Make or Buy – A New Look for Derivative Action Costs in Chinese Law for a More Enabling Environment

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Abstract

Derivative actions in modern company law play a crucial role in protecting shareholders and promoting the soundness of corporate governance. However, since China's inauguration of derivative action there have been complications surrounding cost-related issues, especially for joint stock limited liability companies. This article focuses on a key element of the derivative action mechanism in China, namely the litigation fee. Despite the fact that fee-related issues have been addressed in the recent Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (IV), the provisions failed to address some important aspects in detail, especially in relation to a more effective system for the filing and attorneys' fees. In order to maximize the effectiveness of derivative action and help the mechanism reach its full potential, it is crucial to make sure that litigation costs are tailored to a level that does not discourage shareholders from bringing these actions. This article aims to address the following related questions: are current fee-oriented stipulations in China hindering the effectiveness of derivative action? If so, could Chinese Company Law learn from legislative experiences from the UK, the US, and Japan to address the problem of insufficient incentives for shareholders to bring derivative actions? Through doctrinal and comparative analysis, we will explore the possibilities of establishing a more effective approach unique to China, considering its shareholding structure, corporate law, juridical system, culture, history, legal profession, and professional ethics. A fixed filing fee approach and a contingency fee arrangement supported by a common fund and substantial tests are proposed.

"The biggest problem of derivative actions in China is not too many lawsuits, but too few of them."[1]

INTRODUCTION

The "proper claimant rule" has been established as a key principle of corporate law since *Foss v. Harbottle*,[2] holding that if a company has a cause for action against someone, then the company itself and no one else must bring proceedings in relation to that cause of action. Shareholder derivative action is an exception to this general rule, and this mechanism is

1. JUNHAI LIU (刘俊海), XIANDAI GONGSI FA (现代公司法) [MODERN CORPORATION LAW], 412 (3rd ed., 2015). (〈我国当前面临的最大问题不是股东代表诉讼太多了，而是股东代表诉讼太少了〉)

2. Foss v. Harbottle (1843) 67 Eng. Rep. 189.

provided for in common law and via a scheme for statutory derivative proceedings.[3] This scheme has been seen as a useful tool to both mitigate the dominant power of controlling shareholders and curb opportunistic behaviors by boards of directors.[4] Following this trend, derivative action was introduced to China with high expectations in Article 151 of the CCL 2005, in the form of a short provision:

> [T]he shareholders in the case of a limited liability company, or a shareholder that has independently held, or the shareholders that have held in aggregate, 1% or more of the shares of the company for more than 180 consecutive days in the case of a company limited by shares, may request in writing the board of supervisors . . . to institute proceedings with the people's court; where the supervisors fall under the circumstance set forth in Article 150 hereof, the foregoing shareholders may request in writing the board of directors or, the executive directors, in the case of a limited liability company without a board of directors, to institute proceedings with the people's court.[5]

This provision was wholly preserved in the 2013 Company Law reform and remains in full force today.[6] The focus of this Article is on the cost element of such actions in China, which may deter the commencement of proceedings. The enactment of the derivative action mechanism is expected to be actively and effectively applied by shareholders to protect their legitimate interests.

The most regularly suggested reason for the scarcity of derivative litigation in China is the absence of incentives to bring such lawsuits.[7] The rule in *Foss v. Harbottle* is said to be "essentially an issue of costs."[8] The litigation cost is described as "a major obstacle" when "minority shareholder[s] bring[] a derivative action on behalf of [a] company."[9] Prospective claimants may consider a few issues, including the size of the litigation fee at stake, the legal costs, and the likelihood of success in deciding whether to advance a lawsuit.[10] Logically speaking, litigation would only be rational where the sums recoverable and the chances of success exceed the costs of legal expenses and the probability of losing the action. The unique nature of derivative actions, as legal actions on behalf of companies that indirectly benefit the claimants, makes it even more important to make sure the funding issue does not hinder the initiation of litigation against wrongdoing directors or majority shareholders.

3. Edwards v. Halliwell [1950] 2 All ER 1064 (UK). The scheme has also been adopted in the US, Canada, Australia, New Zealand, Ghana, South Africa and Singapore.

4. *See* STOYAN TENEV ET AL., CORPORATE GOVERNANCE AND ENTERPRISE REFORM IN CHINA: BUILDING THE INSTITUTIONS OF MODERN MARKETS 148-49 (World Bank and the International Finance Corporation) (2002) (discussing enforcement of the rights of minority investors).

5. Company Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong. Dec. 28, 1993, effective Mar. 1, 2014) art. 151.

6. *Id*.

7. Hui Huang, *Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis*, 27 BANKING & FIN. L. REV. 619, 650 (2012).

8. D.D. Prentice, *Wallersteiner v. Moir: The Demise of the Rule in Foss v Harbottle?* 40 CONV. & PROP. LAW. 51, 58 (1976).

9. ARAD REISBERG, DERIVATIVE ACTIONS AND CORPORATE GOVERNANCE: THEORY AND OPERATION 222 (2007).

10. Huang, *supra* note 7, at 646.

Since the implementation of the Chinese Company Law 2005, almost all claimants in derivative action cases have been shareholders in limited liability companies (LLCs).[11] There has been only four lawsuits brought by shareholders of a joint stock liability company (JSLC)). Three of them were bought in unlisted JSLCs.[12] There is only one unreported case in listed JSLC, which was subsequently accepted by the Shandong Higher People's Court on December 11th, 2009 with a fixed hearing date of January 29th, 2010.[13] However, the board of Sanlian Group raised a jurisdiction objection because this was the first case of derivative action in China for shareholders in JSLCs, with a high damages claim of 50 million Yuan.[14] The board argued that the Supreme People's Court was the appropriate jurisdiction for the case. However, this request was rejected by the SPC, and subsequently the Shangdong Court suspended the case because the result of the case depended on the trial of another case. It implies that shareholders in JSLCs are either extremely reluctant or have encountered significant difficulties in bringing cases of litigation on behalf of their companies. The derivative action legal mechanism has been criticized as "no more than window dressing . . . for shareholders in JSLCs in China."[15] This article critically evaluates the effectiveness of the mechanism and explore the possibilities of encouraging shareholders to raise cases by introducing reduced, more predictable fees, probably from other sources.

In terms of difficulties, issues such as the appropriateness of thresholds, including shareholding period and shareholding ownership percentage requirements, have been discussed elsewhere.[16] The unique nature of derivative action means the incentives for bringing these actions are challenging, since the mechanism allows shareholders to bring lawsuits as nominal claimants, while the company is the actual claimant in terms of the fundamental interests of successful litigation.[17] In other words, the shareholder as claimant could benefit from a slice of the success of a derivative action based on the fact that the value of his or her shares may grow pro rata as the assets of the company increase leading to hypothetical benefits. Nevertheless, disproportionate and inappropriate litigation fees may affect the popularity of derivative actions, especially among those who own relatively low percentages of shares and who may have limited resources, information, and voice in the

11. *Id*. at 631.

12 *Gushanhua yinsu xianggang shengxun qiye youxian gongsi*、*zhenjiang babaiban shangmao youxian gongsi ji disanren Zhenjiang baihuo gufen youxian gongsi sunhai gongsi liyi an* (2016) Suminzhong 217 Hao (顾善华因诉香港盛迅企业有限公司、镇江八佰伴商贸 有限公司及第三人镇江百货股份有限公司损害公司利益案（2016）苏民终 217 号) [(*Gu Shanhua v Hong Kong Shengxun Enterprise Co., Ltd. et al*. (SuMinZhong No. 217)]; *Yuangao kaiming jianzhudeng yu beigao huangdayindeng sunhai gongsi liyian* (2017) Yu 0110 Minchu9690 hao (原告凯明建筑等与被告黄达银等损害公司利益案 (2017) 渝 0110 民初 9690 号) [Kaiming Construction et al. v Huang Dayin et al. (2017 Yu 0110 MinChu No. 9690)]; *Yuangao huangcongfudeng yu beigao huangrunguodeng sunhai gongsi liyi zeren jiufen yi an* (2016) Xiang 1022 Minchu 711 Hao (原告黄丛付等与被告黄润国等损害公司利益责任纠纷一 案（ 2016）湘 1022 民初 711 号) [Huang Congfu et al. v Huang Runguo et al. (2016, Xiang 1022 MinChu No. 711)]

13. *Huangweihongdeng su shandong sanlian jituan youxian zeren gongsi qinfan shangbiaozhuanyongquan jiufenguanxiaquan yiyian* (2010) Minsanzhongzidi 5 Hao (黄伟宏等诉山东三联集团有限责任公司侵犯商标专用权纠纷管辖权异议案 (2010) 民三终字第 5 号) [*Huang Hongwei et al. v. Shangdong Sanlian Group* (2010 MinsanZhongZi No. 5)]. The case involves an attempt by the claimants, seventy-eight shareholders of *Sanlian Shangshe*, to bring a derivative claim against the former controlling shareholder.

14. *Id*.

15. Jingchen Zhao & Shuangge Wen, *The Eligibility of Claimants to Commerce Derivative Litigation on Behalf of China's Joint Stock Limited Companies*, 48 H.K.L.J. 687, 694 (2018).

16. *See id*. (detailing eligibility of shareholders in LLCs and JSLCs to bring derivative action).

17. SHAOWEI LIN, DERIVATIVE ACTION IN CHINESE COMPANY LAW 175 (2015).

company as a result.[18] Therefore, these fee-related issues are strong disincentives for claimant shareholders to launch derivative actions.

Unlike in common law countries such as the UK, where inadequacies may be alleviated by case law[19] and corresponding procedure rules,[20] the legislative legal basis of the legal costs of derivative action in China rest on the Civil Procedure Law 1992, Measures for the Administration of Attorneys' Fee 2006, supplemented by the Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China IV (Provision IV).[21] The usual rule is that the losing party will be ordered by the court to pay the winning party's case acceptance fee, the fee charged by the court that tries the case, while each party pays its own attorney's fees and other expenses.[22] Provision IV provides that the company should indemnify a shareholder who brings a derivative action directly, or the claim should be partially or fully supported by the People's Court.[23]

It is crucial to make sure that litigation costs are tailored to a level that does not further discourage shareholders from bringing these actions so that the scheme can "reach its full potential."[24] Constructive and feasible proposals are in urgent need to address problems of fee-related issues. This article aims to address three inter-related and incremental questions: are current fee-oriented stipulations in China hindering the effectiveness and enforcement of derivative action in China? If so, could Chinese Company Law learn from legislative experiences from the UK, the US, and Japan to address the problem of insufficient incentives for minority shareholders to bring derivative actions? More importantly, should China directly transplant a proven, successful, and academically grounded legislative exercise? Or should a unique approach be adopted in China considering its unique shareholding structure, corporate law, juridical system, culture, history, legal profession, political, and social institutions, and professional ethics of lawyers and judges? A complex interplay between a transplant process and socio-cultural forces may well cause the transplant process to be far from straightforward. This Article aims to establish a balanced and effective approach,

18. *See* Wei-qi Cheng, *Protection of Minority Shareholders after the New Company Law: 26 Case Studies*, 52 INT'L J. L. & MGMT. 283, 285 (2010) ("hurdles that minority shareholders may have to overcome when they decide to lodge a direct or a derivative action such as the difficulty of collecting crucial evidence and the huge litigation fees that shareholders may have to pay"); *see also* Benjamin Liebman, *Class Action Litigation in China*, 111 HARV. L. REV. 1534 (1998) (discussing the use of class actions in the Chinese legal system and the associated fees and costs).

19. *See*, *e.g.*, Wallersteiner v. Moir (No 2) [1975] 1 All ER 849 at 850 (Eng.); Carlisle & Cumbria United Independent Supporters' Society Ltd. v. CUFC Holdings Ltd. [2010] EWCA (Civ) 463 [12–29]; Stainer v. Lee [2010] EWHC (Ch) 1539 [30-55].

20. Civil Procedure Rules 1980, c. 58 (Eng.), http://justice.gov.uk/courts/procedure-rules/civil /rules/part19#text1.

21. *Measures for the Administration of Attorneys' Fees*, Sup. People's Ct., Dec. 5, 2016, effective Sept. 1, 2017.

22. *Susong Feiyong Jiaona Banfa* (诉讼费用交纳办法) [Measure on Payment of Litigation] (2007), art. 29 (China).

23. *Zuigao renmin fayuan guanyu shiyong <zhonghua renmin gongheguo gongsi fa> ruogan wenti de guiding (si)* (最高人民法院关于适用＜中华人民共和国公司法＞若干问题的规定（四)) [Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (IV)], art. 26.

24. Hui Huang, *The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform,* 4 BERKELEY BUS. L. J. 227, 248 (2007).

through theoretical and comparative analysis, in order to eliminate the obstacles that hinder the smooth operation of derivative action and protect the interests of the company and shareholders.

