[Title head] MAKING SHAREHOLDER DERIVATIVE ACTIONS HAPPEN IN CHINA: HOW SHOULD LAWSUITS BE FUNDED?

Zhong Zhang[•]

There has been a high expectation for the derivative action, which was introduced into China in 2005 when the Company Law 1993 was extensively amended, to play an important role in corporate governance in China. But this expectation may not be fulfilled, because, among other things, the Law does not provide for how derivative actions should be financed. By way of a comparative study, this article investigates what rules are appropriate for derivative action funding in China. The general conclusion is that the common law indemnity order is inherently defective, because it entails that judges impose financial obligations on a company before the merit of an underlying claim is ascertained. The American contingent fee is most favourable and the established rules could be reformed to make the arrangement neutral so as to discourage frivolous litigation. Lastly, the special barrier of filing fees in China has to be cleared in order for derivative actions to be actually taken.

[A head] A. Introduction

The shareholder derivative action, an exception to the general rule that a company rather than individual shareholders is the proper plaintiff in respect of wrongs done to the company,[1] has been a focus of interest in China since the late 1990s. As a series of corporate scandals broke out, corporate governance emerged as the central concern in

[•] Academic Research Fellow, White Rose East Asia Centre, School of East Asian Studies, University of Sheffield. This article is converted from one chapter of my PhD thesis. I am grateful to Gerard McCormack and Michael Lower who were frequent sources of insightful feedback, guidance and encouragement during my PhD research at the University of Manchester. The usual disclaimers apply.

[1] *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189.

the corporatisation reform of state-owned enterprises and the development of capital markets.[2] Allowing individual shareholders to take legal action on behalf of a company where the company is unable to do so because of wrongdoer control,[3] the shareholder derivative action has been regarded as a useful tool to check the dominant powers of controlling shareholders and to curb opportunistic behaviour of management.[4] It has been attached importance for the protection of minority shareholders and improvement of corporate governance in general. Repeated calls were made to amend the Company Law 1993 to introduce the derivative action into China.[5] This occurred in 2005 and the revised law explicitly afforded shareholders the right to bring up legal actions on behalf of their companies under certain circumstances.[6] This addition to the shareholders' rights and the amendment in other aspects have been viewed positively as a significant improvement of the law which was predicted to contribute to good corporate governance in China.[7] The new law took effect from 1 January 2006.

---

[2] For the origin and evolution of corporate governance in China, *see* generally Tenev, Stoyan & Chunlin Zhang with Brefort, Loup, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (World Bank and the International Finance Corporation, Washington, DC 2002), Chapter 2; Schipani, Cindy A. & Liu Junhai, 'Corporate Governance in China: Then and Now' (2002) *Columbia Business Law Review* 1-69. For a description of corporate scandals, *see* Zhong Zhang, 'Legal Deterrence: The Foundation of Corporate Governance – Evidence from China' (2007) 15(5) *Corporate Governance: An International Review* 741-767; Yi Zhang, 'Law, Corporate Governance, and Corporate Scandal in an Emerging Economy: Insights from China', *Working Paper* (November 2004), Available at SSRN: http://ssrn.com/abstract=957549.

[3] *Edwards v Halliwell* [1950] 2 All ER 1064.

[4] *See* Tenev & ~~Chunlin~~Zhang, *ibid*, at 149; Schipani & Liu, *ibid*. Gan Peizhong, 'Youxian Zeren Gongsi Xiaogudong Liyi Baohu De Faxue Sikao-Cong Susong Shijiao Kaocha (Legal Thoughts on the Protection of the Interests of Minority Shareholders of Limited Liability Companies – From a Litigation Perspective)' (2002) 6 *Fa Shang Yanjiu (Studies in Law and Business)* 35-45; Liu Junhai, *Gufeng Youxian Gongsi Gudongquan De Baohu (The Protection of the rights of Shareholders of Joint Stock Companies)* (Falu Chubanshe (Law Press) 2004), p 313-362.

[5] *Ibid*.

[6] *See* Company Law 1993 (amended 2005), Art 152.

[7] *See* Feinerman, James V., 'New Hope for Corporate Governance in China?' (2007) 191 *China Quarterly* 590-612; Anderson, Craig & Bingna Guo, 'Corporate Governance under the New Company Law (Part 2): Shareholder Lawsuits and Enforcement' (2006) 20(4) *China Law & Practice* 15-22.

The derivative action has long been controversial and a thorny issue in company law in developed economies. Views on the role of derivative action in corporate governance have been polarised, with a judge in the US hailing it as "the chief regulator of corporate management" [8], while another dismissing it as doing "little to promote sound management and often hurt the firm by diverting the managers' time from running the business"[9]. It is not the purpose and beyond the scope of this article to examine the role of derivative action in corporate governance in China. It can only be briefly stated that, unlike in mature economies where "the opportunity cost of excess leisure and not working hard is probably the single largest source of agency costs",[10] Chinese corporate governance currently is still in a primitive stage where serious misbehaviour like appropriation and fraud is the major problem.[11] For such misbehaviour, deterrence by way of legal sanctions is the solution and voluntary market discipline would not function well.[12] The critical issue concerning Chinese corporate governance presently is how to enhance legal deterrence. Considering the fact that the public enforcement of law is inherently weak [13] and other private enforcement mechanisms like the securities class action will remain unavailable for the foreseeable future,[14] the derivative action should be accorded a prominent status in corporate governance in China.

---

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

[9] *Felzen v Andreas*, 134 F.3d 873, 877 (7th Cir. 1998). For the academic debate, *see* Coffee, John C. & Schwartz, Donald E., 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' ~~[~~(1981)~~]~~ 81 *Columbia Law Review* 261; Ramsay, Ian 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15(1) *University of New South Wales Law Journal* 149; Cheffins, Brian R. & Black,~~–~~ Bernard S., 'Outside Director Liability across Countries' (2006) 84 *Texas Law Review* 1385.

[10] Fischel, Denial R., & Bradley, Michael, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis' (1986) 71 *Cornell Law Review* 261, 291.

[11] *See* Zhong Zhang (n 2 above).

[12] *Ibid*.

[13] *See* Qiao Liu, 'Corporate Governance in China: Current Practices, Economic Effects, and Institutional Determinants' (2006) 52(2) *CESifo Economic Studies* 415-453.

[14] *See* Clarke, Donald C., 'Corporate Governance in China: An Overview' (2003) 14(4) *China Economic Review* 494.

However, will the derivative action introduced by the new Company Law actually become a useful corporate governance tool in China? It has now been rightly recognised that there are various inadequacies in the Law which hamper the derivative action from delivering on its promise.[15] For example, the Law provides very limited guidance with respect to the causes of action that should proceed as derivative actions; the procedure for taking derivative action is vague and many components are missing; the 1 per cent minimum shareholding requirement in respect of companies limited by shares[16] rules out the possibility that public shareholders other than institutional investors actively bring up derivative actions to pursue wrongs done to listed companies which are the focal concern of corporate governance. Relatively, these inadequacies in the legislation are easier to address and rules on derivative actions can be clarified and supplemented by judicial interpretation or changed by revising the Law. More fundamental and difficult to overcome are hurdles posed in the judicial system, like the lack of skills and absence of case law to help judges hear derivative cases which are more complex compared with ordinary suits. However, even these problems are not insoluble. The key is the government's determination to strengthen legal deterrence and make use of the derivative action as one mechanism to achieve that end. With determination, it can be provided, for example, that derivative actions shall be under the jurisdiction of the Intermediate People's Court in bigger cities, just like the hearing of securities litigation arising from misrepresentation.[17] As a result, the concern of lack of judicial skills could be met. Regarding the absence of case law,

[15] *See* Xiaoning Li, *A Comparative Study of Shareholders' Derivative Actions* (Kluwer, Deventer, 2007), Chapter 5.4; Anderson & Bingna Guo (n 7 above).
[16] Company Law 1993 (amended 2005), Art 152.
[17] *Some Provisions on Trying Cases of Civil Compensation Arising from False Statement in Securities Market* (the Supreme People's Court, December 26, 2002), s 8.

although precedents cannot be cited to support court decisions in China, there actually exists the mechanism enabling judges to consult previous cases for guidance.[18]

Besides the aforementioned inadequacies, the new Company Law says nothing about how derivative actions should be funded. This omission is a critical failure, considering the intrinsic deficiency of incentive on the part of shareholders, especially minority shareholders of listed companies, to take on derivative actions. The established rule of derivative action is that, because the cause of action belongs to the company, recoveries, if any, from the action go to the company.[19] On the other hand, if there is no other source of funding, the whole costs of litigation have to be born by the plaintiffs personally. Thus a plaintiff of derivative action "has nothing to gain, but much to lose".[20] Although it can be argued that the plaintiff as a shareholder benefits from the recoveries, because the value of his shareholdings would increase *pro rata* as the assets of the company swell up, the benefit is hypothetical. For one reason, he has no legal right to compel that the recoveries be handed out as dividends and, for the other, the value of shares of a company is determined not just by the underlying assets but also by many other factors, which means that the value of the company's shares may not increase even though winning a derivative action brings recoveries to the company.[21] More significantly, even if the benefit materialises, it is inconsequential as far as minority shareholders are concerned. Indeed, it is negligible where the company is big and the number of shares is very large. It is thus clear that the

[18] For example, the Supreme People's Court publishes 'typical cases' in its Gazette which, although short of carrying the force of precedent, are a helpful consulting point for lower court judges to adjudicate cases. *See* Nanping Liu, "'Legal Precedents' with Chinese Characteristics: Published Cases in the Gazette of the Supreme People's Court" (1991) 5(1) *Journal of Asian Law* 107-140.
[19] *See Spokes v The Grosvenor & W. End Ry. Terminus Hotel Co. Ltd.* (1897) 2 Q.B. 124, at 128; Boros, Elizabeth J., *Minority Shareholders' Remedies* (Oxford: Clarendon Press, 1995), p 191.
[20] *Wallersteiner v Moir (No 2)* [1975] 1 All ER 849, *per* Lord Denning M.R. at 862.
[21] Wilson, J. D., 'Attorney Fees and Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholder's Derivative Action' (1985) 5 *Windsor Yearbook of Access to Justice* 142.

potential benefits and costs from a derivative action for litigating minority shareholders are so incommensurate that they would have little incentive to bring up a lawsuit. For derivative action to be actually taken, proper legal rules should be put in place to alleviate minority shareholders' concern for litigation costs. That is why the rule in *Foss v Harbottle* [22] is said to be "essentially an issue of funding".[23]

