not the market value of shares or liquidation value of shares, but the overall fair value of the corporation & the attribution to the shares of an aliquot part of the overall value.”

Besides, when the market price is influenced by undue insider activities, the market price would not be a fair indication of the share value. Moreover, for most closely held corporations for which the market price is not usually available, the market price may also be in difficulty.

Investment or earning value is theoretically consistent with the value of shares, but is very difficult to calculate.²⁴⁸

Professor Welling summarized the fourth approach as follows: “[t]he fourth approach combines the first three in whatever way is thought appropriate to the particular corporation. It may be used where the first three methods generate wildly different results or in the case of a corporation with two entirely different types of operations or assets, each more easily valued by a different method”²⁴⁹

The fourth approach implies that there is no fixed rule for valuation—it will depend on the facts and circumstances of each case. Lambert J.A. in *Re Cyprus Anvil*

²⁴⁶ [1980], 111 D.L.R. (3d) 116 (Sask. Q.B.).

²⁴⁷ (1986) 38 Man. R. (2d) 134 (C.A.).

²⁴⁸ See Welling, *supra* note 2 at 584.

²⁴⁹ *Ibid.* at 584-585.

*Mining Corporation and Dickson*²⁵⁰ put an emphasis on this notion:

Each case must be examined on its own facts, and each presents its own difficulties...no method of determining value which might provide guidance should be rejected...but when all that has been done, the judge is still left only with a mixture of raw material and processed material on which he must exercise his judgement to determine fair value.

This flexible approach is undoubtedly correct, and may be followed by China. The guiding principle is just that share valuation is case-specific and needs special methods that are applicable to the particular cases.

It is suggested that when the valuation in a certain case poses special difficulties, or when the parties suggest or agree, the judge may sometimes appoint a qualified professional, such as an account or an auditor to value the shares and then examine the report by the professional.²⁵¹ This may bring a more accurate result and save the judicial cost to a large degree.

Another likely approach can be deduced in the decision of *O'Neill and Another v. Phillips and Others*, a case in which Lord Hoffmann listed some criteria to establish that a reasonable offer has been made: a competent expert acceptable to both parties may be an ideal authority to determine its value.

6.5.3 Summary

To summarize, the following suggestions can be made concerning the enactment by China of the appraisal remedy: this remedy is mainly triggered by fundamental changes in the corporate constitution or the rights of different classes of shares; the valuation date is the last possible day to accept the offer price; the valuation approach varies case by case and may often best be achieved by a combination of various

²⁵⁰ [1986], 33 D.L.R. (4th) 641 (B.C.C.A.)

²⁵¹ When reviewing the report of the professional, the judge may review it in the approach of an administrative decision or an expert witness. The Author suggests the later approach be taken to prevent from potential breach of duty by the professionals.

approaches; if the valuation is extremely complicated, the judge may find help from competent professionals that are to be either commonly agreed by the parties or appointed by the judge if a consensus can not be reached and, the judge will make the final decision as to the valuation.

6.6 Chapter Summary

In this chapter entitled “Shareholder Remedies” systematic proposals for shareholders’ remedies were made, rejecting the “right approach”.

The first priority for China in order to improve the protection of minority shareholders would be to improve the personal suits that can be brought by minority shareholders.

If, however, the harm is done to the corporation and not to the minority shareholders personally, a derivative action should be allowed, subject to certain conditions.

If the conduct of the majority shareholders or the directors is technically lawful but oppressive on minority shareholders, the oppression remedy shall be allowed. The Author discussed the concepts of “oppression” and “unfair prejudice”, and tried to explain the oppression remedy through “reasonable shareholders' expectations”. The remedies that can be granted in a suit for oppression remedy are very broad and overlap considerably with other minority protection devices.

The appraisal remedy was discussed at the same time as the oppression remedy. Here the Author mainly discussed the principles of share valuation.

These systematic remedies would improve the protection of minority shareholders to a large degree, but to realize them raises considerable challenges in a broader social context. After balancing the pros and cons, the Author proposes to take a positive attitude and provide for the remedies as soon as possible.

7.0 Conclusion

In this thesis, two major tasks were carried out. First, the defects of the protection of minority shareholders in the Company Law of China were discussed. Secondly, some mechanisms in other legal systems that were designed to protect minority shareholders were examined, and proposals to reform the Company Law of China were made.

The defects were mainly characterized by the two facts: first, the inability of the minority shareholders to deal with dual oppression by both the managerial power and the majority rule; secondly, the difficulties for them to seek for remedies through lawsuits.

Proposals for reform were made in these aspects, respectively. First, the proposed mechanisms to protect minority shareholders from managerial power mainly included the rights of minority shareholders to convene the shareholders' general meeting and to propose resolutions. Secondly, the imposition of a fiduciary duty of majority shareholders towards minority shareholders was proposed, as well as cumulative voting and class voting as the mechanisms to mitigate the absolute majority rule in Chinese Company Law. Thirdly, much significance was attached to the remedies available to minority shareholders through lawsuits, including the direct suit, the derivative action, the oppression remedy, the appraisal remedy, the remedy of liquidation and dissolution, and the compliance and restraining order.

This thesis finishes here, but the efforts to improve minority protection in China do not.

A mechanical legal transplant is not difficult, but by manner by which to adapt the well-accepted experiences from other traditions to the social reality of China remains a tougher task, whose result remains to be seen. Improving minority shareholders protection is not only a shareholder remedy issue, but also an issue of judicial reform, social justice and rule of law—it is broader, deeper, and more important than the literal interpretation of this thesis title carries. It is even not only a legal issue, but also a political, economical, and cultural one that invites continuous research and heated debates.

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