This original comparative attempt may enhance our knowledge and understanding of the topic and improve the utility of derivative action in China.[25] The research is important in putting forward proposals to alter the situation whereby a shareholder "has nothing to gain but much to lose."[26] The research is significant in terms of enabling healthy numbers of shareholders to launch derivative suits against companies, especially among minority shareholders in JSLCs. These questions should be an essential primer for legal practitioners, in-house counsel, shareholders, members of supervisory boards, and legal theorists who are working in the field—not only in China but also globally. Since the initiation of China's "One Belt, One Road" (OBOR) intercontinental trade and infrastructure initiative in 2013, shareholder protection, including for foreign investors, has become a significant issue beyond the domestic market, with international implications and impact.[27]

First, I will critically review the how fee-related issues in derivative actions can protect shareholders. Then I will turn to the Japanese approach to filing fees. Japan was chosen in relation to this discussion since a sliding scale mechanism was originally adopted in China mirroring the conventional Japanese approach. However, reform has taken place since the *Nikko Securities* case in Japan,[28] and the new approach has not been followed in China. Then I shall look at the US and the UK approaches respectively. The Chinese and US systems take a similar approach to attorneys' fees. The UK system in Commonwealth countries includes a few jurisdictions in that share similar geographical locations and cultures with China such as Singapore and Hong Kong. The approach, which has encouraged derivative action and been applied effectively by shareholders, will be particularly discussed. Finally, I will develop the most suitable approach for China, discussing multi-dimensional factors.

I. THE IMPORTANCE OF THE FEE ISSUE TO PROMOTE THE EFFECTIVENESS OF DERIVATIVE ACTION

The critical issue in relation to corporate governance in China rests on how to enhance legal deterrence.[29] With the inherently weak public enforcement of law in China and the incomplete picture of private enforcement mechanisms such as securities fraud class action, derivative action is a mechanism which carries high expectations from both government and shareholders in order to enhance corporate governance in China. [30] Derivative action, as a legal deterrent, should be given a prominent position. A unique feature of this deterrent is that the claimant does not enjoy relief and compensation from the litigation directly. Instead,

25. MATHIAS M. SIEMS, COMPARATIVE LAW 3-4 (2nd ed. 2018).

26. Wallersteiner v. Moir (No 2) [1975] 1 All ER 849 (Eng.).

27. Foreign direct investment grew the most in 2018 and 2019 and was up 5.8% year-on-year to 941.5 billion yuan ($136.71 billion) in 2019. *China says its foreign direct investments increased 5.8% in 2019* () see https://www.cnbc.com/2020/01/21/china-says-its-foreign-direct-investments-increased-5point8percent-in-2019.html, CNBC (Jan. 20, 2020).

28. Tōkyō Kōtō Saibansho [Tokyo High Ct.] Mar. 30, 1993, 101 SHIRYŌBAN SHŌJI 70 (Japan).

29. *See generally* Zhong Zhang, *Legal Deterrence: The Foundation of Corporate Governance—Evidence from China,* 15 CORP. GOVERNANCE: AN INT'L. REV. 741 (2007).

30. *See* Qiao Liu, *Corporate Governance in China: Current Practices, Economic Effects, and Institutional Determinants,* 52 CESIFO ECON. STUD. 415-16 (describing the weak public enforcement of law in China).

recoveries from the action will go to the company.[31] Furthermore, derivative action may add additional burdens to companies.[32] Companies may suffer collateral harm, including monetary and non-monetary harms such as unwanted publicity disclosures and negative long-term reputation damage, which could outweigh any gains from the litigation.[33]

In addition to these obstacles, funding issues are central to encouraging eligible and sincere shareholders to bring legitimate actions, in order to promote the long-term interests of the company. The mechanism's effectiveness in constraining managerial misconduct is highly doubtful if these obstacles cannot be removed. These unique lawsuits brought by claimants will encounter obstacles to its initiation if we cannot position appropriate and reasonable rules to settle funding issues.

The cost of litigation is not a problem for derivative action in China alone. It is an issue in a number of jurisdictions due to the nature of the litigation, and related rules will have a direct impact on the popularity of this type of action. For example, private shareholder actions are an integral part of corporate governance in the US because the rules governing litigation costs promote lawsuits.[34] However, this is not the case in the UK, where the litigation costs rules discourage lawsuits.[35]

UK, US, and Japan are chosen to act as examples here due to the fact that these three jurisdictions represent three main approaches in practice to deal with issues surrounding funding derivative actions.[36] Another reason that these jurisdictions have been selected is that derivative actions are relatively popular in the US, UK, and Japan. In UK the popularity of derivative actions is reflected in the proportion of cases at public companies versus those with private companies, which is a major concern in China in relation to JSLCs.[37] However, it should be noted that more well-adjusted figures in other jurisdictions could be regarded as the result of multiple factors, such as mitigated thresholds through legal reforms, litigation costs, and court permission as a threshold.

In Japan, where the shareholding percentage is not a requirement for bringing a derivative action, derivative actions involving publicly held companies have exceeded those involving closed companies since 1993.[38] It is reported that 119 derivative actions were brought against listed companies in Japan from 1993 to 2009.[39] In the US, many cases involve

31. *See* Spokes v. The Grosvenor & W End Ry. Terminus Hotel Co. Ltd. [1897] 2 Q.B. 124 (UK); Prudential Assurance Co Ltd v. Newman Industries Ltd No 2 [1982] 2 Q.B. 221 (UK) (holding that recoveries must be distributed to companies).

32. *Id*.

33. REISBERG, *supra* note 9, at 47–48.

34. John Armour et al., *Private Enforcement of Corporate Law: An Empirical Comparison of the US and UK*, 6 J. EMPIRICAL LEGAL STUD. 689, 690 (2009).

35. *Id*.

36. Jingchen Zhao, *A More Efficient Derivative Action System in China: Challenges and Opportunities through Corporate Governance Theory*, 64 N. IR. LEGAL Q. 233, 243 (2013).

37. *See* Wendy Wu, *China's top state-run firms told to become joint stock corporations by year's end*, SOUTH CHINA MORNING POST (Sept. 23, 2019), https://www.scmp.com/news/china/economy/article/2104239 /chinas-top-state-run-firms-told-become-joint-stock-corporations (describing efforts made by the Chinese government to increase the presence of JSPC's and thereby attract a greater number of private investors).

38. Shiro Kawashima & Susumu Sakurai, *Shareholder Derivative Litigation in Japan, Law, Practice and Suggested Reforms*, STAN. J. INT'L L. 9, 21 (1997).

39. Dan W. Puchniak & Masafumi Nakahigashi, *Japan's Love for Derivative Actions: Irrational Behavior and*

public companies. The empirical research conducted by Tompson and Thomas showed that derivative actions against listed firms have been regarded as a common issue historically, based on research on a sample of 535 public corporations.[40] In the limited evidence from the UK, three cases,[41] namely *Bridge v. Daley*,[42] *Eckerle v. Wickeder Westfalenstahl GmbH*,[43] and *BNP Paribas SA v. Open Joint Stock Company Russian Machines*,[44] have involved public companies.

II. THE CURRENT LAW FOR COURT FEES FOR DERIVATIVE ACTION IN CHINA AND THE JAPANESE EXPERIENCE: CHALLENGES AND OPPORTUNITIES

Chinese civil procedure has not been directly transplanted from any mainstream legislative approach, such as the approaches used in UK, US, Japan, or in Taiwan, which has a quasi-public foundation with the function of bringing such actions.[45] The fundamental rule currently applied in Chinese civil procedure is that the loser pays the court fees, whereas the attorneys' fees are borne by their respective parties.[46] This is also confirmed in the sample study by Clarke and Howson of fifty cases in China, which showed that court fees are generally allocated to the loser, while it failed to reveal how attorneys' fees are allotted between the parties.[47]

Current Chinese law and regulations on both civil litigation filing fees and attorneys' fees have been factors that deter shareholders from bringing derivative claims on behalf of companies.[48] As far as court fees are concerned, the rule on these fees is set by the Measure

Non-Economic Motives as Rational Explanations for Shareholder Litigation, 45 VAND. J. TRANSNAT'L L. 1, 69 (2012).

40. Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55, 59 (1991); *see* Robert Thompson & Randall Thomas, *The Public and the Private Faces of Derivate Lawsuits*, 57 VAND. L. REV. 1747, 1749 (2004) (describing general outcomes of derivative lawsuits); *see also* Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996); *In re* The Walt Disney Company Derivative Litigation, 825 A.2d 275 (Del. Ch. 2003); *In re* Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch. 2003); *In re The Walt Disney Company Derivative Litigation*, 906 A.2d. 27, 62-67 (Del. 2006) (providing more concrete examples of derivative lawsuits and judicial interpretations).

41. *See* Andrew Keay, *Assessing Rethinking the Statutory Scheme for Derivative Action under the Companies Act 2006*, 16 J. CORP. L. STUD. 39, 41 (2016) (noting that since the enforcement of Section 260 of the Companies Act 2006 on October 1, 2007, the regime of derivative action has not been used and that 22 derivative actions were instituted up to September 2015); *see also* Brannigan v. Style [2016] EWHC 512 (CH) (citing to the only other reported case up to June 2016). Twenty-three derivative actions have been instituted up to June 2016.

42. Bridge v. Daley [2015] EWHC 2121 (UK).

43. *Eckerle v. Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (CH) (UK).

44. *BNP Paribas S.A. v. Open Joint Stock Co. Russian Machines* [2011] EWHC (Comm)308[1] (UK). In this case, the first defendant, Open Joint Stock Company Russian Machines, and the second defendant, Joint Stock Asset Management Company Ingosstrakh-Investments, are Russian companies.

45. *See* Wang Ruu Tseng & Wallace Wen Yeu Wang, *Derivative Actions in Taiwan: Legal and Cultural Hurdles with a Glimmer of Hope for the Future*, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 215, 240–241 (Dan W. Puchniak et al. eds., 2012) (discussing the role of the government-sanctioned Securities and Futures Investors Protection Center (SFIPC) in Taiwanese derivative actions).

46. *Susong Feiyong Jiaona Banfa* (诉讼费用交纳办法) [Measure on Payment of Litigation] (2007), arts. 6, 29 (China).

47. Donald C. Clarke & Nicholas C. Howson, *Pathway to Minority Shareholder Protection: Derivative Action in the People's Republic of China*, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 243, 287 (Dan W. Puchniak et al. eds., 2012).

48. *Id.* at 258–259.

on Payment of Litigation (*Susong Feiyong Jiaona Banfa*) 2007.[49] Court fees consist of filing fees, application fees and court expenses.[50] In detail, filing fees (case acceptance fees) are the fees that every claimant needs to pay within seven days upon a notification issued by the court.[51] Application fees are the expenses of applying for the enforcement of judgement and mediation by the People's Court and taking preservation measures, such as a payment warrant, a public summons, or insolvency, among others.[52] Court expenses include "the travel expenses, accommodation expenses, living expenses, and subsidies for missed work, which are incurred by witnesses, authenticators, interpreters, and adjustment makers for their appearance in the People's Court on designated dates."[53]

In practice, application fees and court expenses are charged based on the amounts that are incurred. Such fees are generally low, and they are not the concern of this article.[54] However, according to Article 29 of the Measure, a major part of the cost of the litigation is the case filing fee, which is based on the "loser pays" rule.[55] In the scenario of a derivative action, if a shareholder wins the case, he or she could recover the fees from the company. However, if the lawsuit is unsuccessful, the shareholders may have to bear the costs personally. This is confirmed by Provision IV, which clarifies that companies will only indemnify shareholders in claims that are partially or entirely supported by the Court.[56] Furthermore, reasonable costs in Provision IV may not include the filing fee.[57] The filing fee is calculated in two ways according to the nature of the case, based on whether the case is a litigation against a property claim.[58] Where the nature of the claim is property-oriented with a monetary nature, a sliding scale will be adopted, whereas a fixed fee will be charged for non-property claims that are not monetary in nature.[59] Derivative actions may be seen as litigation brought by shareholders on behalf of companies for damages when the board of directors or majority shareholders engage in misconduct.[60] In such derivative actions a sliding scale is adopted.[61]

This approach is similar to the litigation calculation rules adopted in Japan before the 1993 Commercial Code, where a sliding scale system was adopted.[62] This means that the

49. *Susong Feiyong Jiaona Banfa* (诉讼费用交纳办法) [Measure on Payment of Litigation], art. 6, 2007.

50. *Id*.

51. *Id.* art. 22.

52. *Id.* art. 10.

53. *Id.* art. 6(3).

54. SHAOWEI LIN, DERIVATIVE ACTIONS IN CHINESE COMPANY LAW 128 (2015).

55. Susong Feiyong Jiaona Banfa (诉讼费用交纳办法) [Measures on the Payment of Litigation Costs] (promulgated by the St. Council, Dec. 7 2006, effective Apr. 1, 2007) art. 29, ST. COUNCIL GAZ., Dec. 19, 2006, http:// www.gov.cn/zwgk/2006-12/29/content_483407.htm (China).