How should derivative actions be funded in China so as to address the problem of insufficient incentive on the part of minority shareholders? This is the focus of this Article. To find an answer, it undertakes a comparative study of the relevant law of England and the US. It examines what arrangement is preferable in the sense that it encourages the taking of derivative actions, while not instigates nuisance lawsuits.[24] The general conclusion is that the American contingent fee is most favourable and the established rules could be reformed to make the arrangement neutral so as to discourage frivolous litigation. On the contrary, the English indemnity order, which requires judges to impose concrete financial obligations on a company before the merit of the underlying claim is ascertained, is inherently defective. To make recommendation of how derivative actions should be funded in China, it takes account of the different features of the Chinese civil litigation funding system to see whether the suggested funding rules are workable in the specific context of China. The following section introduces briefly the Chinese derivative action and litigation funding in China. Section C examines different options that are available for derivative action funding. Section D looks into which option is most favourable in terms of encouraging derivative actions by alleviating minority shareholders' concern for costs. Section E addresses the issue of whether the American contingent fee model

[22] (1843) 2 Hare 461.
[23] Prentice, D. D., '*Wallersteiner v Moir*: The Demise of the Rule in *Foss v Harbottle*?' (1976) 51 *Conveyancer and Property Lawyer*, 58.
[24] [AQ: Could you provide reference information for footnote 24?]

is compatible with the Chinese civil procedure system. Section F discusses the problems of frivolous litigation and cheap settlement associated with American contingent fees and looks into what changes can be made to the established rules to ensure that the arrangement is more neutral. Section G explores the special issue of filing fees in China which constitute a serious barrier to the taking of derivative actions. The final section draws a conclusion.

[A head] B. The Derivative Action And Litigation Funding In China: Law And Practice

There was a dispute over whether the derivative action was permissible under the old Company Law. Article 111 of the Company Law 1993 provided that:

"Where a resolution adopted by the shareholders' general meeting or the board of directors violates the relevant national statutes or administrative regulations, or infringes the rights and interests of shareholders, a shareholder is entitled to bring a suit to the People's Court to enjoin such illegalities or infringements." [25]

The majority view was that this article did not afford shareholders the standing to initiate derivative actions but only direct actions to stop the execution of illicit resolutions passed by shareholders' meetings or the board of directors.[26] This is actually quite obvious and several courts which refused to accept derivative suits filed with them subscribed to this view.[27] Nevertheless, out of necessity, some derivative suits were in practice allowed before the derivative action was formally introduced in 2005. In 1994 the Supreme People's Court, in reply to a High People's Court's enquiry about the acceptance of a specific case, indicated that where a company was unable to take an action to redress a wrong done to it, shareholders should be

[25] *See* Company Law 1993, Art 111.
[26] *See* Xiaoning Li (n 15 above), pp 266-267.
[27] For example, *see Zhongtian v Bichun, etc*., cited in Xiaoning Li, *ibid*, p 268.

permitted to do so.[28] This is probably the first derivative case that has been accepted in China. The High People's Court in Zhejiang,[29] Shanghai,[30] Jiangsu[31] and Beijing[32] before 2006 had also issued judicial opinions on the application of the Company Law, instructing courts under their respective jurisdictions to accept derivative actions. There were thus cases of derivative action before 2006 when the new Company Law came into force, although the old Company Law did not provide unequivocally legal basis for derivative actions. However, those cases involved mostly limited liability companies. The derivative action was resorted to as a method of solving disputes between shareholders rather than as a tool of corporate governance in the normal sense. So far as listed companies were concerned, the situation was less remarkable: there were only three reported cases and one case was dismissed with the court explicitly holding that there was no legal basis for accepting a derivative action,[33] while the other two were accepted initially with much publicity but what happened subsequently was unknown.[34] The dismissed case was concerned with a common corporate governance problem for listed companies in China: corporate funds were tunnelled out of listed companies by the controlling shareholder.

---

[28] Fa Jing (1994) No. 269, cited in Xiaoning Li, *ibid*, p 268.

[29] Zhejiang Sheng Gaoji Renming Fayuan Minshi Shenpan Di'er Ting (No. 2 Civil Division of the High People's Court of Zhejiang Province), *Guanyu Gongsifa Shiyong Ruogan Yinan Wenti de Lijie* (*Understandings on Several Difficult Issues Regarding the Application of Company Law*) (December 2002), Art 15.

[30] Shanghai Shi Gaoji Renming Fayuan Minshi Shenpan Di'er Ting (No. 2 Civil Division of the High People's Court of Shanghai), *Guanyu Shenli Sheji Gongsi Susong Anjian Ruogan Wenti de Chuli Yijian (Yi)* [~~*The*~~ *Opinions on Adjudicating Cases Regarding Corporate Litigation (No. 1)*] (June 2003), art. 5.

[31] Jiangsu Sheng Gaoji Renming Fayuan (the High People's Court of Zhejiang Province), *Guanyu shenli Shiyong Gongsifa Anjian Ruogan Wenti de Yijian (Shixing)* [~~*The*~~ *Opinions on Several Issues on Adjudicating Cases Applying Company Law (Trial Implementation)*] (June 2003), art. 17.

[32] Beijing Shi Gaoji Renming Fayuan (the High People's Court of Beijing), *Guanyu Shenli Gongsi Jiufen Anjian Ruogan Wenti de Zhidao Yijian (Shixing)* [~~*The*~~ *Guiding Opinions on Several Issues on Adjudicating Corporate Dispute Cases (Trial Implementation)*] (February 2004), Art 1(8).

[33] A case involved Shenzhen Sanjiu Medical and Pharmaceutical (Sanjiu Yiyao 000999).

[34] Two cases involved Henan Lianhua Weijing (600186) and Shenzhen Xingdu Hotel (000033).

The new Company Law explicitly affords shareholders the right to take on derivative actions, but conditions are imposed.[35] First, for a company limited by shares, only (a) shareholder(s) who alone or jointly own(s) at least 1 per cent shares of the company is / are qualified. But there is no such a limitation for limited liability companies. Second, the shares should have been held for at least 180 days continually. Third, the shareholder(s) should make a written demand to the supervisory board or boar of directors and only if the board has refused or failed within 30 days to act can the shareholder(s) take(s) the demanded legal action. After the law came into effect on 1 January 2006, there have been reports of derivative actions. However, the imbalance between limited liability companies and listed companies has not been changed: there have been derivative actions involving limited liability companies but not listed companies. One listed company was a defendant in a case because it was accused of inflicting injury, but not because its interests were injured.[36] Indeed there have been two cases that are brought up by minority shareholders against listed companies,[37] but they are not derivative but direct suits based on Article 22 of the new Company Law which allows shareholders to take direct actions to revoke illicit resolutions adopted by shareholders' meetings or the board of directors.[38]

One reason that explains the imbalance is the difference of minimum shareholding requirement for taking a derivative action. The 1 per cent threshold requirement for companies limited by shares means practically that individual public shareholders of listed companies would be virtually excluded and only institutional shareholders

[35] Company Law 1993 (amended 2005), Art 152.
[36] *See* Li Jianping, 'Gongsifa Xiuding Hou Guonei Zuida Biaodi Gudong Daibiao Susong An Shilu (Witnessing a Shareholder Derivative Action with the Highest Claim Value in the Country since the Company Law was Revised)', Fizhi Ribao (Legal Daily) (11 January 2008).
[37] *Zhang Qiuju v Sinopec Wuhan Petroleum Group Co. Ltd* [2007]; *Chen Dongmei v Sinopec Shandong Taisan Petroleum Co. Ltd* [2007 Taisan minchuzhi No. 594]. Both the minority shareholder plaintiffs lost their cases.
[38] Company Law 1993 (amended 2005), Art 22.

would qualify, but institutional shareholders nonetheless do not have the incentive to vigorously pursue wrongs done to their companies, according to the experience of the US.[39] Another reason may lie in the uncertainty of litigation funding. Although the new company law provides shareholders the standing to sue, it says nothing on how derivative lawsuits should be funded. The judicial interpretation and judicial opinions that were promulgated before 2005 are also of little help. Two opinions indeed mentioned that a court could decide to indemnify a winning plaintiff shareholder for reasonable litigation costs,[40] but did not elaborate on details. The others were ~~similarly~~ silent on the issue. Because of this uncertainty, it is not surprising to see the imbalance between limited liability companies and listed companies. As a shareholder of limited liability companies usually holds a much larger stake in the companies than a minority shareholder of listed companies does, the lack of funding may not be a big problem. He may still have an economic incentive to take a derivative action, even though he may not be compensated for his litigation costs. For example, in a derivative action whose claim value has been the highest thus far in China, the majority shareholder and the general manager of the company were ordered to restitute about half a billion RMB.[41] The minority shareholder plaintiff owned 35 per cent of the shares of the company. The gains to the shareholder from the action were huge. Hence the lack of litigation funding was not a problem. But the situation is quite different insofar as listed companies are concerned. For a minority shareholder of a listed company who usually owns only a very small portion of the company's total shares, the gains from a derivative action are miniscule. Thus a minority shareholder

[39] *See* Cox, James D. & Thomas, Randall S. 'Does the Plaintiff Matter?: An Empirical Analysis of Lead Plaintiffs in Securities Class Actions' (2006) 100 *Columbia Law Review* 101.
[40] *See* n ~~30~~ 29 above, Art 5; n ~~31~~ 30 above, Art 78.
[41] *See* Guo Hengzhong, 'Guonei Suopei e Zuida de Gudong Paishen Susong An Yishen Panjue (A Derivative Action with the highest Claim Value so Far in the Country Adjudicated in the First Instance), *Fazhi Ribao* (*Legal Daily*) (22 April 2007).

of listed companies, if he is economically rational, would not take on a derivative action where he is not compensated for litigation costs.

It is therefore clear that for derivative actions to happen to listed companies, rules for the compensation of litigation costs should be put into place. As a matter of fact, even for limited liability companies where shareholders may not be short of incentives, such rules are still necessary, because it is not fair for a plaintiff shareholder alone to shoulder the whole costs of an action which benefits all the shareholders. But what rules are fair and appropriate? How should lawsuits be funded so that the problem of lack of incentive can be best addressed while shareholders are not over-incentivised so as to bring up unmeritorious cases? To answer this question, let us first examine what options are available to fund derivative actions in the developed world.

[A head] C. Funding Derivative Actions: Available Options

[B head] 1. Funding Derivative Actions in England: Indemnification by Companies

In England, the disincentives on the part of plaintiffs to take derivative actions were first recognised and addressed by *Wallersteiner v Moir (No 2).*[42] A brief introduction to the facts of the case is helpful. By way of a series of manipulative transactions, the defendant, Dr Wallersteiner, who was a director of the company at issue, acquired 80 per cent of the shares of the company actually funded by the company. Mr Moir, the plaintiff and a minority shareholder, had previously applied to the Board of Trade to investigate the transactions, but failed. The defendant had also refused to allow the affairs to be referred to the shareholders' meeting. The court was the only venue

[42] [1975] 1 All ER 849.

where those dubious transactions could be challenged. Up to this stage, Mr Moir had obtained a judgment against the defendant, but further judicial procedure was needed to assess the damages. The defendant had also applied to appeal to the House of Lords and, if allowed, Mr Moir had to defend his case in the House of Lords. But Mr Moir had exhausted all of his financial resources throughout the action which had been successfully prolonged for more than 10 years by the defendant.

Mr Moir's plight found sympathy with the Court of Appeal, in particular with Lord Denning. Though it was held that a plaintiff in a derivative action was not eligible for legal aid[43] and the contingent fee scheme was beyond the court's mandate to introduce,[44] the court ordered the company to indemnify Mr Moir the costs he had incurred and was to incur in the upcoming proceedings. The rationale that a company should indemnify a plaintiff in a derivative action is that the plaintiff acts on behalf of the company and the company is the beneficiary. A plaintiff in a derivative action, it was held, is analogous to a trustee or agent on behalf of the trust estate or the principal. The test for the eligibility of indemnity is that the plaintiff is in good faith and reasonable to bring the action and the action is in the company's interests. The success of the action is not necessarily a precondition for indemnity. Even if an action fails, the plaintiff may still be entitled to indemnity, because a derivative action is an action of the company and hence the risk of losing the case should be borne by the company. It was further held that the general rule is that a plaintiff should apply for an indemnity order at the stage when he applies for leave to continue an action, but exception should be allowed if at the end of a proceeding the court decided that it is

[43] Because the genuine plaintiff in a derivative action is the company who, as a corporate body, was excluded by statute from legal aid. *See Wallersteiner v Moir (No 2)* [1975] 1 All ER 849, *per* Lord Denning M.R. at 859.
[44] For a different view, *See Wallersteiner v Moir (No 2)* [1975] 1 All ER 849, *per* Lord Denning M.R. at 860-862.

appropriate to make such an order.[45] The application shall be made *ex parte* and the procedures should be "simple and inexpensive".[46]

The rule for an indemnity order was further clarified, as well as restricted, by S*mith v Croft (No. 1).*[47] Walton J regarded the rule framed in *Wallersteiner v Moir* somewhat oppressive and unfair. He held that an indemnity order should not normally be made *ex parte*. Rather, the company should be joined as a party to the application so that relevant evidence can be provided by the company and made available to it. He also decided that a plaintiff should be indemnified only if he is genuinely in need, which means that a plaintiff should pass a means test. However, this proposition was not followed by another case.[48] An order for interim payment, it was held, should not extend to complete payment.[49] Further, an indemnity order does not confer a lien on company assets or recoveries and thus indemnity granted has no priority in the event of insolvency of the company. Finally, Walton J restated the standard of test on the availability of indemnity order, holding that, to decide whether such an order should be granted, the court should satisfy that an independent board of directors would consider the action in the circumstances.

The common law *Wallersteiner* order has now found a place in statutes. First the Rules of Supreme Court[50], then the Civil Procedure Rules 1998[51] and the Civil Procedure (Amendment) Rules 2000 in a simplified version[52] expressly provided that a court may order a company to indemnify the plaintiff against liability in respect of costs incurred in the action. This provision has since remained largely without

---

[45] *Ibid*, *per* Scarman LJ at 871.
[46] *Ibid*, *per* Lord Denning M.R. at 859.
[47] [1986] 2 All ER 551.
[48] *See Jaybird Group Ltd v Greenwood* [1986] BCLC 319.
[49] Otherwise, it was proposed, the plaintiff would have no incentive to conduct the case diligently (*per* Walton J at 565).
[50] Order 15, r 12A.
[51] Schedule 1 at 162-3.
[52] S.I. 2000/221, r. 19.9.

change.[53] However, the provision is simple and does not specify detailed procedures the parties and the court should follow. The conditions or tests for granting an indemnity order are not mentioned. Thus guidance needs to be sought from case law and case law remains much relevant in applying the statutory provision. The Companies Act 2006 which introduced the statutory derivative action said nothing about the issue of litigation funding.

[B head] 2. Funding Derivative Actions: Conditional Fees

As a result of recent reform of civil litigation funding, the conditional fee arrangement were introduced in England.[54] This gives rise to the possibility that derivative actions could be funded through conditional fees.[55] Under the Access to Justice Act 1999, parties to litigation other than criminal and family proceedings can enter into conditional fee agreements with their lawyers.[56] Thus in theory shareholder plaintiffs in derivative actions could make use of the conditional fee arrangement to fund their suits.[57]

---

[53] *See* Civil Procedure (Amendment) Rules 2000 (October 2006 42nd Update), r 19.9.

[54] *See* Peynser, John, 'A Revolution by Degrees: From Costs to Financing and the End of the Indemnity Principle' (2001) 1 *Journal of Current Legal Issues*, available at http://webjcli.ncl.ac.uk/2001/issue1/peysner1.html. For the latest development of conditional fee regulation, *see* Andrew Hogan, 'Conditional Fees: Problems Solved and Problems yet to Come' (2006) 1 *Journal of Personal Injury Law* 40-60.

[55] Reisberg, Arad, 'Derivative Actions and the Funding Problem: The Way Forward' (2006) *Journal of Business Law* 445-467.

[56] *See* Access to Justice Act 1999, s 58A (1). Criminal proceedings under s 82 of the Environmental Protection Act 1990 can be funded through conditional fee agreements.

[57] It was argued that conditional fee agreements might not be available for derivative actions, because the proceeds of a derivative action must accrue to the company and 'it is not open to the plaintiff shareholders in a derivative action to bargain away any part of the proceeds of a successful judgment'. *See* Boyle, A. J., *Minority Shareholders' Remedies* (Cambridge University Press, 2002), at 83. But, as long as legal fees plus success fees are paid by the defendant, it is difficult to see they are 'proceeds' of judgments.

Basically, a conditional fee agreement is a "no win, no fees" arrangement.[58] It allows a lawyer to charge fees only when the case is won. As a result, the plaintiff in a derivative action is relieved from the financial burden of paying his lawyer personally. If a case is lost, the lawyer has no right to charge fees. If a case is won, legal fees charged by the lawyer are paid by the losing party rather than by the winning plaintiff. The success fees charged by the lawyer to compensate the risk he assumed of not getting payments when the case is lost are also payable by the losing party.[59] In any event, there is no need for a plaintiff shareholder to pay the lawyer he retains for legal services. Thus it seems that conditional fee agreements can be a way to finance derivative actions.

However, funding through conditional fees is only a partial solution to the funding issue in jurisdictions where legal costs follow the event, because, although he does not need to pay his own lawyer, a shareholder plaintiff has to pay legal costs of the winning opponent when his case is lost. It is this problem that makes the conditional fee arrangement impractical as an option to finance derivative actions.[60]

[B head] 3. Funding Derivative Actions in the US: Contingent Fees

In the US, there is the so-called "American rule" which states that each party in civil litigation should normally pay their own attorney's fees, regardless of whether they win or lose.[61] However, in litigation where a plaintiff has been successful in creating a fund for others, it has well been established that he is entitled to compensation out of

[58] Robinson, Graham, 'The CFA is here to Stay--A Litigator's Guide to Conditional Fee Agreements and Other Funding Arrangements' (2001) 1 *Journal of Personal Injury Law* 44-71.
[59] *See* Access to Justice Act 1999, s 58A (6).
[60] *See* ~~infra~~ discussion below on pages 26-29 [AQ: which pages?].
[61] *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 US 240 (1975); *Hall v. Cole*, 412 US 1 (1973). *See* DeMott, Deborah A., *Shareholder Derivative Actions: Law and Practice* (Westlaw Database, 2004 Update), s 6.12.

the fund for his costs incurred in conducting the litigation, including attorney's fees.[62] In the case of derivative action, if a plaintiff has been successful in bringing a tangible benefit to the company, he is entitled to be paid compensation by the company out of the common fund obtained. [63] But the losing defendant is not liable for the plaintiff's attorney fees, and awards of fees separate from damages will not been given.[64] In this sense, the traditional "American rule" has not been changed in derivative action.

It is clear that, in the US where the "American rule" applies and lawyers are used to working on the basis of "no win, no fees",[65] plaintiffs in derivative actions do not need to worry about paying attorney's fees. If a case is successful, the lawyer is paid by the company out of the recoveries from the action. If a case is lost, the lawyer is not entitled to payments and the plaintiff also does not need to pay attorney's fees incurred by the defendant, because of the "American rule". Thus in the US, a minority shareholder, while enjoying minuscule financial benefits, bears little financial risk in bringing a derivative action, whatever the outcome of that action is. Noticeably, the plaintiff's lawyer becomes having much more at stake in the action in that he may collect a large sum of awards when the action is successful or find that his efforts are wasted when the case is lost.

It should be pointed out that only when a plaintiff of derivative action is successful in bringing a "tangible" benefit to the company does he become eligible for compensation. So it is important to consider what constitutes a "tangible" benefit.

---

[62] *Mills v. Electric Auto-Lite Co.*, 396 US 375 (1970); *Duban v. Diversified Mortg. Investors*, 87 FRD 33 (SD NY 1980). *See* DeMott, *ibid*.
[63] *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502 (1986). *See* DeMott, *ibid*, s 6.13.
[64] *Abreu v. Unica Industrial Sales, Inc.*, 224 Ill App 3d 439 (1991). *See* DeMott, *ibid*.
[65] *See* DeMott, *ibid*, s 6.2; American Law Institute (ALI), *Principles of Corporate Governance: Analysis and Recommendations* (2005 Update), Reporter's Note 3 on s 7.17.