56.

57. *Id*.

58. *Susong Feiyong Jiaona Banfa* (诉讼费用交纳办法) [Measure on Payment of Litigation], art. 13, 2007.

59. *Id*. art. 13 (1)-(5)

60. Harald Baum & Dan W. Puchniak, *The Derivative Action: An Economic, Historical, and Practice-Oriented Approach*, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 1, 7–8 (Dan W. Puchniak et al. eds., 2012).

61. *Susong Feiyong Jiaona Banfa* (诉讼费用交纳办法) [Measure on Payment of Litigation], art. 13, 2007. See also GIOVANNI PISACANE, CORPORATE GOVERNANCE IN CHINA: THE STRUCTURE AND MANAGEMENT OF FOREIGN-INVESTED ENTERPRISES UNDER CHINESE LAW (2017)

62. *See* Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351, 355 (2001)

litigation fee is charged in proportion to the amount of damage the plaintiffs seek in the claim. According to Article 13(1) of the Measure, renminbi (RMB) 50 shall be paid for each case seeking damages of no more than RMB 10,000.[63] After the initial RMB 10,000, different percentages (starting at 2.5%) of the damages sought (starting from amounts between RMB 10,000 and 100,000) will be charged for different damage amounts.[64] The lowest percentage of 0.5% will be charged for damages of more than RMB 20 million.[65] In derivative actions, the claimants may have to pay huge amounts in litigation fees if the claimed damages are high. This is particularly likely to be the case for listed companies due to their size, capitalization and the seriousness of potential damages caused by directors' misconduct. In a hypothetical but realistic case, a claim of RMB 25 million will result in a fee of RMB 125,000 (approximately US dollar (USD) 17,000), which seems unreasonable and unaffordable for a shareholder, especially for a minority shareholder or a group of minority shareholders, in a collective action. If the court supports the claim, either fully or partially, at the first instance and no appeal is raised by the defendant, the shareholder could recover the fees from the defendant. This may not be the end of the journey for the court fees, however, because the plaintiff shareholder may still need to pay an additional sum of RMB 25,000 for the enforcement of the judgment.[66] In *Zhejiang Hexin Electricity Power Development Ltd* (浙江和信电力开发有限公司), the shareholders' claim resulted in total court fees of RMB 1,802,760 (approximately USD 255,701).[67] In *Zhongqi qihuo jingji youxian gongsi* (中期期货经纪有限公司) a claim of more than RMB 164 million (approximately USD 23.5 million) resulted in a litigation fee of RMB 830,000 (approximately USD 117,000).[68] Clearly, this fee would be extremely difficult for shareholders to pay if they were not financially solvent.

Another controversial case concerning the high cost of litigation is *Hongshi Shiye youxian zeren gongsi* (红石实业有限责任公司), in which the plaintiff lowered the amount of the claim because of the exorbitant litigation costs.[69] In this case three individual litigant shareholders (Gang Wang, Guanxue Xie and Jun Yao), brought a litigation against Pan Shiyi, a major shareholder, CEO, general manager, and legal representative of the company. They claimed that he did not execute adequate due diligence in looking after the company's assets. The filing fee was RMB 500,000 (approximately USD 71,000) based on their monetary

(discussing how litigation fees based on a sliding scale posed a roadblock to shareholder litigation prior to 1993).

63. Susong Feiyong Jiaona Banfa (诉讼费用交纳办法) [Measure on Payment of Litigation], art. 13(1), 2007.

64. *Id.*

65. *Id.*

66. *Id.* art. 14(2) (stipulating that if the enforceable amount or price is not more than 10,000 Yuan, 50 Yuan shall be paid for each case; if from 10,000 Yuan up to 500,000 Yuan, the fee shall be paid at the rate of 1.5%; if from 500,000 Yuan up to 5 million Yuan, the fee shall be paid at the rate of 1%; if from 5 million Yuan up to 10 million Yuan, the fee shall be paid at the rate of 0.5%; if more than 10 million Yuan, the fee shall be paid at the rate of 0.1%).

67. *Zhejiang hexin dianli kaifa youxian gongsi, jinhuashi daxing wuzi youxian gongsi yu tonghe zhiye touzi youxian gongsi, guangsha konggu chuangye touzi youxian gongsi, shanghai fuwo qiye fazhan youxian gongsi sunhai gongsi quanyi jiufen shangsuan* (2008) Min'er zhongzi di 123 hao (浙江和信电力开发有限公司、金华市大兴物资有限公司与通和置业投资有限公司、广厦控股创业投资有限公司、上海富沃企业发展有限公司损害公司权益纠纷上诉案 2008 (民二终字第 123 号)) [Zhejiang Dianxin Electronic Development Ltd Co et al. v Tonghe Investment Property Ltd Co et al.] 2008 MinerZhongZi No. 123 (China).

68. JIMING ZHAO (赵继明) & GAOCHEN WU (吴高臣), ZHONGGUO LÜSHI BANAN QUANCHENG SHILU: GUDONG DAIBIAO SUSONG (中国律师办案全程实录：股东代表诉讼) [CHINA LAWYER TODAY: DERIVATIVE ACTIONS] 229, 280 (Ping Jiang ed., 2007).

69. DONGJING LIU, STUDY ON SHAREHOLDERS' DERIVATIVE ACTIONS IN CHINA (我国股东派生诉讼制度研究 103 (2011) (reporting that the amount claimed in this case is 105 million Yuan, but in fact the company's real loss is at least ten times this number).

compensation claim of RMB 100.5 million.[70] In the *Sanlian Shangshe* (三联商社) case of 2009, the only case involving a group of shareholders in a JSLC bringing a derivative action, the litigation cost was also astonishingly high at RMB 191,800 (approximately USD 27,203).[71]Despite the fact that the case acceptance fee is in principle reimbursable when the derivative action is successful,[72] the need to pay in advance without knowledge of the result of the case could be a considerable hurdle in bringing such actions. Sometimes if the case is appealed, the claimants may need to pay on more than one occasion. For example, in the case *Lin Cheng'en v. Li Jiangshan* (林承恩与李江山等损害公司利益纠纷案),[73] the filing fee for the first case was RMB 331,800 and the fee for the appeal was another RMB 331,800, totalling RMB 663,600 (approximately USD 94,126). This cost was borne by the shareholders when they initiated the case and later exercised their right to appeal.

In addition to the uncertainties of court fees being recovered from the defendant if shareholders win the case, it has to be recognized that a limited number of plaintiff shareholders, especially minority shareholders in JSLCs, will have the financial capacity to pay for court fees even if they may be able to recover their money later on.[74] As a result, their claim will be treated as withdrawn by the litigant.[75] Therefore, the derivative action mechanism will lose its compensatory function for shareholders and companies, as well as its deterrence function based on the significant reputational and financial consequences for directors or senior managers as defendants.

In order to establish an enabling rather than hindering legal environment for legitimate plaintiffs to bring derivative actions, reform proposals should improve the current situation, by encouraging shareholders to exercise their right to initiate a derivative suit. It is sensible to look at the legislative experience in Japan that Chinese law is following in terms of sliding scale approach.

The reform in Japanese law, predominantly the changes brought by the *Nikko Securities* case, have had an impact on the popularity and effectiveness of the mechanism.[76] In Japan,

70. Yingcai (英才), Chuangye xiongdi fanmu panshiyi bei suopei 1yi (*创业兄弟反目 潘石屹被索赔 1 亿*) [*Entrepreneurial brothers turned against Pan Shiyi was claimed more than 100 million*] https://business.sohu.com/20041025/n222676585.shtml Sohu (October 20, 2004); *see also* Global Times (环球房产周刊), Dichan dawan zaoyu tianjia suopei panshiyi yiyuan guansi xianjiaozhe (*地产大腕遭遇天价索赔 潘石屹亿元官司陷胶着*) [*Real Estate Big Names Encountered Astronomical Claims: Pan Shiyi's Billion Yuan Reminbi Lawsuit*] http://biz.163.com/41126/4/164C5D4900020QEO.html (Nov. 25, 2004).

71. *See* WENJING CHEN, A COMPARATIVE STUDY OF FUNDING SHAREHOLDER LITIGATION, 124 n.202 (Springer 2017) (noting how Chinese courts do not publish all cases but the Sanlian Shangshe case was publicized in Chinese media, notifying the public of case details); *see also* Viroshan Poologasundram, *Investing in China? Beware, if You are a Minority Shareholder: How Effective is the Derivative Action as a Protection Device for Minority Shareholders in China?* 7 U. Puerto Rico Bus. L.J. 331, 349 n.83.

72. *Susong Feiyong Jiaona Banfa* (诉讼费用交纳办法) [Measure on Payment of Litigation], art. 29, 2007 (China).

73. *Linchengen yu lijiangshandeng sunhai gongsi liyi jiufenan* (林承恩与李江山等损害公司利益纠纷案) [*Lin Cheng'en v. Li Jiangshan*] Min 4th Zhong Zi no.1 (Jiangxi Provincial Higher People's Ct. 2012).

76. LIN, *supra* note 54, at 131.

75. Unless the plaintiff shareholder is eligible for judicial aid according to one of the circumstances listed in Chapter 6 of the Administration of Attorney's Fee 2006.

76. *See* Hiroshi Oda, *Shareholder's Derivative Action in Japan*, 8 EUR. COMP. & FIN. L. REV. 334, 338 (2011) (characterizing the *Nikko Securities* case as a ground-breaking decision in the history of derivative action after the court accepted the plaintiff's argument that the stamp duty was prohibitive and ruled that the stamp duty would be

the sliding scale system has historically proven to be a barrier to shareholder derivative claims,[77] constituting "the real determining factor."[78] The story in Japan may be traced back to the earlier period before the reform of 1993, which provided the impetus for a palpable increase in derivative suits.[79] Prior to 1993, shareholders needed to purchase an *inshi* (revenue stamp) before filing a derivative action.[80] The claims were divided into two kinds based on their nature, which were categorized as "calculable" and "incalculable" claims.[81] In the former case, the stamp fee was calculated based on a sliding scale dependent on the amount of claimed damages, and a normal fixed flat rate was charged in the latter case.[82] The actual effect of the pre-1993 Japanese litigation fee principles was to discourage all suits due to the high litigation fees, which were not recoverable unless the shareholders eventually won the case.[83] Statistics show that there were fewer than twenty derivative action suits between 1950 and 1990, but there was a dramatic increase after 1993 to hundreds of lawsuits each year.[84] It was reported that 119 derivative actions were brought against listed companies in Japan from 1993 to 2009,[85] and it is claimed that Japan has now started to imitate the litigious United States, where derivative actions are actively used.[86] This increase could be a consequence of multiple reasons, but the fee issue is widely discussed and accepted as a very important one.[87]

8,500 yen).

77. Curtis J. Milhaupt, *A Lost Decade for Corporate Governance Reform? What has changed, what hasn't, and why*, *in* INSTITUTIONAL CHANGE IN JAPAN 100, 100 (Magnus Blomström & Summer La Croix eds., 2006); *see also* Mark D. West, The Pricing of Shareholder Derivative Actions in Japan and the United States, 88 NW. U. L. REV. 1436, 1458–1459 (1994) (discussing how attorney fees calculated using a sliding scale create a barrier to potential shareholder plaintiffs).

78. Tomotaka Fujita, *Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision*, *in* TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA 15, 16 (Hideki Kanda et al. eds., 2008).

79. Shiro Kawashima & Susumu Sakurai, *Shareholder Derivative Litigation in Japan: Law, Practice and Suggested Reforms,* 33 STAN. J. INT'L L. 9, 11 (1997) (discussing how sliding scale-based litigation fees posed a roadblock to shareholder litigation prior to 1993).

80. *Id*. at 19.

81. Oda, *supra* note 76, at 338. See also Mark D West, *Pricing of Shareholder Derivative Actions in Japan and the United States* 88 Nw. U. L. Rev. 1436, 1464-1465 (1993-1994)

82. *See* Kaisha-hō [Companies Act], Law No. 86 of 2005, art. 847, para. 6 (Japan) (describing the value of the subject matter of a suit that is not based on a property right claim); Minji Soshō Hiyō Tō Ni Kansuru Hōritsu [Act on Costs of Civil Procedure], Law No. 40 of 1971, art. 4, para. 2 (Japan) (describing the value of a suit that is not based on a property right claim to be 1,600,000 yen).

83. CURTIS J. MILHAUPT & MARK D. WEST, ECONOMIC ORGANIZATIONS AND CORPORATE GOVERNANCE IN JAPAN: THE IMPACT OF FORMAL AND INFORMAL RULES 21 (2004).

84. Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351, 352 (2001).