There is no controversy if an action generates some monetary benefits.[66] However, what if the action is won but brings no monetary recoveries? Case law has recognised that "tangible" benefits are not necessarily pecuniary. Even if an action produces only a non-pecuniary relief for the company, the plaintiff's lawyer may nevertheless be entitled to be paid under certain circumstances. The classic test is the "substantial benefit" test: whether the action has achieved "a result which corrects or prevents an abuse which would be prejudicial to the rights and interests of the corporation or affect the enjoyment or protection of an essential right to the stockholders' interest".[67] Under this test, a non-pecuniary relief may constitute a "substantial" benefit and thus entitle a plaintiff's attorney to be paid. For example, it was held that a shareholder's action which resulted in a judicial declaration of the invalidity of a corporate election conferred benefits upon the company.[68] In another case, an action which resulted in a judgment establishing that the proxy statements soliciting votes for a corporate merger were defective was also held to have brought "substantial benefits" to the company.[69] It was said that the action involved "corporate therapeutics" and had rendered "substantial services" to the corporation and its shareholders in "vindicating the statutory policy".[70] However, in certain other cases, a non-pecuniary relief is held as not constituting a "substantial benefit".[71]

---

[66] *See Shlensky v. Dorsey*, 574 F2d 131 (CA3 1978); *Seigal v. Merrick*, 619 F2d 160 (CA2 1980). *See* DeMott, *ibid*, s. 6.15.
[67] *Bosch v. Meeker Coop. Light & Power Ass'n*, 257 Minn 362 (1960); *Mills v. Electric Auto-Lite Co.*, 396 US 375 (1970).
[68] *Ibid*.
[69] *Mills v. Electric Auto-Lite Co.*, 396 US 375 (1970).
[70] *Ibid*.
[71] Eg, in *Braude v. Automobile Club*, 178 Cal App 3d 994 (1986), it was held that an order invalidating corporate bylaw conferred insufficiently concrete and present benefit to justify award of fees; In *EZ Painter Corp. v. Newel Cos., Inc.*, 65 FRD 371 (ED Wis 1974), even if a settlement was described as 'successful', thereby benefiting minority shareholders of the target company, no fees should be awarded if the target company itself derived no clear benefit.

In general, notwithstanding the widely cited test, it is not very clear under what circumstances a non-pecuniary relief qualifies for fee awards. Each case needs to be decided on their individual circumstances. Furthermore, using the "corporate therapeutics" theory as justification for awarding fee to lawyers who obtain only non-pecuniary relief for the company has been criticised. It was argued that, in reality, this theory serves no more than to justify exorbitant fee awards.[72] Some empirical studies identified a prevalence of settlements in derivative actions with non-pecuniary relief to the company but substantial fee awards to the attorneys.[73] Because of this, the utility of derivative action was questioned.

The "substantial benefit" test does not require a judgment or settlement either. If an action has brought benefits to the company without its completion, the plaintiff shareholder is still entitled to compensation.[74] Indeed, it was held that a shareholder was eligible for compensation even when no filing was lodged after a demand [75] or filing was dismissed after the recommendation of a litigation committee[76]. In these cases, the goals of the complaining shareholder, it was said, were achieved through remedial actions taken by putative defendants or the company after a demand or filing. It was held that a causal link existed between the shareholder's complaint and the corrective actions. Thus, the shareholder's compensation is said to be justified. So, to be accurate, the criteria for awarding attorney fees are not a successful judgment or

[72] *See* Dawson, John P., 'Lawyers and Involuntary Clients in Public Interest Litigation' ~~[~~(1975)~~]~~ 88 *Harvard Law Review* 849; John Coffee, 'The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation', ~~[~~(1985)~~]~~ 48 *Law & Contemporary Problems* 5; Note, 'Attorneys' Fees in Shareholder Derivative Suits: The Substantial Benefit Rule Re-examined' (1972) 60 *California Law Review* 164.

[73] *See* Romano, Roberta, 'Corporate Governance in the Aftermath of the Insurance Crisis' (1990) 39 *Emory Law Journal* 1155; Romano, Roberta 'The Shareholder Suit: Litigation Without Foundation?' (1991) 7 *Journal of Law, Economics & Organization* 55.

[74] *See* DeMott (n 60~~35~~ above), s 6.15; ALI (n 64~~39~~ above), Comment e on s 7.17.

[75] *Blau v. Rayette-Faberge, Inc.*, 389 F2d 469 (CA2 1968). *See* DeMott, *ibid*.

[76] *Black v. NuAire, Inc.*, 426 NW2d 203 (Minn App 1988). *See* DeMott, *Ibid*.

settlement, but the causation between a shareholder's complaint and the relief obtained.[77] In Delaware, while defendants or the company is allowed to disprove, case law has established a presumption of causation in cases where a claim or demand made is decided to be "meritorious".[78]

There are two methods to decide how much a plaintiff's attorney is entitled to be paid.[79] One is the "lodestar" method, under which attorney's fees are determined by the amounts of time reasonably expended in conducting the action and the attorney's customary hourly rate, adjusted according to the risk assumed by the attorney and the quality of his work.[80] The other is to reward the attorney with a percentage of the total recovery, which normally ranges between 20-30 per cent when the total recovery is below $1 million and 15-20 per cent when it is above that amount.[81] Traditionally, the "lodestar" method was common and particularly prevalent in federal courts, but it is said that now the percentage method has gained popularity.[82]

[B head] 4. Funding from Other Sources?

Legal aid, which has been very limited for civil litigation in England,[83] is not available for derivative actions. This has been established since *Wallersteiner v Moir (No 2)*, and the Access to Justice Act 1999 expressly excludes legal aid for corporate and business litigation.[84] In other developed countries, commercial litigation is

---

[77] *See* ALI (n ~~48~~ 73 above).
[78] *Bird v. Lida, Inc.*, 681 A2d 399 (Del Ch 1996). *See* ALI, *ibid*.
[79] *See* ALI, *ibid*, Comment c and Reporter's Note 1-4 on s. 7.17; DeMott (n ~~35~~ 60 above), s 6.17 & s 6.18;
[80] But some courts expressly declined to take the risk factor into consideration or the quality of attorney's work. *Ibid*.
[81] *See* ALI (n ~~48~~ 73 above).
[82] *Ibid*.
[83] *See* Access to Justice Act 1999, Sch 2, para 1. *See* Loughlin, Paula & Gerlis, Stephen, *Civil Procedure* (Cavendish Publishing Limited, 2nd ed, 2004), pp 71-75.
[84] *See* Access to Justice Act 1999, Sch 2, para 1.

similarly not eligible for legal aid,[85] and the rule is the same in China.[86] In England, an association or trade union may support an action where it is, even indirectly, interested in the suit, but this situation would ~~not~~ rarely arise in the case of corporate derivative litigation.

In the Canadian provinces of Quebec and Ontario, public funds were set up specifically to fund class actions when the class action was first introduced there.[87] This innovation of setting up a public fund to finance litigation may inspire a solution to the funding problem of derivative action. However, such a fund means a drain on the public purse and finances are needed not only to set up and maintain the fund, but also to meet the expense of administrating the fund. Inevitably, like many other public institutions, such a fund is in danger of becoming bogged down in bureaucracy and captured by private interests. Caution, inertia, error, backlog, political interference and even corruption are predictable.[88] This would be particularly true currently in China where bureaucracy and corruption are big concerns.[89] In addition, it is dangerous to tie the destiny of the derivative action to the success of one organisation. Last but not the least, that funding is granted in one case but denied in another may itself generate intense dispute and litigation.[90] For all these reasons, public funds are not an appropriate option for funding derivative actions.

---

[85] Vince Morabito, 'Federal Class Actions, Contingent Fees, and the Rules Governing Litigation Costs' ~~[~~(1995)~~]~~ 21 *Monash University Law Review* 231.
[86] *See* Legal Aid Regulation 2003, Art 10.
[87] *See* Watson, Garry D., 'Class Actions: The Canadian Experience' (2001) 11 *Duke Journal of Comparative & International Law* 269; Rowe, Jr., Thomas D., 'Shift happens: Pressure on Foreign Attorney-Fee Paradigms from Class Actions' (2003) 13 *Duke Journal of Comparative & International Law* 125.
[88] *See* Rowe, Jr., *ibid*.
[89] China ranked 78th, 70th and 72nd in 2005, 2006 and 2007 respectively in the *Corruption Perceptions Index* published by Transparency International, available at http://www.transparency.org/.
[90] *See* the Law Reform Commission of Ireland, *Consultation Paper on Multi-Party Litigation (Class Actions)* (LRC CP25-2003), para 4.128.

[A head] D.Funding Derivative Actions: Which Model Is Favourable?

[B head] 1. The Problems with the English Indemnity Order

The criticisms over the current English law on derivative action funding are that, first of all, the law is uncertain. The Civil Procedure (Amendment) Rules 2000[91] state only that a court may order a company to indemnify a claimant. It does not provide any guidance on when and how an indemnity order may be granted, so judges need to look to case law for direction. But case law itself is indeterminate in many respects. For instance, the question of whether indemnity is a type of legal aid or a shareholder plaintiff's legitimate right is not clear. As a result, it is uncertain whether indemnity should be conditional upon financial needs[92] and authorities diverge on this.[93] If the decision of *Smith v Croft (No.1)* is correct, the availability of indemnity is very limited.[94] Institutional shareholders would not qualify, because they would not pass a means test, and thus the possibility that institutional shareholders could become an active player in derivative actions is thus in doubt. Secondly, the test of the availability of indemnity order that an independent board of directors should consider taking the action in the circumstances[95] is also uncertain.[96] It is not an easy task to determine directors' independence. The experience from the US illustrates this[97] and sophisticated legal rules have yet to be developed by case law in England.

---

[91] S.I. 2000/221, r. 19.9.
[92] *See* Reisberg, Arad, 'Funding Derivative Actions: A Re-Examination of Costs and Fees as Incentives to Commence Litigation' (2004) 4 *Journal of Corporate Law Studies* 345.
[93] Comparing *Smith v Croft (No.1)* [1986] 2 All ER 551 and *Jaybird Group Ltd v Greenwood* [1986] BCLC 319.
[94] Prentice, D. D., '*Wallersteiner v Moir*: A Decade Latter' [1987] *Conveyancer and Property Lawyer* 167.
[95] *See* above discussion on page 13[AQ: which page?].
[96] *See* Quigxiu Bu, 'The Indemnity Order in a Derivative Action' (2006) 27(1) *Company Lawyer* 2.
[97] *See* Gevurtz, F. A., 'Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits' (1985) *University of Pittsburgh Law Review* 265.