85. Masafumi Nakahigashi & Dan W. Puchniak, *Land of the Rising Derivative Action: Revisiting Irrationality to Understand Japan's Unreluctant Shareholder Litigant, in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 128, 172 (Dan W. Puchniak, Harald Baum & Michael Ewing-Chow eds., 2012).

86. Gen Goto, *Growing Securities Litigation Against Issuers in Japan: Its Background and Reality* 3 (2016), https://ssrn.com/abstract=2714252.

87. *See*, *e.g.*, Hiroshi Oda, *Shareholder's Derivative Action in Japan*, 8 EUR. COMP. & FIN. L. REV. 334, 337 (2011) (explaining that prior to 1993 the cost of the derivative action was high); Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351, 352 (2001) (describing that Japanese shareholders prior to 1993 had chosen not to sue in part because of high fees); Shiro Kawashima & Susumu Sakurai, *Shareholder Derivative Litigation in Japan: Law, Practice and Suggested Reforms*, 33 STAN. J. INT'L L. 9, 12 (1997) (explaining how the 1993 Commercial Code amendments lowered the filing fees for derivative actions and made the mechanism more accessible to shareholders).

This fundamental change, which came as an unexpected shock,[88] started from the *Nikko Securities* case decisions by the Tokyo High Court, where the court supported the shareholders' argument that the stamp fee for bringing a derivative action should be tailored to a fixed rate because the economic benefit to shareholders from derivative actions is in practice "incalculable."[89] The principle was subsequently confirmed by national legislation embedded in the amended Article 267 of the Commercial Code, in order to confirm that all derivative actions "shall be deemed to be lawsuits with respect to non-property claims for the calculation of the amount of the claim."[90] As a result, the cost of filing a derivative action as a non-property, non-calculable claim was reduced to a flat fixed fee of 8,200 Japanese Yen if the target of the litigation did not exceed 950,000 Yen. In 2003, the filing fee was changed to a flat rate of 13,000 Yen if the target of the litigation does not exceed 1.6 million Yen.[91] This amended fee is obviously likely to be lower than the stamp fee, and this is regarded as one of the most influential events in Japanese corporate governance history.[92] It is argued that the reform will improve the performance of Japanese firms in the long run and enhance the law's disciplinary effects on management misconduct.[93]

In China it was concluded through historical evidence related to case numbers that the current sliding system served as "a robust disincentive to prospective shareholders suing derivatively on behalf of the company."[94] Therefore, it is worth considering partially transplanting the Japanese approach to China, in order to encourage shareholders in JSLCs to use derivative actions as effective shareholder remedies to safeguard the interests of companies. This is relevant due to the fact that the sliding scale system was first adopted following the approach in Japan, and the Japanese reform after the *Nikko Securities* case proved to be effective and positive in encouraging healthy numbers of derivative actions. The transplant of the fee rules is necessary and urgent to promote board accountability in China and open boards up to the supervision and scrutiny of shareholders.[95] Indeed, the only way to make monitoring effective is to provide sufficient financial rewards to compensate for mounting costs.[96] Proposals have already been made to transplant the Japanese rule for filing

88. Tomotaka Fujita, *Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision*, *in* Transforming Corporate Governances in East Asia 15, 17 (Hideki Kanda, Kon-Sik Kim, & Curtis J. Milhaupt eds., 2008).

89. *See* Hiroshi Oda, *Shareholder's Derivative Action in Japan*, 8 EUR. COMP. & FIN. L. REV. 334, 338 (2011) (detailing plaintiff's argument that the contested value was incalculable).

90. SHŌHŌ [COMM. C.], 1899, art. 267, para. 4 (Japan).

91. *See* Minji soshō hiyō tō ni kansuru hōritsu [Act on Costs of Civil Procedure], Law No. 40 of 1971, art. 4, para. 2 (Japan) (noting the litigation target cannot exceed 1.6 million Yen in an action where the claim is not a property right).

92. Fujita, *supra* note 89.

93. *Id.* at 16 (citing Sumio Hirose & Noriyuki, *Yanagawa, Daihyo-sosho-seido Kaisei no Kigyo-kachi heno Eikyo* (デリバティブ行為に対する改革の企業価値への影響) [*The Impact of Reform on Derivative Action to the Firm Value]*) (2002) (unpublished)).

94. Fangpeng (Frank) Meng, *Funding Derivative Actions in China: Lessons from Wallersteiner v. Moir (No. 2) for the Court*, 31(1), COMPANY LAW. 29, 29 (2010).

95. *See* Andrew Keay & Jingchen Zhao, *Ascertaining the Notion of Board Accountability in Chinese Listed Companies*, 46 H.K.L.J. 671, 699-700 (2016) (explaining that an accountability system can be transplanted to China through importing legal rules subject to changes and local conditions).

96. *See* Jean Tirole & Bengt Holmstrom, *Market Liquidity and Performance Monitoring*, 101 J. POL. ECON. 678, 680 (1993) ("However, market monitoring is not costless. Somebody has to pay the speculator for his

costs.[97] Within these proposals, the focus has been on transplanting the fixed fee. However, there has been a lack of discussion of the rationale for these proposals, which should be closely linked to the nature of claims and the remedy of derivative action.

In addition to encouraging more litigation in the form of derivative action, it is key to clarify the nature of the mechanism and the relationship between its nature and the litigation fee. The nature of derivative action mechanisms is related to the filing fee in two interlocking ways. First, shareholders are seeking remedies and recoveries through legal action taken on behalf of their companies, which will benefit directly from successful litigation. The company is the "functional plaintiff" as "the real party in interest."[98] The value of the derivative action mechanism is twofold, including the *ex ante* value—namely the deterrence effect that prevents directors' misconduct, and the *ex post* value—offering redress for the company directly and the shareholders indirectly. Both values are closely related to the interests of the company. In the derivative action regime, companies are the aggrieved party, and the claimants enforce the right of the companies to take legal action. [99] Therefore the compensation claim is an indirect one. Second, the relief from successful litigation rests upon various factors—including some that are long-term or short-term, tangible or intangible, and directly or indirectly linked to the suspension or deterrence of directors' misconduct. Like derivative action in any jurisdiction, it is virtually impossible to assess the benefits of the deterrence of corporate wrongdoing or the net recovery from the litigation.

A shareholder under the scheme will institute an action on behalf of the company for the harm suffered by the company, in circumstances where the boards of directors are reluctant or incompetent to enforce their rights.[100] The benefit that the shareholders could obtain from increased share prices and higher dividends as the result of any deterrence of misconduct cannot be calculated. The shareholders will thereby ensure the management of company affairs in a manner whereby they stand to acquire maximum returns on their investments through dividends, if declared.[101] A derivative action is intended to rectify a wrong,[102] but the result of this wrongdoing may be impossible to calculate. It may be a long-term outcome affected by a range of factors that have an impact on share price and company performance, including strategic management policies, corporate governance, a better business environment or government policies, etc. The shareholder, as the direct claimant, shares the success of the litigation partially and proportionately with other shareholders. In

monitoring service.").

97. Zhong Zhang, *Making Shareholder Derivative Action Happen in China: How Should Lawsuits be Funded*, 38 H. K. L. J. 523, 561 (2010); Jingchen Zhao, *A More Efficient Derivative Action System in China: Challenges and Opportunities through Corporate Governance Theory*, 64 N. IR. LEGAL Q. 233, 243 (2013); Jingchen Zhao & Shuangge Wen, *The Eligibility of Claimants to Commerce Derivative Litigation on Behalf of China's Joint Stock Limited Companies*, 48 H. K. L. J. 687, 726 (2018); Dan Wang (王丹), Paisheng susong zijin jili wenti yanjiu (*派生诉讼资金激励问题研究*)〔*The Analysis of Establishing Adequate Funding Incentive of Shareholder Derivative Litigation*], BIJIAO FALÜ YANJIU (比较法律研究)[RESEARCH ON COMP. L.] 165, 169-170 (2015).

98. Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1756 (2010).

99. Farnham v. Fingold, [1972] 3 O.R. 688 (Can.).

99. *Id*.

101. Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball,* 77 MINN. L. REV. 1339, 1345 n.34 (1993).

102. *See* Thomas P. Kinney, Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers, 78 MARQ. L. REV. 172, 172 (1994) (explaining that derivative lawsuits allow shareholders to bring lawsuits against wrongdoers on behalf of a corporation).

cases where the board has exercised its discretion, rewards are distributed through the payment of dividends or more sustainable stakeholder relationships and beneficial contractual terms to benefit stakeholders such as employees and suppliers.[103]

All in all, learning from Japanese historical, empirical, and legislative experiences, it is clear that filing fees can have an immense impact on the frequency of derivative actions. If derivative action is to be an effective tool to promote corporate governance and protect shareholders by improving the soundness and effectiveness of boards' decisions, the barrier of the filing fee needs to be removed. This is particularly relevant and urgent for the case of JSLCs, where professional directors are appointed to ensure a separation of ownership and control,.[104] The derivative action mechanism not only has a supervision function towards boards' behavior, but also has a deterrence function in terms of the misconduct of boards and majority shareholders. Unreasonable fees based on a sliding scale should be replaced by fixed and affordable fees. As the most significant barriers for JSLCs to pursue derivative actions, issues around the filing fee merit an examination of the substance of the problem.[105] However, due to the dispersed shareholding ownership of JSLCs in China, a reasonable fixed filing fee in combination with an appropriately revised shareholding percentage and period requirements for shareholder eligibility to bring derivative actions, may be a way forward in order to achieve a good balance between giving adequate incentives to shareholders to use derivative action and the avoidance of issues such as frivolous lawsuits ("strike suits"), unnecessary distraction for directors, supervisors and senior managers, and excessive workloads for the courts.

III. THE CURRENT LAW CONCERNING ATTORNEYS' FEES FOR DERIVATIVE ACTION IN CHINA: CHALLENGES AND THE US EXPERIENCE

Another key litigation cost that has a direct impact on the incentives of attorneys and claimant shareholders to bring derivative lawsuits is lawyers' fees. There is no legislation in China directly regulating lawyers' fees because the relationship between the lawyer and claimant shareholders is seen as a private business relationship. The "American rule" has been adopted in China to address the issues of lawyers' fees: the claimant and defendant will pay their own attorneys' fee irrespective of the outcome of the lawsuit.[106] A plaintiff shareholder will need to reach an agreement with the lawyer who will charge the shareholder contingent on the result of the derivative action litigation. This is also similar to the

103. *See* George S. Geis, *Shareholder Derivative Litigation and the Preclusion Problem*, 100 VA. L. REV. 261, 291 (2014) (arguing that a derivative claim is "doomed" in a legal system that forces an individual shareholder to shoulder all of the legal fees related to filing).

104. *See* Huang, *supra* note 7, at 645 (noting that one reason for the high volume of derivative suits is low procedural barriers).

105. *Id.* at 648 (stating that other barriers include the prescribed shareholding threshold—constituting a requirement to hold 1% or more of the company's shares for 180 consecutive days—and the difficulties in pre-payment with the possibility of getting indemnified).

106. *Cf.* JAMES M. ZIMMERMAN, CHINA LAW DESKBOOK: A LEGAL GUIDE FOR FOREIGN-INVESTED ENTERPRISES 55-79 (3rd ed. 2010) (discussing the development of lawmaking in China).

contingency fee arrangement in US law.[107] Therefore, we will look to US law to explore possible improvements regarding lawyers' fees.

In terms of the value of the attorneys' fee, two options are available according to the Measures for the Administration of Attorneys' Fees 2006: the fees may be fixed at a percentage no higher than 30% of the amount of the damages claimed as the result of a successful litigation;[108] or a "reasonable fee arrangement" may be adopted, whereby fees are charged on the basis of the subject-matter of the case or of the time taken.[109] In the approach based on a fixed percentage of the amount of damages claimed, a claimant shareholder could conclude an agreement and the attorney's fee would be charged contingent on the amount of the claimed damages in a successfully litigated or settled case, which is similar to the approach adopted in the US (a contingency fee arrangement).[110] However, a deeper and closer look at the approach generates some concerns about making this relatively successful method equally efficacious in China.

A. Contingency Fee Agreement

A "contingency fee arrangement" has been adopted and was regarded as an approach that provides a "significantly lower disincentive to prospective claimants," compared with the approaches adopted in other jurisdictions such as the UK. [111] However, a question arises as to whether this positive effect will also be applicable in China, where the claimant shareholder could reach an agreement with the attorney by agreeing the attorney's fee if the damage claims are monetary. This fee may only be payable contingent on the result of the derivative action, thereby providing incentives for shareholders to employ the arguably under-used derivative action mechanism.[112]

The pervasiveness of "contingency fee agreements" in the US largely solved the problem of a lack of compensatory incentives for shareholders.[113] According to this rule, claimant shareholders are not supposed to pay attorneys' fees unless and until the attorney recovers compensation for the shareholders by acquiring a settlement or by attaining a favorable trial judgement. In other words, the shareholders and attorney agree that the latter will shoulder the financial cost of pursuing the litigation and will be compensated according to a fixed percentage for a successful litigation or settlement.

107. WENJING CHEN, A COMPARATIVE STUDY OF FUNDING SHAREHOLDER LITIGATION 199 (2017) (ebook).

108. Lvshi fuwu shouli fei guanli banfa 2006 (律师服务受理费管理办法 2006) [Measures on Services Fee of Lawyers 2006], art. 13.

109. Meng, *supra* note 94.

110. *See* ZHONG ZHANG, DERIVATIVE ACTION AND GOOD CORPORATE GOVERNANCE IN CHINA: ECONOMIC THEORIES AND LEGAL RULES 212 (2011) (stating that with this practice "there is a possibility that a plaintiff can be protected from the risk of paying his lawyers.").

111. REISBERG, *supra* note 9, at 226.

112. *See* Yunyang Zhu (朱芸阳), *Lun gudong paisheng susong de shixian* (*论股东派生诉讼的实现*) [*The Realisation of Derivative Action*], QINGHUA FAXUE (清华法学) [TSINGHUA L. J.] Vol. 6, 107, 118 (2012); JUNHAI LIU (刘俊海), XIANDAI GONGSI FA (现代公司法) [MODERN CORPORATION LAW] 412 (3rd ed., 2015); WENJING CHEN, A COMPARATIVE STUDY OF FUNDING SHAREHOLDER LITIGATION 18-31 (2017).

113. *See* Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia*, 29 YALE J. OF INT'L L. 169, 184—85 (2004) (explaining that the availability of fee arrangements for plaintiff's attorney in the U.S. stands in sharp contrast to the corporate law enforcement in East Asia).

However, the contingency fee arrangement has already shown potential deficiencies in China as a fair approach for shareholders, insofar as it lacks potential to give shareholders sufficient incentives to bring a derivative action. If the litigation is successful, benefits will be awarded directly to the company and indirectly to the shareholders. The claimant shareholder would have to fund the initial attorneys' fee because the service contract is between the shareholder and the attorney. Consequently, claimant shareholders will receive only a small *pro rata* benefit, and the rest of the shareholders will enjoy a free ride on the backs of claimant shareholders.

Under this contingency fee approach, the shareholder would personally have to pay a certain percentage of the damages recovered up-front, if the litigation was successful in the case of monetary claims. Fees go to attorneys only if the derivative action generates money damages and tangible relief, which is not always possible in derivative actions. Some of the damages related to directors' misconduct may be measurable, while some may be hard to assess in terms long-term impact on the company (e.g. reputational damage). Positively, it is stipulated by Provision IV that courts in China should support the indemnity claims of shareholders who bring lawsuits on behalf of the company for reasonable expenses paid by the shareholder for participating in the action.[114] However, this is only applicable to cases where the claims are fully or partially supported by the court.[115] In addition to limitations on the scope of the provision, "reasonable" expenses is a vague term, with its interpretation relying on what are perceived by the parties to be standard terms.[116] These terms may be not uniformly defined in the case of derivative actions in practice. It is not completely clear that attorneys' fee will be fully recoverable as part of "reasonable" expenses.[117] Ironically, if the litigation is not successful the shareholder might be in a better position in terms of the litigation costs, being free from responsibility for attorneys' fees based on the contingency fee arrangement.

Before 2006, the "no win, no fee" agreement was very common in China for derivative action cases, despite the fact that the mechanism itself had not been adopted in national legislation.[118] However, under the current regulation in China the contingency fee approach has been prohibited in specified classes of cases, such as criminal, administrative, state compensation and multi-claimant lawsuits.[119] In relation to litigation in derivative actions, the rule applies to multi-claimant lawsuits when more than one shareholder bring the litigation together. Despite the fact that this limits the scope of the contingency fee arrangement, this could be problematic in terms of derivative actions, particularly in JSLCs, due to difficulties

114. Zuigao renmin fayuan guanyu shiyong <zhonghua renmin gongheguo gongsi fa > ruogan wenti de guiding (si) (最高人民法院关于适用＜中华人民共和国公司法＞若干问题的规定(四)) [Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (IV)], art. 26.

115. *Id*.

116. *See* Flora Xiao Huang, *Shareholder Revolt?: The Statutory Derivative Action in China*, 5 COMP. RES. IN L. & POL. ECON. 1, 7, 16 (2009) (discussing how courts in China provide alternative ways for the reimbursement of expense, including "reasonable litigation fees" such as attorneys' fee).

117. *Id*. at 16.

118. Zhong Zhang, *Making Shareholder Derivative Actions Happen in China: How Should Lawsuits Be Funded*, 38 H.K.L.J. 523, 545 (2008).

119. Lvshi fuwu shouli fei guanli banfa (律师服务受理费管理办法 2006) [Measures on Services Fee of Lawyers 2006], art. 12.

in reaching the holding threshold of 1% of the company's shares for 180 consecutive days.[120] There may be a need for collective litigation in order to satisfy the 1% requirement.[121]

Furthermore, the approach adopted in China, which is similar to the contingency fee arrangement, may not work in the same way as in the US for a number of reasons. Primarily, in China the contingency fee arrangement is not supported by a "common fund," which would allow the payment of attorneys' fees out of the fund for successful actions. A claimant shareholder needs to pay the attorneys' fee for a successful lawsuit, despite the fact that the relief and rewards from successful derivative lawsuits go to the company. It is rather irrational and discouraging that claimant shareholders do not pay attorneys' fees for unsuccessful claims based on the contingency fee agreement, whereas they have to pay if the lawsuits are successful. As the claimant's costs increase, shareholders may seek remedies other than bringing an action on behalf of the company in a derivative manner. All in all, it is worth revisiting the case of multi-claimant (collective) litigation, including clarification regarding whether constraints apply to collective derivative action litigation where more than one shareholder brings the lawsuit in order to satisfy the 1% shareholding ownership requirement. Additionally, it may be necessary to explore the possibility of introducing a common fund arrangement and the notion of "entrepreneurial attorneys" in China to support the effectiveness of the contingency fee model, although this may be quite difficult and take a long time.

B. Common Fund Arrangement

The "common fund" is set up in a scenario where an attorney in a derivative action helps to set up, accumulate or maintain a fund from which the attorneys themselves may receive fees and claim expenses directly.[122] This approach is designed to encourage more attorneys to take on derivative action cases.[123] All monetary awards to companies or settlements resulting from derivative actions have to be paid into the common fund, and the contingency fee of the attorney, based on the agreement between the claimant shareholders and the attorney, is treated as a charge on the common fund.[124] The attorneys will get a certain percentage of the common fund as their fee.[125] The common fund principle and supplementary mechanisms as adopted in the US shift the financial risk of pursuing a derivative action from the claimant shareholders to the attorneys.[126] Therefore, shareholders

120. *Zhonghua renmin gongheguo gongsi fa* (中华人民共和国公司法) [Chinese Company Law] (promulgated by the Standing Comm. Nat'l People's Cong. Dec. 28, 1993, effective Mar. 1, 2014), art. 151.

121. *Id.*

122. *See* Boeing Co. v. Van Gemert, 444 U.S. 472, 478 (1980) (reiterating that "a litigant or a lawyer who recovers a common fund for the benefit of persons other than himself or his client is entitled to a reasonable attorney's fee from the fund as a whole.").

123. HERBERT M. KRITZER, RISKS, REPUTATIONS AND REWARDS: CONTINGENCY FEE LEGAL PRACTICE IN THE UNITED STATES 178 (2004).

124. *See* Carol G. Hammett, *Attorneys' Fees in Shareholder Derivative Suits: The Substantial Benefit Rule Reexamined*, 60 CAL. L. REV. 164, 168 (1972) (explaining the theories of why attorneys' fees may be recovered from a fund in derivative suits).

125.See Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty* 83 WASH. U. L.Q. 1017-1044 (2005); Jamie D. Kurtz, *An Exception to the Derivative Rule: Allowing Mutual Fund Investors to Bring Suits Directly*, 82 BROOK. L. REV. 1425 (2017).

126. Harald Baum & Dan. W. Puchniak, *The Derivative Action: An Economic, Historical and Practice-*

may be willing to proceed with the lawsuit even if they are not confident about the litigation, since there is no downside risk.[127]

Additionally, the common fund principle for US attorneys, as controllers of the conduct of litigation on behalf of the claimant shareholders, is closely related to the nature of litigation as an entrepreneurial activity with the purpose of maximizing profit. Attorneys are commonly regarded as "entrepreneurs," who, in the case of derivative actions, may conduct litigation nearly independently without being monitored by shareholders.[128] Shareholders are merely used as the key to the courtroom door. This type of entrepreneurial litigation is regarded as a process by which adversaries reach an agreement on the litigation odds and subsequently settle the case out of court, so as to avoid additional transaction costs.[129] Different from the two-way fee shifting in English law, the attorney in the US model is seen as being in a joint venture with the litigant shareholders.[130] Attorneys and their clients appear to be in the same boat, sharing the gains and the fruits of victory in the litigation. However, without involvement, supervision and monitoring by their clients, the attorneys, who are typically senior partners in the US,[131] may act largely according to their own interests, subject to the regulations imposed by "bar disciplines, judicial oversight and their own sense of ethics and fiduciary responsibilities."[132]

Applying the same notion in China, Huang argues that "there is no shortage of entrepreneurial lawyers in China, and they race to represent as many investor plaintiffs as possible in the area of securities cases."[133] He observed through empirical research that "China's securities civil cases are lawyer-driven."[134] Coffee asserts that "the size and scale of the Chinese securities market could potentially encourage and support a sizable indigenous population of entrepreneurial litigators."[135] These arguments imply that the environment for establishing a common fund arrangement does exist in China, entrepreneurial lawyers are not uncommon, and the situation may apply to derivative action cases. However, the legislative frameworks in areas such as bar discipline and legal ethics are under development in China, and the enforcement of legislative frameworks in these areas is worrying and far from perfect.[136]

Oriented Approach, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH, 21 (Dan W. Puchniak et al. ed. 2012).

127. *Id*.

128. John C. Coffee, *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 887, 893 (1987).

129. John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279, 288-91, 296 (1973).

130. Coffee, *supra* note 129, at 896.

131. DOUGLAS E. ROSENTHAL, LAWYER AND CLIENT: WHO'S IN CHARGE? 23 (Russell Sage Foundation, 1974).

132. Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 3, 8 (1991).

133. Hui Huang, *Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment*, 61 AM. J. COMP. L. 757, 768 (2013).

134. *Id*. at 798.

135. John C. Coffee, *The Globalization of Entrepreneurial Litigation: Law, Culture, and Incentives*, 165 U. PA. L. REV. 1895, 1925 (2017).

136. *See generally* Eli Wald, *Notes from Tsinghua: Law and Legal Ethics in Contemporary China*, 23 CONN. J. INT'L L. 369 (2008); Christopher Arup, *Lawyers for China: The Impact of Membership of the World Trade Organization on Legal Services and Law in China*, 4 J. WORLD INTELL. PROP. 741 (2001); Sida Liu, *Lawyers,*

A few additional concerns may require policy makers and the government to think carefully before introducing such an approach in China, since it may entail some potential challenges. First, the current emphasis on economic development in China and the companies' priorities in putting profit maximization at the top of their agenda[137] make it very hard for companies to set aside money at the request of minority shareholders, in order to establish a common fund for litigations against their board members or controlling shareholders. Traditionally, many listed companies within the scope of JSLCs in China still constitute "state-owned enterprises" (SOEs), and the largest shareholder is normally the state.[138] It may be even harder for SOEs to establish a common fund for derivative actions where the claimants in these cases are civil servants (as directors) and the state is the majority shareholder or the biggest shareholder. It is hard for the board of directors to authorize such a common fund, considering the close *guanxi* between executive board members, supervisors, and controlling shareholders. Moreover, it is problematic to envisage that Chinese lawyers would be willing to take on the big risks of pursuing derivative actions if the initiation of the case comes from minority shareholders, who may have a limited voice and information that could be made available for attorneys to promote the success of the cases. The attorneys may also be aware of difficulties in convincing the supervisor or supervisory board to pursue a derivative action, particularly if they are aware of potential difficulties in concluding a successful derivative lawsuit considering the *guanxi* between the two boards, independent directors, and the controlling power of majority shareholders and the directors.