Moreover, the scope of "costs" for which a plaintiff is entitled to be indemnified is not very clear. It has been held that a company may be ordered to compensate a plaintiff shareholder's litigation costs even he has lost his case,[98] but, will an indemnity order cover a plaintiff's liability to the defendant's litigation costs? There seems no authority on this. The procedural issue is also ambiguous: to what extent should the issue of whether an indemnity order should be granted be allowed to litigate? While it was emphasised in *Wallersteiner* that an application for costs should be kept "simple and inexpensive" and not be allowed to "escalate into a minor trial",[99] Walton J in *Smith v Croft (No.1)* found that it would be "palpably unjust" for the court to order an indemnity without discovery.[100]

The relationship between the procedures of giving permission to continue an action and an order for indemnification is in particular troublesome.[101] In *Smith v Croft*, there was a separate proceeding dealing with the application for indemnity order and the test for granting such an order seemed different from the test of the permissibility of ~~an~~ the action itself.[102] Besides causing additional costs to both the parties and the court, these dual tests and proceedings may give rise to a paradoxical situation where it would be conceivable that an indemnity order has been given but the action is nevertheless dismissed. For example, in *Smith v Croft*, the plaintiffs' application for an indemnity order was rejected in January 1986[103] and then the derivative action

[98] *Wallersteiner v Moir* [1975] 1 All ER 849.
[99] *Ibid*, *per* Lord Denning MR at 859.
[100] *Smith v Croft (No.1)* [1986] 1 WLR 580, *per* Walton J at 589.
[101] *See* Reisberg (n ~~71~~ 91 above); Graham, Cosmo, 'Reconciling Conflicting Interests: *Wallersteiner* Revisited' (1986) 7(4) *Company Lawyer* 153.
[102] *See* above discussion on page 13[AQ: which page?]. For the criteria for granting leave to proceed, *see Prudential Assurance Co. Ltd v. Newman Industries Ltd and Others (No. 2)* [1982] Ch 204 (CA) and *Smith v Croft (No.2)* [1988] Ch 114.
[103] *Smith v Croft (No.1)* [1986] 1 WLR 580.

brought by them was dismissed latter in December[104]. What if they were successful in securing an indemnity order? A situation that an indemnity order has been given but the derivative action is later dismissed seems bizarre and unacceptable. All efforts and expenses on litigating the issue of indemnity are just a waste and a company would have to indemnify for costs of an action which is nevertheless not allowed to continue. While this situation can be avoided by providing that an application for costs be dealt with after the issue of *locus standi* has been determined, or integrating the two proceedings into one with the result that an indemnity order is, and only is ~~only~~, given upon the action being permitted to continue,[105] currently there is no law in England that can be applied to achieve such an effect. All in all, the current law on derivative action funding in England is undeveloped and uncertain. This results from the fact that the judiciary have not had enough opportunities to elaborate on the law because of the limited number of cases. To a large degree, this may be in turn due to the system of litigation funding.[106] Uncertainty may not be a serious problem in England where judges can make law, although the accessibility of the law is compromised and thus shareholders are discouraged from taking derivative action. But in China where precedents are not law, a blanket judicial discretion is unworkable.

While uncertainty could be rectified by enacting detailed rules, there is an inherent defect with the English common law indemnity order which renders it an unsatisfactory method for derivative action funding. An indemnity order means

[104] *Smith v Croft (No.2)* [1988] Ch 114.

[105] This is what was recommended by the German Corporate Governance Panel. *See German Government Panel on Corporate Governance*, paras 72-73, available at http://www.ecgi.org/codes/documents/baums_report.pdf. Indeed, there is no justification for the additional costs caused by two separate proceedings. It is also argued that a cost order is the legal right that a plaintiff should have, because he is bringing the action on behalf of the company. As such, an application for costs should be given when the action is permitted to continue. *See* Davies, Paul L., *Gower and Davies' Principles of Modern Company Law* (London: Sweet & Maxwell, 7th ed., 2003), p 455.

[106] *See* Cheffins & Black (n ~~11~~ 9 above).

imposing concrete financial obligations on the company. These obligations, which may include the plaintiff's liability to the defendant's litigation costs, have to be borne by the company, even if a derivative action fails and brings no recovery.[107] In effect, an indemnity order is no different from a judgment of damage against a company, both imposing the company financial liabilities. But in procedure, an indemnity order is different from a judgment of damage, the latter being made after the merit of the claim has been determined following a trial but the former not. The advantage that Lord Denning had in *Wallersteiner*, where the merit of the case had already been judged when the application for indemnity was dealt with, is unusual and not ~~more~~ many judges would have such a benefit. Basically, granting an indemnity order is not much different from awarding damages before a trial is undertaken. Thus, the concern of Walton J, who held that it would be "palpably unjust" for the court to order an indemnity without discovery,[108] is fully understandable. A court would condemn a company "to considerable penalties unheard"[109] if it grants an indemnity order without discovery. Because of this concern, a judge would either go into great detail to ascertain the merit of the underlying claim before granting an order, which on the one hand renders the goal of keeping the indemnity procedure "simple and inexpensive" unattainable[110] and on the other makes the leave procedure meaningless. Or more probably, because an indemnity order hearing should not be allowed to "escalate into a minor trial", a judge, acting on the benefits of doubt, would be reluctant to grant an indemnity order. It is thus evident that the common law indemnity order, which requires judges to impose concrete financial obligations on a company at a stage where the merit of underlying claim is unclear, is inherently

[107] *See* n ~~77~~ 97 above.
[108] *Smith v Croft (No.1)* [1986] 1 WLR 580, *per* Walton J at 589.
[109] *Ibid*.
[110] *Wallersteiner v Moir* [1975] 1 All ER 849, *per* Lord Denning MR at 859.

defective. This difficulty judges face in adjudicating indemnity orders could explain why the judge who interpreted the first statutory derivative action in New Zealand insisted that "all questions of costs and indemnity from the company should be reserved pending the outcome of the action on the merits".[111] But if that is the rule, the disincentive on the part of minority shareholders to take on derivative actions would not be changed much, because minority shareholders, when considering bringing an action, are uncertain whether their litigation costs could be compensated or not.

Lastly, it is argued that even if an indemnity order can be successfully obtained, the under-incentive problem faced by minority shareholders is still not fully addressed.[112] An indemnity order only compensates shareholders litigation costs, but does not generate benefits for them (or the benefits are trivial[113]). They are only protected from exposure to financial risk that an action would bestow on them, but not rewarded with extra benefits. They cannot even be compensated for the time and effort expended in conducting an action. As a result, shareholders are still under-incentivised to take on derivative actions. Another problem facing shareholders in England is that their costs will not be compensated when the company runs into insolvency. Even if they have been successful in obtaining an indemnity order, such an order does not confer any security over the company's assets or even the recoveries.[114]

---

[111] *See Vrij v Boyle* (1995) 3 NZLR 763, *per* Fisher J. at 766. *See* also *Thorrington v McCann* (1998) 8 NZCLC 261 564, cited in Matthew Berkahn, 'The Derivative Action in Australia and New Zealand: Will the Statutory Provisions Improve Shareholders' Enforcement Rights?' ~~[~~(1998)~~]~~ 10(1) *Bond Law Review* 74.

[112] *See* Reisberg (n ~~71~~ 91 above).

[113] *See* above discussion on pages 5-6 ~~2~~.

[114] *See Quayoumi v Oakhouse Property Holdings Plc* [2003] 1 BCLC 352.

In conclusion, the indemnity order under English law is unsatisfactory for derivative action funding. This is not just because the law is underdeveloped and uncertain. The inherent problem is that such an arrangement requires judges to impose financial obligations on a company at a stage where the merits of the underlying case are unclear. Additionally, the arrangement does not afford shareholders any significant benefits for taking on derivative actions and the under-incentive problem has not been fully addressed.

[B head] 2. Conditional Fees or Contingent Fees?

If the common law indemnity order is unsatisfactory, the next question is whether the arrangement of conditional fees or contingent fees is preferable. The essential difference between conditional and contingent fees is that the losing party has to compensate the legal costs of the winning party under conditional fee arrangements but not under contingent fee schemes. This means that, in a conditional fee agreement, the plaintiff of derivative action faces the risk of paying his opponent's legal fees, although he does not need to pay his own lawyer. Because of this risk and in light of the negligible benefits from an action, a minority shareholder would not bring up an action. Financial benefits are virtually none, but potential losses are significant. It is impossible to guarantee the success of an action, even if a plaintiff himself is quite sure that it is meritorious. If the case is lost, that could be disastrous and his financial status would be ruined. Therefore, an economically rational minority shareholder would not take on a derivative action if the default funding method is conditional fees.[115] As a result, the intrinsic disincentive for minority shareholders to take on

[115] *See* Cheffins & Black (n ~~11~~ 9 above).

derivative actions would not be satisfactorily addressed by introducing conditional fee agreements.[116]

How can a would-be plaintiff be insulated from the risk of paying his opponent's legal costs? In theory, this risk can be met by insurance,[117] and the costs of the premium are recoverable if a plaintiff wins his case.[118] But on deeper analysis, insurance does not provide a realistic answer to the difficulties faced by minority shareholder plaintiffs. Insurance available to cover the risk of litigation can be before-the-event (BTE) or after-the-event (AFT) insurance.[119] But it is difficult to imagine that a shareholder would take out BTE insurance when investing in a company, although such insurance may be available[120] and is less expensive than the ATE insurance.[121] The accepted view concerning minority shareholders of listed companies is that these shareholders are indifferent in monitoring the company's management, let alone take legal actions. It is said that general legal insurance is unpopular in England and the experience of the last 20 years suggests that this is unlikely to change significantly.[122] This prediction would be particularly true regarding insurance for funding derivative actions.[123] On the other hand, the costs of ATE insurance are inhibitive.[124] This is understandable, considering the imminent risk faced by an

---

[116] *See* Reisberg (n ~~71~~ 91 above)~~; Sugarman, David, 'Reconceptualising Company Law: Reflections on the Law Commission's Consultation Paper on shareholder Remedies: Part 1' (1997) 18(8) *Company Lawyer* 226~~.

[117] *See* Robinson (n ~~31~~ 57 above).

[118] *See* Access to Justice Act 1999, s 29.

[119] *See* Sime, Stuart, A *Practical Approach to Civil Procedure* (OUP, 5th ed, 2002), pp 33-32; Robinson (n ~~31~~ 57 above).

[120] This is not currently true for China.