As a strong theoretical basis for the common fund principle, classic Anglo-American derivative actions are, *de facto*, double suits at equity. One of the suits is a claim by the company as the "real party plaintiff" against alleged wrongdoers, while the other is the claim by the shareholder.[139] Conventionally in Chinese civil procedure law, a company in a derivative lawsuit may be regarded as either a second claimant after the shareholders who initiate the derivative action or a third party allowed under the Civil Procedure rules on a voluntary basis if the company considers that it has the independent right to claim the subject matter of the action or join the litigation without independent rights.[140] This is further interpreted after the enactment of the Provision IV. The statutes of companies and shareholders in derivative actions have been explicitly confirmed as follows: where the board of supervisors or a supervisor of a LLC without a board of supervisors initiates an action against a director or a senior executive under Article 151(1) of the Company Law, *the company shall be treated as the plaintiff*; where the board of directors or the executive director of a LLC without a board of directors initiates an action against a supervisor of the company

State Officials and Significant Others: Symbiotic Exchange in the Chinese Legal Services Market, CHINA Q. 276 (2011).

137. Dana M. Muir et al., *The Future of Securities Class Actions Against Foreign Companies: China and Comity Concerns*, 46 U. Mich. J. L. Reform 1315, 1343 (2013).

138. *See* Yordying Thanatawee, *Ownership Structure and Dividend Policy: Evidence from China,* 6 INT'L J. ECON. & FIN. 197, 199 (2014) (describing that it is reported that an average of 31.27% of the shares in these companies are held by the government).

139. Donald Clarke & Nicholas Calcina Howson, *Pathway to Minority Shareholder Protection: Derivative Action in The People's Republic of China*, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 243, 291 (Dan W. Puchniak et al. eds., 1st ed. 2012); Maximilian Koessler, *The Stockholder's Suit: A Comparative View*, 46 COLUM. L. REV. 238, 242 (1946); *see* Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 470 (Cal. 1969) (describing the purpose of a stockholder derivative suit).

140. *See* Civil Procedure Law of the People's Republic of China, art. 56 2013 *Zhonghua renmin gongheguo minshi susong fa* 中华人民共和国民事诉讼法.

under Article 151(1) of the Company Law or against any other person under Article 151(3) of the Company Law, *the company shall be treated as the plaintiff*; where a shareholder meets the conditions set out in Article 151(1) of the Company Law and directly initiates an action against a director, supervisor, senior executive, or any other person under Article 151(2)-(3) of the Company Law, the company shall be named as *a third person*.[141] Moreover, where a shareholder directly initiates an action under Article 151(2)-(3) of the Company Law, the company shall be the party to benefit from successful litigation.

Therefore, it may be helpful to introduce the notion of "real party plaintiff" where a shareholder directly initiates a derivative action. This may be archived through the interpretation of the Provisions offered by the Supreme Court. Recognition and a clear classification of the role played the company will be important before the common fund principle may be established in China. If the company is defined as the "plaintiff" or "real party plaintiff" in derivative action, it makes cost allocation appropriate and rational, which makes the potential transplant of the "common fund principle" possible and legitimate.

C. The American Rule and Substantial Benefit Test

In addition to and in conjunction with the contingent rule and the common fund approach, a few more rules and tests are applied in US courts in order to give attorneys enough incentives to take on derivative actions. These include the "American rule" and the "substantial benefit test". The "American rule" provides that each party in the litigation is responsible for paying his or her own attorney's fee, irrespective of the result of the litigation.[142] Functioning on the basis of the principle of "no win, no fee,"[143] the "American rule" makes the claimant in derivative actions less concerned about attorneys' fees, since attorneys will be paid by the company out of the funds recovered from the action for successful cases, whereas they won't be eligible for any payment if the cases are lost. However, these benefits only apply to cases when there is a tangible benefit to the company.

As for intangible or therapeutic relief, the "substantial benefit test" makes economic incentives for claimant attorneys possible and enforceable[144] by allowing them to receive a contingency fee through the "lodestar method".[145] Based on this method, attorneys are paid for their work by multiplying the number of hours they reasonably spend on the case to secure a successful result for the client by a reasonable hourly rate.[146] If a successful derivative action

141. Zuigao renmin fayuan guanyu shiyong <zhonghua renmin gongheguo gongsi fa > ruogan wenti de guiding (si) (最高人民法院关于适用＜中华人民共和国公司法＞若干问题的规定(四)) [Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (IV)], art. 24.

142. *See* Alyeska Pipeline Service Co. v. Wilderness Society, 421 U.S. 240, 247 (1975); *but see* Court Awarded Atty. Fees, 108 F.R.D. 237, 241 (1985) (criticizing the *Alyeska Pipeline* rule).

143. *See generally* MODEL RULES OF PROF'L CONDUCT r. 1.5(d) (AM. BAR ASS'N, 2018).

144. JAMES COX & THOMAS LEE HAZEN, CORPORATIONS 466 (Aspen, 2nd ed. 2003).

145. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 395-397 (1970) (explaining the relationship between derivative suits and attorney fees).

146. *See generally* Friedrich v. Fidelity Nat. Bank, 545 S.E.2d 107 (Ga. Ct. App. 2001); Lindy Bros. Builders v. American Radiator & Standard Sanitary Corp., 487 F.2d 161 (3rd Cir. 1973); Mahler v. Szucs, 957 P.2d 632, 650–51 (Wash. 1998); Travis v. Wash. Horse Breeders Ass'n, 759 P.2d 418, 425–26 (Wash. 1988)*; see also* Robert T. Mowrey, *Attorney Fees in Securities Class Action and Derivative Suits*, 3 J. CORP. L. 267, 334-48

brings about a substantial benefit for the company, the lodestar will be adjusted by a multiplier to reflect a number of additional factors including, most significantly, the risk of the litigation. The parties in the case and the courts are required to utilize a demonstrable method for the fee calculation.[147]

The "substantial benefit" doctrine is regarded as an exception to the contingency fee rule,[148] since the payment of contingency fees is limited to tangible relief. It is necessary and functional to have this exception for fee-oriented issues due to the unique nature of the derivative action mechanism. This was further affirmed by the practical implications of the rule as demonstrated by an empirical study, which concluded that derivative actions in the US always result in non-monetary relief.[149]

It can be observed that the contingency fee system, enriched by common funds and the substantial benefit doctrine, gives attorneys and shareholders adequate incentives to use the derivative action approach. However, the "lodestar method," which is used in the majority of states in the US for awarding fees out of the fund, has various problems and drawbacks such as very heavy calculation costs; the factors that have been relied on for calculating a reasonable fee are "amorphous [and] ill-defined."[150] This may also give attorneys incentives to exaggerate their hours or delay the litigation needlessly in order to gain a higher fee.[151] It also fails to give claimants' attorneys a proper incentive to reach a settlement agreement. A settlement may maximize recovery for the claimant, since such agreements assure attorney's fees if successful.[152] The hourly rate that is potentially recoverable must be the rate actually charged by professionals according to an objective comparison—it must be reasonable for professionals with similar skills and experience. This comparison could nevertheless be unpredictable, unclear, and uncertain.

These problems could be equally, if not more, significant in China, considering problems such as a lack of a fully comprehensive legal system regulating attorneys' behavior, and the information asymmetry that affects minority shareholders. Information is an important precondition for deciding on a reasonable number of hours, a reasonable rate, and ensuring the accurate application of the objective test. Minority shareholders may not have effective access to the information they need; they are likely to be limited to the information already available to the public. This may lead to blind trust in the attorney's advice and proposed solutions. Furthermore, it is widely acknowledged that Chinese communities are

(1978).

147. *See generally* Mahler, 957 P.2d at 650–51.

148. *See* Vincent v. Hughes Air West, Inc., 557 F.2d 759, 768 (9th Cir. 1977) (describing the substantial benefit doctrine as a significant variance to the common fund doctrine); Alyeska Pipeline Serv. Co., 421 U.S. at 264-67 n.39 (describing Justice Marshall's preferred approach as an expanded version of the common fund approach to the awarding of attorneys' fees); *see also* Arad Reisberg, *Funding Derivative Actions: A Re-Examination of Costs and Fees as Incentives to Commence Litigation*, 4 J. CORP. L. STUD. 345 (2004).

149. *See* Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55, 62 (1991) (stating the data "make[s] clear that derivative suits have a minor compensatory function").

150. *See* Philip A. Talmadge & Thomas M. Fitzpatrick, *The Lodestar Method for Calculating Reasonable Attorney Fee in Washington*, 52 GONZAGA L. REV. 1, 3 (2017) (commenting on Washington's rules for attorney fees); *see also* WASH. CT. RPC § 1.5 (1990) (outlining the state of Washington's rules for attorney fees);.

151. Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 3, 22 (1991).

152. *Id.* at 4; *see also* Talmadge & Fitzpatrick, *supra* note 150, at 1 (arguing that when a party secures a favorable result by settlement, the party should also be entitled to an award of attorney fees if otherwise permitted by statute, contract, or equity to receive fees).

suffering from low trust; China has been in a credibility-and-trust crisis since the 1960s, mainly as a result of the Cultural Revolution.[153] This has been extended to companies with the global impact of corporate scandals such as the San Lu baby milk powder scandal in 2008, the Hogwash cooking oil scandal in 2010, and the RYB kindergarten abuse scandal in November 2017.[154] Furthermore, the lack of an effective and rigorous public complaints mechanism, a unified industry assessment supervision mechanism, and commonly recognized average market prices are further reasons making the effective enforcement of the lodestar method doubtful and difficult.

D. The Approach in the UK: Popularity and Enforceability

The approach in the UK has been followed by most Commonwealth jurisdictions as the traditional approach in order to address the obstacle of funding in a derivative action.[155] The logic and reason for the "indemnity order" approach rests on the principle of equity.[156] This approach gives a shareholder who brings a derivative action rights to be indemnified from the company against costs. It is designed to reflect the true nature of derivative actions as a mechanism enabling shareholders to enforce the company's rights for the company's benefit. The rationale is that the rights being vindicated are those of the company and recovery flows to it, and therefore the company should be responsible for repayment of the costs.[157] The approach has been suggested by some scholars as a way forward for China.[158] This Section serves two functions. First, it tests the fitness of the UK model for China in detail, rather than relying on principle-based discussions alone. Second, it clarifies the rationale of the UK derivative action fee model, particularly in relation to the nature of the mechanism in order to justify the stipulation in Provision IV on fee-related issues in relation to derivative actions.

The "indemnity order" was enforced in the UK in order to address issues of disincentives for claimants in taking derivative actions.[159] The rule was first made legitimate in *Wallersteiner v. Moir (No 2)*, where Lord Denning in the Court of Appeal asserted that a company should indemnify a shareholder defendant in a derivative suit since the shareholder was acting on behalf of the company, which is the direct beneficiary.[160] In the case, the

153. *See*, *e.g.*, Lingwei Wu, *The Invisible Wound: The Long Term Impact of China's Cultural Revolution on Trust,* H.K. U. SCI. & TECH. 1, 25 (2015) (finding that individuals from counties with higher Cultural Revolution intensity and exposed to more years of interrupted schooling trust significantly less).

154. *See* Weiying Zhang & Rongzhu. Ke, *Xinren Jiqi Jieshi: Laizi Zhongguo de Kuasheng Diaocha Fenxi* (*信任及其解释：来自中国的跨省调查分析*) [*Trust in China: A Cross-Regional Analysis*] 10 JINGJI YANJIU (经济研究) [ECON. RESEARCH J.] 59 (2002); Qing Yang & Wenfeng Tang, *Exploring the Sources of Institutional Trust in China: Culture, Mobilization, or Performance?* 2 ASIAN POL. & POL'Y 415 (2010).

155. *See generally* Foyster v. Foyster Holdings Pty. Ltd. [2003] NSWSC 135 (Austl.); *see also* Companies Act 1993, s 166 (following the UK's approach in New Zealand); Australian Corporations Act 2001, s 236 (following the UK's approach in Australia).

156. Wallersteiner v. Moir (No 2) [1975] 1 All ER 849 at 858 (Eng.).

157. John D. Wilson, *Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholders' Derivative Action*, 5 WINDSOR Y.B. ACCESS JUST. 142, 177 (1985).

158. Meng, *supra* note 94, at 29.

159. Zhong Zhang, *Making Shareholder Derivative Action Happen in China: How Should Lawsuits be Funded*, 38 H.K. L. J. 523, 530 (2010).

160. Wallersteiner v. Moir (No 2) [1975] 1 All ER 849 at 858 (Eng.).

difficulties of Mr. Moir were met with sympathy from the Court of Appeal, particularly from Lord Denning.[161] According to the judgement, shareholders who bring a claim should be treated as trustees or agents who act on behalf of the beneficiary or the principal.[162] Lord Denning suggested a more reasonable procedural rule;[163] the test in deciding whether to make such an order was held to be whether the shareholders are acting *in good faith*, and it would have been reasonable for an independent board of directors to bring such actions in the company's name.[164] The result of a derivative action is irrelevant to the order of indemnity. That means that even if an action fails the claimant is also entitled to be indemnified, since the lawsuit is *de facto* an action of the company and hence the risk of losing the case should be borne by the company. It is non-arguable that if the derivative action is successful the recoveries accrue to the company as a whole, with the shareholder who brought the claim receiving only a small percentage of the benefit. The fact that other shareholders may have a "free ride" and directly benefit from derivative claims brought by the defendant shareholder, who did all the hard work, will make defendant shareholders less willing and give them less incentive to bring such actions in the future.