[121] Zander, M., 'The Government's Plans on Legal Aid and Conditional Fees' ~~[~~(1998)~~]~~ 61 *Modern Law Review* 538.

[122] *Ibid*.

[123] *See* Reisberg (n ~~71~~ 91 above), foot note 256.

[124] *See*Walters, A. & Peysner, J., 'Event-Triggered Financing of Civil Claims: Lawyers, Insurers and the Common Law' (1999) 8(1) *Nottingham Law Journal* 1; Zander (n 120~~00~~ above).

insurer offering such coverage.[125] The first question to ask, therefore, is whether a minority shareholder can afford to pay a considerably priced premium up front. The second question is whether he is willing to pay (assuming that he can pay due to his own wealth or finances obtained from other sources). The bottom line is that he may not be able to recover the cost of such a premium, because there is no guarantee of winning an action. Thus, the imbalance between the benefits and costs for minority shareholder plaintiffs remains and the disincentive is not fully addressed by insurance.

It could be suggested that a plaintiff can enter into a conditional fee contract with his lawyer, who agrees to advance the expenses of premiums. However, it is both unreasonable and unrealistic to expect that a lawyer would be willing to bear such expenses and, indeed, other out-of-pocket litigation costs.[126] A plaintiff's attorney only earns fees, plus some uplift bonuses, rather than the whole recovery amount, while by this arrangement he would risk not only losing fees but also bearing the costs of premiums.

A lawyer may be willing to take the risk that he will be paid nothing for their work, but a risk of losing a substantial amount of out-of-pocket money plus fruitless labour is too big.[127] It is unrealistic that a lawyer would be willing to take such a risk, unless he perceives the probability of success being very high. In other words, a lawyer would be extremely cautious about accepting an offer of case if he is required to advance a substantial amount of premiums. This means that the barrier to pursuing derivative actions would remain, even if the law were changed so that the risk of

[125] *See* Underwood, Kerry, 'CFAs, Success Fees and After-the-Event Insurance' (2001) 3 *Journal of Personal Injury Law* 272.
[126] *See* Sime (n ~~98~~118), p 39.
[127] *See* Robinson (n ~~31~~ 57 above).

paying defendants is not borne by plaintiffs but by their lawyers. Furthermore, currently in England there is a 100 per cent cap on success fees that a lawyer can charge under a conditional fee agreement.[128] This does not seem to be in line with the logic that a lawyer who takes a higher risk charges higher uplift fees. More relevantly, this restriction further reduces the incentive for lawyers to expend their own finances to fund litigation.[129] However, if the cap were abolished, unlimited success fees would be too excessive for the losing party to pay, who also have to compensate the winning plaintiff the normal fees and perhaps insurance premiums. Success fees, even within the 100 per cent cap, have already caused complaints and concerns in England.[130]

Compared with conditional fees, the US contingent fee arrangement is much more favourable for minority shareholders who intend to bring derivative actions. Because of the "American rule" and "no win, no fees" agreement, a contingent fee arrangement insulates a plaintiff from exposure to the risk of paying either their own or the opponent's attorney's fees, regardless of whether an action is lost or won.[131] It is even not uncommon for an attorney working on contingent fees to advance out-of-pocket expenditures during an action, and contracts providing that a plaintiff in any event is not liable for such expenditures have been held valid.[132] Indeed, an unsuccessful plaintiff may need to compensate the defendant some non-fee costs, but such recoverable costs are very limited.[133] The primary risk in bringing a derivative

[128] Conditional Fee Agreement Order 2000 (S.I. 2000/823), s 4.
[129] *See* Cheffins & Black (n ~~11~~ 9 above).
[130] *See Campbell v Mirror Group Newspapers Ltd (Costs)* [2005] UKHL 61; Wade, Alex, '"No win, No fee" Poses a Threat to Freedom of Expression', *Times* (18 October 2005), available at http://www.timesonline.co.uk/article/0,,200-1829956,00.html.
[131] *See* above discussion on pages 15-20 [AQ: which pages?].
[132] Rossi, Robert L., *Attorneys' Fees* (Westlaw Database, updated July 2006), s 2.13.
[133] *See* Martin, Lucas D., *American Jurisprudence—Costs* (Westlaw Database, 2nd ed., updated January 2007), Chapter 5.

action has been shifted to the plaintiff's attorney, who may find that his work does not pay and, if he agrees to advance up-front expenses, may find that the money he has expended is lost. But this loss is much smaller than that would be suffered by an English plaintiff or lawyer, one of whom needs also to pay the legal costs of the defendant or buy insurance to avoid this. Hence, the financial disincentive against derivative actions from being pursued is much less under the regime of contingent fees. Indeed, among all the funding arrangements, the US contingent fee is most favourable to plaintiffs and their lawyers. This is the most important reason why derivative action has flourished in the US but not in other countries.[134]

[A head] E. Contingent Fees: The Model For Derivative Action Funding In China?

Although contingent fees are most favourable to encourage derivative actions, there is the question of whether they are suitable to the special context of China. To answer this question, the first issue to consider is whether it would be permissible for a company in China to compensate the plaintiff for litigation costs where a derivative action brings benefits to the company. It seems not controversial to introduce this rule. It is fair enough for a company to pay a value in return for a gain. As a matter of fact, the judicial opinions promulgated by the High People's Court in Shanghai and Jiangsu contain a rule to that effect,[135] as does the draft second judicial interpretation on the application of the new Company Law circulated by the Supreme People's Court for

[134] *See* Ramsay (n ~~2~~ 9 above); Wilson (n ~~9~~ 21 above).

[135] Shanghai Shi Gaoji Renming Fayuan Minshi Shenpan Di'er Ting (No. 2 Civil Division of the High People's Court of Shanghai), *Guanyu Shenli Sheji Gongsi Susong Anjian Ruogan Wenti de Chuli Yijian (Yi)* [~~*The*~~ *Opinions on Adjudicating Cases Regarding Corporate Litigation (No. 1)*] (June 2003), Art 5; Jiangsu Sheng Gaoji Renming Fayuan (the High People's Court of Zhejiang Province), *Guanyu shenli Shiyong Gongsifa Anjian Ruogan Wenti de Yijian (Shixing)* [~~*The*~~ *Opinions on Several Issues on Adjudicating Cases Applying Company Law (Trial Implementation)*] (June 2003), Art 78.

feedbacks. [136] More difficult to formulate are detailed rules on what constitute a "benefit", ie whether or under what circumstances a plaintiff is entitled to compensation when a derivative action is won but brings no monetary recovery to the company, and how much a plaintiff is entitled to be paid. These questions are related to the topic of frivolous suits and cheap settlements - problems alleged to be associated with contingent fees- which will be discussed in the next section.[137]

The second issue is whether an "American rule" is permissible in China, ie whether a plaintiff could be exempted from paying the opponent's litigation costs where a derivative action is lost. Civil litigants in China bear two parts of costs: those paid to the lawyers, including lawyers' fees and expenses, and those paid to the courts, including filing fees, which are payable when a plaintiff brings up a suit to the court,[138] and expenses incurred by the court in conducting the case, such as costs of translation, survey, appraisal, verification; payments to witnesses, etc.[139] For the costs paid to the lawyers, there is no law concerning whether a losing party should pay the winning party. In practice, litigants pay their own costs irrespective of the outcome of the case.[140] As far as the costs paid to the courts are concerned, in principle they ~~the~~

[136] *See* Yue Jingfei, 'Gudong Qisu Gongsi Youqian Bu Feng, Fayuan You Wang Shouli (Courts Will Accept Cases Brought up by Shareholders Against Companies for not Distributing Profits)', *Shanghai Zhengquan Bao* (*Shanghai Securities News*) (31 January 2007).

[137] *See* ~~infra~~ discussion below on pages 34-51 [AQ: which pages?].

[138] *See* ~~infra~~ discussion below on page 52[AQ: which pages?].

[139] Since 1st April 2007 courts are only allowed to charge fees that compensate witnesses, translators, etc for attending a trial. Expenses for appraisal, surveyance, translation, etc are paid by litigants directly to service providers and courts are no longer allowed to charge fees in this respect. *See Measures of Charging Litigation Fees* (the State Council 2006), Arts 11 & 12.
~~*Measures of Charging Litigation Fees* (the State Council 2006), Art 6, 7, 10, 11 & 12. *See* Zimmerman, James M., *China Law Deskbook: A Legal Guide for Foreign Invested Enterprises* (American Bar Association, 2nd ed., 2005), Ch 3.~~

[140] *See* Ping'an Tian *et al*, *Minshi Susongfa (Civil Procedure Law)* (Qinghua Daxue Chubanshe (Tsinghua University Press 2005), Chapter 17.
~~Zimmerman, *ibid*; Peerenboom, Randall, 'Law Enforcement and the Legal Profession in China' in Jianfu Chen, Jan Michiel Otto & Yuwen Li (eds.) *Implementation of Law in the People's Republic of China* ([AQ: Could you provide the publication location?]Kluwer Law International, 2002).~~

~~filing fees~~ are recoverable, but only when the action is won~~. For the court expenses, courts enjoy discretion in deciding which party should pay~~.[141]

It can be seen that the practice in China regarding taxing lawyer's fees is quite similar to the "American rule" and a litigant is responsible for his own lawyer's fees regardless of the outcome of a case. In this respect, the practice in China actually conforms to the model of contingent fee and a plaintiff of derivative action would be insulated from the risk of indemnifying the defendant for costs paid to the lawyer. However, unlike in the US, a plaintiff in China needs to pay the court a significant amount of filing fees~~ in China~~.[142] The filing fees present a substantial obstacle to the pursuance of derivative actions. For derivative actions to actually happen and play a role in corporate governance in China, the rule on filing fees has to be changed. This will be discussed in Section G.

The last important feature of contingent fees is that a plaintiff's lawyer charges fees conditioning on the success of a case. In other words, lawyers are allowed to fund derivative action in the US. Is this permissible in China? Before 2006 there was no specific regulation on this issue and it was not uncommon for lawyers to charge fees contingent on the outcome of a case.[143] This means that a plaintiff of derivative action in China could enter into a "no win, no fees" agreement with his lawyer and thus be exempted from paying his own lawyer~~'s~~ ~~fees~~ where a case was not successful.[144] However, in April 2006 the National Development and Reform Commission and the

[141] *Measures of Charging Litigation Fees* (the State Council 2006), Arts ~~11 & 12~~29.
[142] *See* ~~infra~~ discussion below on pages 51- 52[AQ: which pages?].
[143] *See* the Law Reform Commission of Hong Kong, '*Conditional Fees*' (Consultation paper, 2005), s.5.39.
[144] But he might need to pay his lawyer when a case was won, if he could not secure compensation from the company.