The principle has been followed in both case law and statues in the UK. Lord Justice Hoffmann in *McDonald v. Horn* (with whom Lord Justices Hirst and Balcombe agreed) referred to the principles which apply when trustees and other fiduciaries apply for an indemnity out of the relevant fund; [165] Justice Roth claimed in *Stainer v. Lee* that a shareholder who has passed the stages for derivative action "should normally be indemnified as to his reasonable costs by the company[.]"[166] Lord Justice Arden asserted in *Carlisle & Cumbria United Independent Supporters' Society Ltd v. CUFC Holdings Ltd* that in a "derivative action on behalf of the Club, the trust had an expectation of receiving its proper costs from the Companies on an indemnity basis[.]"[167] However, the court needs to exercise considerable care in deciding whether to give a preemptive indemnity order.[168] The circumstances under which an order is to be made are rather obscure,[169] with many uncertainties dependent on judicial discretion.[170] This considerable discretion may create uncertainties and cause great distress for shareholders and result in no positive impact in terms of encouraging derivative actions.

161. *See id*. at 856 (stating that Mr. Moir had exhausted all of his financial resources during the 10-year litigation).

162. *Id.* at 858–59.

163. *See id.* at 859 (considering Mr. Moir's plight, stating, "[t]he minority shareholder should apply ex parte to the master for directions, supported by an opinion of counsel, as to whether there is a reasonable case or not. The master may then, if he thinks fit, straightaway approve the continuance of the proceeding until the close of pleadings, or until after discovery or until trial . . . The master need not, however, decide it ex parte . . . The master should simply ask himself: is there a reasonable case for the minority shareholder to bring at the expense (eventually) of the company? If there is, let it go ahead.").

164. *Id.* at 868.

165. [1995] ICR 685.

166. Stainer v. Lee [2010] EWHC (Ch) 1539 [56] (Eng.).

167. Carlisle & Cumbria United Indep. Supporters' Soc'y Ltd. v. C.U.F.C Holdings Ltd [2010] EWCA (Civ) 463 [8] (Eng.).

168. Bhullar v. Bhullar [2003] EWCA (Civ) 424 [11]-[13] (Eng.).

169. Carsten A. Paul, *Derivative Actions under English and German Corporate Law – Shareholder Participation between the Tension Filled Areas of Corporate Governance and Malicious Shareholder Interference*, 7 EUR. COMPANY & FIN. L. REV. 81, 96 (2010); *see also* Smith v. Croft (No.1) [1986] 2 All ER 580 (Eng.).

170. Anil Hargovan, *Under Judicial and Legislative Attack: The Rule in Foss v. Harbottle*, 113 S. AFR. L. J. 631, 648 (1996).

Furthermore, understanding the nature of and attitude towards indemnity orders in cases has not reached a consensus. It would be hard for China to learn from an uncertain principle with ambiguity in common law, despite the fact that China's own guiding cases system has attracted much attention and optimism.[171] For example, it was established in *Wallersteiner* that an indemnity order by the court should be one that is "simple and inexpensive" without being allowed to "escalate into a minor trial".[172] However, Walton J took a restrictive view of the jurisdiction to make an indemnity order, and found that the order would be "palpably unjust."[173] There are also concerns about the possibility of generating strike suits; the very possibility of obtaining an order could conceivably encourage vexatious claims.[174]

Furthermore, a "financial need test" was proposed for the application of an indemnity order in *Smith v Croft*,[175] where Walton J dealt with funding issues in a cautious manner due to the fact that making an indemnity order "may turn out to have imposed on the company a liability which ought never to have been imposed upon it."[176] It was held that an indemnity order would have been oppressive and unfair and should not be made *ex parte*.[177] Following this logic, shareholders should only pursue funding through "an order for interim payment" if they do not have sufficient resources to fund the action or can demonstrate that they genuinely require funding support.[178] It is held that the precise amount of the order will depend upon the "pecuniary situation" and "the individual circumstances of each case."[179] Additionally, the test of whether an independent board of directors would consider taking action in the same circumstances to clarify the availability of an indemnity order was introduced by Walton, which may further complicate the application of the *Wallersteiner* principle.[180] Finally, the independence judgment and board independence in themselves are vague definitions.[181] The dual-proceedings rule applies to the indemnity order, and the test relying on judgment of an independent board of directors further muddies the waters.

The approach derived from the *Wallersteiner* Principle has been criticized for contradicting the nature of derivative action, where shareholders are the "representatives" and the financial situations of shareholders should not be relevant to decisions of the court in granting an indemnity order.[182] The approach also increases the discretion of the court, not only in terms of whether to grant the order but also regarding how much should be granted if the application were to be successful. These discretions make it harder for civil law countries with limited judicial resources and troubling judicial ability to use discretion in reaching legitimate and justifiable decisions on a case-by-case basis.

171. Mark Jia, *Chinese Common Law? Guiding Cases and Judicial Reform*, 129 HARV. L. REV. 2213, 2234 (2016).

172. Wallersteiner v. Moir (No 2) [1975] 1 All ER 849 at 859 (Eng.)

173. Smith v. Croft (No.1) [1986] 2 All ER 580 at 589 (Eng.)

174. See 679 House of Lord Official Report (5th series), Report Column: GC13, 27 Feb. 2006.

175. Smith v. Croft (No.1) [1986] 2 All ER 580 (Eng.)

176. *Id*.

177. *Id*.

178. *Id*.

179. *Id*. at 598.

180. *See generally id.*; Wallersteiner v. Moir (No 2) [1975] 1 All ER 849 (Eng.)

181. *See generally* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231 (2002).

182. REISBERG, *supra* note 9, at 238.

The principle derived from *Wallersteiner* has been embedded in statutes.[183] It is stipulated that "the court may order the company … for the benefit of which a derivative claim is brought to indemnify the claimant against liability for costs incurred in the permission application or in the derivative claim or both."[184] However, it has not promoted the enforcement and frequency of application of this mechanism. In general terms, it is argued by Keay that in only two of the eight cases in which the shareholder has been successful under the statutory regime has the Court granted costs with limits.[185] He proposed a more relaxed attitude in terms of awarding an indemnity in relation to the costs of shareholders who successfully obtain permission to continue a derivative action and criticized the current scheme for being "harsh."[186]

The question then arises of whether the English approach should be adopted in China. Meng views the indemnity order positively and considers it a "feasible scheme for funding shareholders in China," which could be "fairly conveniently achieved" by order of the court without introducing new reforms to the current legal structure.[187] It is argued that two aspects need to be considered, including whether a case is "a reasonable case for the minority shareholder to bring at the expense (eventually) of the company," and whether the court is convinced that claimant has any real prospect of success.[188] Without additional or detailed guidelines for the claimant and court to follow, the application of the rule needs to be sought with the discretion of the judge.

Provision IV makes it clear that the company should indemnify "reasonable expenses" for cases where the claims are fully or partially supported by the court.[189] However, the enforcement measure of this principle is unclear; i.e. it is unclear whether this should be performed through an indemnity order. Other than the Provision, current legislation and rules of court fail to give any clear and enforceable instruction to the shareholder as to what they should do or the criteria for their litigation being funded by the company.

Without a transparent legislative process and public scrutiny, it is uncertain whether the Supreme Court's provision and the UK approach share the same legislative aims and rationale. However, the scope of application in the Provisions is actually narrower than the UK approach. Moreover, the granting of indemnity orders in the UK is based on rigorous and individualized multiple-tier tests including the "good faith test." the "financial need test," plus "considerable care" exercised by the Court.[190] It could be rather difficult to introduce such rules in a civil law jurisdiction, especially one with an immature juridical system and limited judicial resources. It is also contradictory to arguments in favor of establishing a more

183. *See* Civil Procedure Rules 1998, SI 1998/3132, Sch. 1(15) rule 12A (UK).

184. Civil Procedure Rules 1998, SI 1998/3132, Pt 19(II), rule 19.9E (UK).

185. Andrew Keay, *Assessing Rethinking the Statutory Scheme for Derivative Action under the Companies Act 2006*, 16 J. CORP. L. STUD. 39, 57 (2016).

186. *Id.* at 57–58.

187. Meng, *supra* note 94, at 29–30.

188. *Id.* at 30.

189. Zuigao renmin fayuan guanyu shiyong <zhonghua renmin gongheguo gongsi fa > ruogan wenti de guiding (si) (最高人民法院关于适用＜中华人民共和国公司法＞若干问题的规定(四)) [Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (IV)], art. 26.

190. *See* Smith v. Croft (No.1) [1986] 2 B.C.C. 99010 at 99014 (Eng.) (explaining that "where a shareholder has in good faith and on reasonable grounds sued as plaintiff in a minority shareholder's action . . . and which it would have been reasonable for an independent board of directors to bring in the company's name, it would, I think, clearly be a proper exercise of judicial discretion to order the company to pay the plaintiff's costs.").

enabling legal environment for shareholders—especially those in JSLCs—to pursue derivative actions.

Therefore, the transplant should also be subject to more rigorous assessment of its fitness with a comprehensive consideration of other path dependence factors, including a number of issues such as overburdened court systems, limited judicial resources, judges' skills and knowledge,[191] the limited knowledge of shareholders as natural persons, and information asymmetries between minority and institutional shareholders. The transplants in China in general, not just in the area discussed this article, are plagued by judicial corruption, incompetence, and inefficiency.[192] In fact, many civil servants are described as judges in China but work in administrative roles.[193] Problems such as the lack of expertise and the absence of case law to help judges means derivative actions in China are far from useful when compared with ordinary suits. The guiding cases system was introduced as a novel attempt to benefit from the advantages of both the common law and civil systems. It has the potential to bring some benefits by enhancing the faith of the masses in the judiciary in China.[194] However, guiding cases are nothing more than administrative instructions presented in the form of cases.[195] It is hard to obtain instruction in the case of litigation costs, which vary significantly between individual cases with a heavy involvement of directors' discretion.

The author's hesitation extends to the scenario in Hong Kong, a jurisdiction with similar history, tradition, culture, and geographical location to China. Courts there have yet to approve any orders indemnifying an applicant for the costs incurred in a statutory derivative action.[196]

The considerable extent of corruption in China's judicial system should be of instrumental concern in assessing the possibility of adopting an indemnity order system. Evidence has shown that most jurisdictions in developing countries suffer from democratic or authoritarian judicial corruption and parochialism.[197] The judicial discretion of judges in China always leads to opportunity for corruption, especially in terms of decisions in relation to fees.[198]

191. *See* Ting Gong, *Dependent Judiciary and Unaccountable Judges: Judicial Corruption in Contemporary China*, 4 CHINA REV. 33, 35 (2004) (discussing factors affecting judicial corruption in China); *see generally* Weixia Gu, *The Judiciary in Economic and Political Transformation: Quo Vadis Chinese Courts?* 1 CHINESE J. COMP. L. 303 (2013) (discussing current shortcomings and prior reform efforts within the Chinese judiciary).

192. *See* Gu, *supra* note 191, at 313 (explaining that the Chinese judiciary struggles with corruption, "the slow pace in processing cases, [and] the lack of professional judges.").

193. *Judging Judges*, THE ECONOMIST (Sep. 24, 2015), https://www.economist.com /china/2015/09/24/judging-judges.

194. Ruiyi Li, *Case-law adopted by China?*, UK CONST. L. ASS'N (Jan. 26, 2012), https://ukconstitutionallaw.org/2012/01/26/ruiyi-li-case-law-adopted-by-china/.

195. Jinting Deng, *The Guiding Case System in Mainland China*, 10 FRONTIERS L. CHINA 1 (2015)

196. Felix E. Mezzanotte, *The Unconvincing Rise of the Statutory Derivative Action in Hong Kong: Evidence from its First 10 Years of Enforcement*, 17 J. CORP. L. STUD. 469, 471 (2017).

197. *See* Keith E. Henderson, *Halfway Home and a Long Way to Go: China's Rule of Law Evolution and the Global Road to Judicial Independence, Judicial Impartiality and Judicial Integrity*, *in* JUDICIAL INDEPENDENCE IN CHINA: LESSONS FOR GLOBAL RULE OF LAW PROMOTION 23, 32 (Randall Peerenboom ed., 2010) (analyzing endemic judicial corruption in developing states); *see also* Jacques deLisle, *Law in the China Model 2.0: Legality, Developmentalism and Leninism under Xi Jinping*, 26 J. CONTEMP. CHINA 68 (2017) (discussing corruption as a development-challenging threat).