Ministry of Justice promulgated a regulation on charging lawyer fees.[145] One provision of that regulation is the prohibition of "no win, no fees" agreements in respect of criminal, administrative, state compensation suits and *collective litigation*.[146]

It is not clear what "collective litigation" exactly means and the regulation does not provide a definition. While lawsuits with multiple plaintiffs or defendants and following the special procedure for group litigation provided for by the Civil Procedure Law[147] may fall into the category, it is not clear that the prohibition is applicable to derivative actions. The derivative action is a representative lawsuit. The true plaintiff is actually the company and it is the company's interests that are at stake. A derivative suit usually does not have multiple shareholder plaintiffs, although shareholders can jointly take an action or other shareholders may be allowed to join an action after it was filed. Moreover, rules governing the conducting of derivative action are not the special rules for group litigation, but those stipulated in the Company Law. For these reasons, it could be argued that the derivative action in general should not be categorised as "collective litigation" and the prohibition not applied. Were it otherwise, the consequence would be unfortunate. The plaintiff would face the risk of bearing lawyer's fees where a lawsuit is unsuccessful. As a result, a shareholder, especially that of listed companies, would not risk taking a legal action. This is also true for shareholder plaintiffs who consider joining in together to take an action in order to meet the 1 per cent shareholding requirement. Even if a derivative action were brought up, a dilemma would arise if lawyers were not allowed to fund derivative actions, a dilemma that was presented in *Wallersteiner v Moir (No*

[145] *Measures on the Services Fee of Lawyers* (April 2006).
[146] *Ibid*, Art 12.
[147] Civil Procedure Law 1991 (amended 2007), Arts 53, 54 & 55.

2)[148]: a plaintiff has been successful in winning a first instance case, but is too destitute to continue the case. To put it in a different way, if the rule is that a plaintiff will be compensated for litigation costs only after he has won his case and lawyers are prohibited ~~for~~ from funding derivative actions by way of "no win, no fees" arrangement, where are the sources of funding for suits that are promising but the plaintiff is unable to fund?

From the above discussion, it can be seen that the civil litigation funding system in China is not particularly incompatible with contingent fees. Introducing a rule that a company compensates a plaintiff for litigation costs where a derivative case brings benefits to the company is not controversial; a rule that litigants pay their own lawyer's fees regardless of the outcome of litigation seems to be the current practice in China; "no win, no fees" agreements were also permissible before 2006. What need to be done to introduce contingent fees into China are, first, the clarification that the prohibition of "no win, no fees" arrangements should not be applicable to derivative actions; second, reforming the law on filing fees for derivative actions, which will be discussed in Section G; third, formulating rules on what constitutes a "benefit" that would entitle a plaintiff to compensation and how much the compensation should be, which is now to be discussed in the context of examining criticisms of contingent fees.

[A head] F. Criticisms Of Contingent Fees And Recommendations For Improvement

[B head] 1. Criticisms of Contingent Fees and the Latest Development of Shareholder Derivative Action in the US

[148] [1975] 1 All ER 849.

Although contingent fees are most favourable to encourage derivative actions, there have been strong allegations in the US that the device of derivative action was abused because of contingent fees. In this section we will examine whether these allegations are true and, if they are true, how the arrangement of contingent fees could be changed so that abusive derivative actions could be discouraged. In doing so, attention will be paid to make these changes adapt to the particular context of China.

There have been two major complaints about derivative actions in the US. One is the so-called "strike suits", which means unmeritorious actions brought for the nuisance value to extort settlements.[149] Some empirical studies showed that judgments of shareholder actions favouring plaintiffs were rare. A study in the 1940s found that, out of the 573 derivative actions surveyed involving public corporations, only 13 resulted in judgments for plaintiffs.[150] Another study in 1980 involving both securities class actions and derivative suits revealed that only two cases (about 0.6 per cent of the total sample and 2.3 per cent of cases resolved by trial) resulted in a judgment for the plaintiffs.[151]

The other complaint is the prevalence of settlements which produce insignificant benefits for the companies but substantial fee awards to plaintiffs' attorneys. It was reported by one study that around 75 per cent of the cases surveyed were settled.[152] Another study with a broader data set from the 1970s to 1980s similarly found that

[149] *See* Brandi, Tim Oliver, 'The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action' (1994) 98 *Dickinson Law Review* 355, 357, foot note 1.
[150] Wood, F., *'Survey and Report Regarding Stockholders' Derivative Suits'* (The Wood Report), p 32.
[151] Jones, Thomas M., 'An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits' (1980) 60 *Boston University Law Review* 542.
[152] *Ibid*.

64.8 per cent cases surveyed were settled out of court.[153] Of all of the settled cases, those in which shareholders obtained some financial recoveries accounted only for half.[154] The non-monetary remedies were alleged as being "inconsequential" and "cosmetic", most likely used to justify attorneys' fee awards.[155] Where monetary settlements were obtained, per share recoveries were minimal.[156] On the contrary, plaintiffs' attorney fees were usually substantial even when remedies were non-monetary or trivial in money value.[157] As such, in contrast to the earlier view which once hailed derivative action as "the chief regulator of corporate management",[158] some commentators are strongly critical of derivative action, and a circuit judge even said that "derivative actions do little to promote sound management and often hurt the firm by diverting the managers" time from running the business while diverting the firm's resources to the plaintiffs' lawyers without providing a corresponding benefit."[159]

It is generally accepted that the alleged abuse of derivative action can be attributed to the funding arrangement and there are theoretical discourses which provide explanations of why strike suits are feasible under ~~the~~ contingent fees. It is said that the cost differentials between a plaintiff and defendant in conducting litigation makes strike suits possible.[160] After a filing, even if frivolous or not sound enough to sustain

[153] *See* Romano (1991) (n 72~~3~~ above).
[154] *Ibid*.
[155] *Ibid*, p 84. The author also claimed that a review of such settlements does not provide evidence that shareholder litigation helps to deter management misconduct and corporations do not adjust management's compensation in response to lawsuits. But for a more optimistic view on this, *see* Jones (n 15~~2~~0 above).
[156] *See* Romano, *ibid*.
[157] 16.2 per cent of total recoveries on average, but ranging as high as 40.2 per cent. *See* Jones (n 15~~2~~0 above).
[158] *Cohen v Beneficial Industrial Loan Corp*, 337 U.S. 541, 548 (1949).
[159] *Felzen v Andreas*, 134 F.3d 873, 877 (7th Cir. 1998).
[160] Rosenberg, David and Shavell, Steven, 'A Model in Which Suits are Brought for Their Nuisance Value' (1985) 5 *International Review of Law & Economics* 3.

dismissal, the defendant faces three possible outcomes: a default judgment, if he chooses to ignore; settlement; dismissal, if he chooses to defend. In defending, he has to incur costs. Where the "American rule" applies, a defendant will choose to settle, if the settlement value is less than the costs of defending. As a result, a plaintiff may file a frivolous case, as long as the costs of filing are less than the ~~settlement value~~costs of defending. This extortion is similarly effective for cases which, although have survived dismissal, only have a very low probability of success in trial. The defendant would not proceed to trial because the costs of defending are more than a settlement. The plaintiff would also choose to settle, because the probability of success is low.[161] So a plaintiff with an unmeritorious case can succeed in forcing a defendant into settlement, as long as litigation costs on the plaintiff side is less than those on the defendant side, which is usually true in shareholder actions.[162] Another study sought to explain strike suits from the perspective of informational asymmetry.[163] A case may be frivolous or the total costs of litigation would exceed the expected judgment. Thus the value of the case expected by the plaintiff is negative. However, the defendant may not know this, due to the existence of informational asymmetry. As a result of uncertainty, a defendant might elect to settle a case whose value to the plaintiff is nevertheless negative.[164]

The allegation that derivative action had been widely abused was disputed, not just by the plaintiff bar.[165] Some people doubted that the data collected in the empirical

[161] *Ibid*.
[162] *See* Brandi (n 14~~1~~8 above); Coffee (n 71~~116~~ above).
[163] Bebchuk, Lucian A., 'Suing Solely to Extract a Settlement Offer' (1988) 17 *Journal of Legal Studies* 43. *See* also Katz, Avery, 'The Effect of Frivolous Lawsuits on the Settlement of Litigation' (1990) 10 *International Review of Law & Economics* 3.
[164] *See* Bebchuk, *ibid*.
[165] For the view from plaintiff bar, *see* Weiss, Melvyn I., 'Shareholder Litigation—Reform Proposals to Shift Fees: Limit 'Professional Plaintiffs' and Cap Punitive Damages', in *Corporate Law and Practice Course handbook Series* (Practicing Law Institute, No. B4-7068, 1994, Westlaw Database); Gross,

studies were adequate to support the assertion.[166] The validity to claim the prevalence of strike suits by demonstrating the infrequency of judgments was challenged, because obviously an attorney working on contingent fees would not push to have a trial, even with a meritorious case.[167] In addition, it was argued that the value of derivative action should not be measured only by the monetary benefits that a settlement brings to the company.[168] Overall, it is fair to say that the issue of whether strike suits were rampant and whether settlements were insignificant was contentious, although critics of derivative action were not a few.

However, the current landscape of derivative action in the US has changed dramatically. The frequency of derivative actions had declined significantly by the end of the last century, with one recent empirical study telling that during 1999 and 2000 there were only about 30 filings of derivative action each year involving public companies in Delaware [169] where more than half of the country's largest companies are incorporated and which attracts more than 85 per cent of companies that choose to incorporate outside the state in which their headquarters are located.[170] The number of derivative actions against private companies was even smaller.[171] From this evidence, it is no longer valid to claim that derivative actions are excessive in the US. Indeed, a concern arises that derivative action, which was "pronounced dead many times but only to rise from the dead with renewed vigour", might eventually be at the death

---

Marc I., 'Loser-Pays—or Whose 'Fault' is It Anyway: A Response to Hensler-Rowe's "Beyond 'It Just Ain't Worth It'" (2001) 64 *Law & Condemnatory Problems* 163;

[166] *See* Weiss, *ibid*.

[167] *See* Coffee, John C., 'Understanding the Plaintiff Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions' (1986) 86(4) *Columbia Law Review* 669.

[168] *Ibid*.