198. *See* Gong, *supra* note 191, at 33; *see also* Margaret Woo, *Law and Discretion in the Contemporary*

IV. FINDING THE MOST SUITABLE APPROACH FOR CHINA: AN OPTION THAT SHOULD INCLUDE MULTI-DIMENSIONAL FACTORS

The new Company Law contains no provisions on funding issues related to derivative action. Provision IV makes indemnity possible for shareholders who bring derivative actions directly or where their actions are supported fully or partially by the Court.[199] Considering the fundamentally disadvantaged position of shareholders—especially minority shareholders in JSLCs who suffer from information asymmetry and weak bargaining power—incentives should be given to shareholders to bring derivative actions. In terms of suggestions for how to make derivative action possible and effective while not triggering nuisance lawsuits, different proposals have been put forward for the reform of litigation fees and attorneys' fees for derivative actions. Issues related to costs are largely responsible for the relative unpopularity of statutory derivative actions. Reform suggestions should be considered carefully in relation to the nature of derivative action as a lawsuit instigated by shareholders on behalf of the company with indirect and uncertain benefits for claimant shareholders.

Commentators have been using different methodologies with diverse focuses that have led to different proposals. Clarke and Howson claimed that it is the losing party who should be responsible for the attorneys' fee.[200] Huang proposes that the US model is more suitable for China due to the effectiveness of contingency fee arrangements in encouraging derivative action in JSLCs and the unfitness of the 'indemnity order' as the leave of the court is not required in China.[201] Mao proposed the adoption of the Japanese model in order to achieve multiple goals, including encouraging minority shareholders to bring derivative actions on behalf of the company and mitigating litigation risks and costs.[202] The approaches of these proposals are largely established as a legal transplant that is a smart way of choosing to forge a legal model.[203] From our discussions of the importance of legal costs in relation to derivative actions in the context of the legislative experiences of the US, the UK and Japan, it seems that a simple transplant should not be the way forward. Just like companies' decisions on whether to "make or buy" certain raw materials,[204] it may be more efficient and rational to

Chinese Courts, 8 PAC. RIM L. & POL'Y J. 581 (1999) (describing how China's commitment to domestic structural reforms within the nation's courts has been tested by the problem of judicial corruption); Chris X. Lin, *A Quiet Revolution: An Overview of China's Judicial Reform*, 4 ASIAN-PAC. L. & POL'Y J. 256 (2003) (detailing how rampant judicial corruption has motivated reform movements).

199. Zuigao renmin fayuan guanyu shiyong <zhonghua renmin gongheguo gongsi fa > ruogan wenti de guiding (si) (最高人民法院关于适用＜中华人民共和国公司法＞若干问题的规定(四)) [Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (IV)], art. 26.

200. Donald Clarke & Nicholas Calcina Howson, *Pathway to Minority Shareholder Protection: Derivative Action in the People's Republic of China*, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 243, 291–92 (Dan W. Puchniak, Harald Baum, and Michael Ewing-Chow eds., 2012).

201. Huang, *supra* note 7, at 653 (2012).

202. WENQING MAO (毛文清), JUNHENG SHIJIAOXIA DE GUDONG DAIBIAO SUSONG YANJIU (均衡视角下的股东代表诉讼研究）[A STUDY ON SHAREHOLDER REPRESENTATIVE ACTION FROM AN EQUILIBRIUM PERSPECTIVE] 157 (2012).

203. MATHIAS SIEMS, COMPARATIVE LAW 212–13 (1st ed. 2014).

204. Ralf Michaels, *Make or Buy—A Public Market fort Legal Transplants?*, *in* REGULATORY COMPETITION IN CONTRACT LAW AND DISPUTE 27 (Horst Eidenmuller ed., Beck / Hart / Nomos, 2013); Ralf Michaels, *'One Size Can Fit All'—Some Heretical Thought on the Mass Production of Legal Transplants*, *in* ORDER FROM TRANSFER: COMPARATIVE CONSTITUTIONAL DESIGN AND LEGAL CULTURE 56 (Gunter Frankenberg ed., 2013).

adopt a hybrid approach, adopting a model in China that is partly imported from other jurisdictions and then adapted to fit the Chinese context.

The legal cost issue should be regulated through a mechanism including stipulations for litigation costs that include court fees, which may be further divided into filing fees, other litigation costs, and attorneys' fees. The selection of the most appropriate model should rest on the status quo of the judicial system, together with the weakness and reform necessity of the derivative action mechanism in China. Moreover, it is important to embed such elements as the nature of the claimants and the current state of the legal profession in China.

As for filing fees, as a cost that the litigant needs to pay in advance, a reform should also be adopted in China to address the lack of incentives that underlies the reluctance of shareholders in JSLCs to bring derivative actions. This could be done by introducing a fixed charge as the litigation cost. This is because the amount of damages to be paid to the suing shareholder is normally difficult to determine, while a fixed charge is predictable and shareholder-friendly. The trajectory of the increasing number of derivative actions in Japan[205] may be echoed in China by enhancing the popularity and effectiveness of the derivative action system.

It is difficult to offer an exact figure, which may sound arbitrary, without empirical support.[206] Nevertheless, the introduction of a fixed fee will achieve dual goals—first, encouraging sincere and legitimate shareholders to bring healthy derivative actions in the interests of companies. Just as West argued in the context of Japan, the change in the nature of derivative actions to involve a nominal fixed stamp fee (a reduction in most cases) explains "much of the increase in cases filed [of derivative action]".[207] However, this fee may be subject to change due to the inflation and well-documented obstacle of insufficient court funding in China in order to achieve the rule of law.[208] Second, it would support claims that shareholders' benefits from derivative actions are truly "incalculable." It is accurate, rational and consistent with respect to the nature of the derivative action mechanism itself, since shareholders are only entitled to the benefits of a successful litigation in percentage terms, indirectly, and with very vague causal links between the benefit to shareholders and the claims of the lawsuits. The *pro rata* benefits that shareholders may enjoy are too difficult to quantify and enumerate. The American Law Institute validates the derivative action mechanism as an outstanding mechanism for shareholder remedy with virtually incalculable, or at least no

205. *See* Masafumi Nakahigashi & Dan W. Puchniak, *Land of the Rising Derivative Action: Revisiting Irrationality to Understand Japan's Unreluctant Shareholder Litigate*, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 128, 129 (Dan W. Puchniak, Harald Baum & Michael Ewing-Chow eds., 2012) (explaining the dramatic increase in derivative actions in Japan).

206. A bold attempt on reform could be a fee of RMB 780 Yuan (equivalent to 13,000 Yen) for LLCs. A higher fee should probably be used for JSLCs or claims with very high targets (capped at probably 100,00 Yuan which is equivalent to 1.6 million Yen) since the monetary claims are likely to be much higher in value. This is due to the size of the companies, the destructive nature of directors' dereliction of duty, and their complicity in these cases. Due to the threshold of 1% ownership for 180 days in JSLCs, a higher fee than RMB 780 Yuan should not put companies under any pressure.

207. Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351, 352–53 (2001).

208. Xin He, *Zhongguo fayuan de caizheng buzu yu sifa fubai* (*中国法院的财政不足与司法腐败*) [*Lack of Financial Resources and Judicial Corruption in Chinese Courts*], 21st Century Rev. 12–23 (February 2008).

readily quantifiable, deterrent effect.[209] In the author's opinion, it is fundamentally important to clarify the nature of derivative action claims, specifying that all derivative actions are defined as "incalculable" claims in the national company law legislation.

In terms of attorneys' fees, it would be feasible but complicated to introduce the US model in China, with the "exceptional nature of the economic incentives"[210] provided within the derivative action regime, due to the fact that attorneys are regarded as entrepreneurs and derivative suits are seen as entrepreneurial litigation. It is argued that there are two important, but rather difficult, prerequisites for the contingency fee arrangement to work effectively in China: a common fund principle and a substantial benefit test. A well understood and reformed approach needs to be introduced in China gradually, and it is always quicker to test ideas at the regional level. As a starting point, it may be valuable to explore the possibilities of introducing localized regulatory measures to deal with the issues surrounding litigation fees. Areas that have been popular for derivative actions based on the historical cases after the enforcement of Section 151 of Chinese Company Law would be a good start, such as Shanghai City, Beijing City, Zhejiang Province, Jiangsu Province, and Guangdong Province.[211] Such a localized approach may give local authorities flexibility in designing or making attempts to develop a workable approach to funding in derivative actions. Local courts have always seemed to be more proactive in awarding legal fee reimbursement for successful claimants.

In fact, the judicial opinions promulgated by local courts always contain rules to the effect of contingent fees. For example, it is suggested by the Civil Division of the High People's Court of Shanghai that a shareholder who successfully brings a lawsuit on behalf of a company should be indemnified for reasonable litigation costs.[212] The Jiangsu High People's Court has issued rules to make indemnifying the claimants possible if they wish to bring a derivative litigation.[213] The fee-oriented requirement issued by the Jiangsu High People's Court was designed to be more protective, and the rule provided that "if the court supports the claimant's derivative claims, litigation costs should be borne by the claimant and other reasonable litigation fees such as the attorney fees and travel costs should be borne by the company; if the court does not support the derivative claims, the litigation cost should be paid by claimant shareholders; the court partly support the claims, the claimant shareholders and the company should bear the cost *pro rata*."[214]

Of course, these flexibilities also bring uncertainties, which may not resolve the lack of incentives for derivative action in China. Furthermore, detailed rules on the nature of benefits,

209. *See generally* AMERICAN LAW INSTITUTE, AMERICAN LAW INSTITUTE PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) (detailing a survey of issues about derivative actions and deterrence); *see also* Melvin Aron Eisenberg, *An Overview of the Principles of Corporate Governance*, 48 BUS. LAW. 1272 (1993) (describing an overview of the book *Principles of Corporate Governance*).

210. Dan Puchniak, *The Derivative Action in Asia: A Complex Reality*, 9 BERKELEY BUS. L.J. 1, 18 (2013).

211. Shaowei Lin, *Derivative Actions in China: Case Analysis*, 44 HONG KONG L. J. 621, 642 (2014).

212. 2003 Guanyu Shenli Sheji Gongsi Susong Anjian Ruogan Wenti de Chuli Yijian (2003 关于审理涉及公司诉讼案件若干问题的处理意见) [Opinions on Adjudicating Cases in Relation to Litigation Regarding Companies 2003] art. 5 (2) subsec. 4, (Civil Division of the High People' Court of Shanghai).

213. *See* Jiangsu High People's Court, Jiangsusheng Gaoji Renmin Fayuan Guanyu Shenli Shiyong Shiyong Gongsifa Anjian Ruogan Wenti de Yijian (江苏省高级人民法院关于审理适用使用公司法案件若干问题的意见) [Opinions on Several Issues in relation to Adjudicating Corporate Disputes of the High People's Court of Jiangsu Province]。

214. *Id.* art. 78.

the triggering point at which a claimant is eligible for compensation, and how to satisfy a reasonable or *pro rata* rate still need further discussion.

CONCLUSION

The mechanism of derivative claims has been a topic of interest in China with the development of corporate governance, particularly in relation to the corporate reform of SOEs and stock market development. The current problem in the Chinese legal system is not the abuse of this mechanism. Instead, the real concern is that the mechanism has not reached its legitimate potential with limited function, especially for JSLCs.[215] A sensible fee arrangement is important for a more enforceable mechanism and better corporate governance. Notwithstanding the significance of derivative actions in modern China, scholarly work has largely overlooked the litigation-related cost of derivative action in this fast-growing nation.

The existing research recognizes the need for a continuous process of adaptation and development, learning appropriately from experience and responding sensitively to local conditions. To date, the development of the financial system in China has had unique Chinese characteristics, and it has been suggested that this pathway to growth will continue. The lack of legal issues on how derivative actions should be funded is a critical failure in the new Company Law, considering the lack of incentives for shareholders to bring derivative actions, particularly those who are investors in JSLCs. Fee-related issues have been addressed in the recent Provision IV. This provision failed to address three important aspects, including fee-related issues for shareholders whose cases are not supported by the court, funds that could be made available for shareholders when they bring litigation rather than paying up-front, and the clear scope of the fund that could be indemnified. The scope in Provision IV seems much narrower than the court fees stipulated in the Measures on Payment of Litigation 2007.

Through the discussions of the legal approaches in Japan, US, and UK as three classic approaches practiced globally, it is concluded that a fixed fee (as in Japan) and a contingency fee supported by a common fund and substantial tests should be the way forward. The approach adopted in the UK is neither feasible nor desirable for China due to strict multi-tier tests, reliance on judges' discretion, an underdeveloped judicial environment, and the lack of judicial resources in China. The introduction of any reform will be hindered by path-dependence factors such as Chinese history, culture, the quality and ethics of the legal profession, existing legislation, and the positions and information available to shareholders, especially minority shareholders in JSLCs.

215. Guanghua Yu & Junhai Liu, *Lixing Lifa he Falü Shishi De Xiaolü* (*理性立法和法律实施的效率*) [*Rational Legislation and the Efficiency of Law Enforcement*] Commercial Law Forum No. 330 of Civil Law (2009).