[169] *See* Thompson, Robert B., and Thomas, Randall S., 'The Public and Private Faces of Derivative Lawsuits' (2004) 58 *Vanderbilt Law Review* 1747.

[170] Bebchuck, Lucian A., & Cohen, Alma, 'Firms' Decision Where to Incorporate' (2003) 46 *Journal of Law and Economics* 383.

[171] *See* Thompson and Thomas (n 1638 above).

door.[172] This study also finds no evidence that those cases were "strike suits" bestowing few benefits to the companies.[173]

Several reasons explain this decline.[174] It is said that the development of the market for corporate control provides an alternative to litigation for disciplining corporate management; the increased numbers of independent directors on corporate boards makes it more difficult to pass procedural hurdles for taking derivative actions; and securities class action is also a substitute that is relatively easy to access. Perhaps most importantly, though, judicial controls over derivative actions were tightened up.[175] For example, the evidence requirement for the plaintiff to provide particular facts which create a reasonable doubt over the independence of the board has been heightened;[176] the fact that judges defer to the recommendation made by the special litigation committee composed of independent directors makes it very difficult for a derivative action to survive dismissal.[177] From this very fact it is clear that, while the contingent fee arrangement is most disposed to encourage derivative actions, excessiveness is not inevitable. The judiciary is the final control, which would put law in place to prevent derivative action from being abused, if the contingent fee arrangement indeed instigates too many nuisance suits.

[B head] 2. An Improved Contingent Fee Arrangement?

---

[172] *Ibid*.
[173] *Ibid*.
[174] *Ibid*. *See* also Veasey, E. Norman, & Di Guglielmo, Christine T., 'What Happened in Delaware Corporate Law and Governance from 1992-2004?' (2005) 153 *University of Pennsylvania Law Review* 1339.
[175] *Ibid*.
[176] *Aronson v Lewis*, 473 A.2d 805 (Del. 1984). *See* the recent decision in *Beam v Martha Stewart*, 845 A.2d 1040 (Del. 2004). *See* also Thomas, Randall S., & Martin, Kenneth J., 'Litigating Challenges to Executive Pay: An Exercise in Futility?' (2001) 79 *Washington University Law Quarterly* 569.
[177] *See* Thompson and Thomas (n 1638 above); Veasey & Di Guglielmo (n 1743 above); *Beam v Martha Stewart*, 845 A.2d 1040 (Del. 2004).

While Delaware's heightened procedural law is effective in filtering out frivolous actions, it may have overreached so as to preclude meritorious suits, in view of the small number of derivative actions. It could be argued that this is a result of backlash from frivolous litigation driven by contingent fees, which are ironically supposed to promote derivative actions. Hence there is a valid case to reform the contingent fee arrangement to make it neutral not to encourage frivolous suits, so that strict procedural law on admitting derivative actions is no longer warranted. Another reason why reform may be necessary is that it is actually very difficult to formulate proper procedural rules to ensure that vexatious suits can be accurately separated from meritorious ones.[178] In other words, using judicial control over the admission of derivative actions to filter out frivolous suits may not be the best choice. Rather, it may be preferable to improve the rule on litigation funding to achieve a balance between discouraging frivolous suits and promoting meritorious actions. This is particularly true as for China where the courts are generally perceived as not competent enough. Moreover, the Company Law in China accommodating the derivative action actually did not provided for a procedure for judicial control over the continuance of derivative actions.[179]

Various proposals have been made to reform the contingent fee arrangement in the US. Simply, some suggest that the "English rule" should become the default rule.[180]

---

[178] *See* F. A. Gevurtz (n ~~77~~ 96above); Reisberg, Arad, 'Theoretical Reflection on Derivative Actions in English Law: The Representative Problem' (2006) 3 *European Company and Financial Law Review* 69.

[179] Article 152 of the Company Law 1993 (amended 2005) set a minimum shareholding requirement and a requirement for making demand by would-be plaintiffs, but did not provide for a procedure where judges can decide to permit or dismiss a case according to whether the action is in the interests of the company.

[180] *See* Smith, Jeffrey Michael, 'The Role of the Attorney in Protecting (And Impairing) Shareholder Interests: Incentives and Disincentives to Maximize Corporate Wealth' (1997) 47 *Duke Law Journal* 161; Rove, Jr., Thomas D., 'The Legal Theory of Attorney Fee Shifting: A Critical Overview' (1982) 31 *Duke Law Journal* 651; Bebchuk, Lucian A., & Chang, Howard F., 'An Analysis of Fee Shifting Based on the Margin of Victory: On Frivolous Suits, Meritorious Suits and the Role of Rule 11' (1996)

There are also proposals that the plaintiff's attorney, rather than the plaintiff, should pay the costs of the prevailing defendant.[181] However, such a radical change is regarded by many as going too far. No such a tag as "meritorious" or "unmeritorious", it is argued, exists for every lawsuit,[182] and law is uncertain in many areas. A case with similar facts may win on one occasion but lose on another. Quite often a court of first instance and appeal split on a particular case. Furthermore, in the early stage of litigation, it is hard to accurately assess the strength or weakness of a claim. This is more often than not the case as with derivative actions, whose facts are usually complex and for which plaintiff shareholders are in a disadvantageous position to access information.[183] While the rule that "losers pay" may indeed deter frivolous litigations, it would also deter uncertain cases, some of which would otherwise turn out to be meritorious, or would enable the court to develop new law.[184] Thus, a change to the "English rule" would inhibit meritorious as well as frivolous cases without distinction.[185] This inhibitive effect is considerably worsened for derivative actions where a minority plaintiff holds a tiny stake in the company and the imbalance between gains and losses are tremendous.[186] If such a plaintiff were required to bear the defendant's costs in the event that he loses the case, a lawsuit short of complete certainty would never be pursued.[187] This inhibitive effect would not change much even if the plaintiff's attorney, rather the plaintiff, is responsible for paying the

---

25 *Journal of Legal Studies* 371; Maggs, Gregory E., & Weiss, Michael D., 'Progress on Attorneys' Fees: Expanding the 'Loser Pays' Rule in Texas' (1994) 30 *Houston Law Review* 1915.

[181] *See* Hensler, Deborah R., & Rowe, Jr., Thomas D., 'Beyond "It Just Ain't Worth It": Alternative strategies for Damage Class Action Reform" (2001) 64 *Law & Contemporary Problems* 137.

[182] *See* Gross (n 1634 above).

[183] *Ibid*.

[184] *See* Goldman, Lee, 'The World's Best Article on Competitor Suits for False Advertising' (1993) 45 *Florida Law Review* 487; Katz (n 132 above).

[185] *See* above discussion on pages 26-29 [AQ: which page?].

[186] *Ibid*.

[187] *See* Hensler & Rowe, Jr. (n 1850 above).

winning defendant.[188] The imbalance between the potential benefits and losses still exists. Moreover, a rule that attorneys pay means that attorneys' financial stakes in an action increase even further, enhancing the legitimacy and power for them to control the action. The pressure on them to settle rather than to push for trial is also raised. As a result, the conflict of interests and agency problems in derivative actions become worse.[189]

Because of the problems with a wholesale change to the "English rule", a partial adjustment has been suggested,[190] proposing that, if a case is dismissed, the plaintiff should pay the defendant; if permission is given to continue the action, each party should bear their own costs or the losing party pays only a very small percentage of the winner's costs.[191] It is argued that a meritorious case would be successful in sustaining the leave proceeding. Thus, a plaintiff would not be deterred from taking a meritorious case for fear of paying the defendant's costs.[192] On the other hand, because frivolous actions would not survive dismissal and plaintiffs needs to pay the costs of the defendants when their cases are dismissed, such a new rule would have the effect of deterring frivolous suits. Therefore, the proposed rule is preferable in that it discourages frivolous suits but does not overreact to deter meritorious cases. It is also a fairer rule, as the winning party to some degree would be made whole by a compensation for his litigation costs.

---

[188] *See* Gross (n 1~~3~~4 above); Weinstein, Jack B., 'Some Reflections on United States Group Actions' (1997) 45 *American Journal of Comparative Law* 833.
[189] *Ibid*.
[190] *See* Root, David A., 'Attorney Fee-Shifting in America: Comparing, Contrasting, and Combining the 'American rule' and 'English rule' (2005) 15 *Indiana International & Comparative Law Review* 583; Feuerstein, Lorraine Wright, 'Two-Way Fee Shifting on Summery Judgement or Dismissal: An Equitable Deterrent to Unmeritorious Lawsuits' (1995) 23 *Pepperdine Law Review* 125
[191] *Ibid*.
[192] *Ibid*.

The proposed rule seems more neutral and is similar to what was recommended by the German Government Panel on Corporate Governance.[193] It breaks the dichotomy of either applying the "American rule" or the "English rule" and avoids the dilemma of escaping one problem only to find the other. Indeed, it would have an effect of deterring frivolous litigation, because a plaintiff or the attorney faces the consequence of paying the defendant's litigation costs, if a frivolous case is filed. On the other hand, it would not be as far-reaching as the "English rule" to deter cases where a plaintiff or attorney is less than totally certain of its merits. However, such a conclusion is based on the assumption that meritorious and frivolous cases are clear-cut, which may not be accurate in reality.[194] Thus, there is still the possibility that some uncertain cases, which might turn out to be virtuous, are nevertheless not pursued. Considering the difficulty minority shareholders have in accessing evidence to ascertain the merits of a case, this concern may indeed be legitimate.

Nonetheless, the modified rule is much less prohibitive than a full-ranged "English rule". In view of the fact that it is difficult for the courts to maintain a proper control over the admission of derivative actions, it is worthwhile having a trial of the new rule. If this new rule on funding is introduced, the law on admission could be relaxed. Overall, the result is more satisfactory if the rule ensures more meritorious actions being pursued while frivolous suits are still discouraged. If this rule is introduced, however, it may be more sensible to require the plaintiff's lawyer who works on contingent fees to pay the defendant, because under such a circumstance the lawyer has a bigger financial stake in the action than a minority shareholder plaintiff does. Moreover, to assist shareholders to ascertain the merits of a case, it is helpful that the shareholders' statutory right to inspect a company's books and records be

[193] *See German Government Panel on Corporate Governance*, paras 72-73, available at http://www.ecgi.org/codes/documents/baums_report.pdf.

[194] *See* above discussion on page 41[AQ: which page?].

expanded.[195] Lastly, if the modified contingent fee is introduced into China, the law on derivative action needs to be changed to provide for a procedure where plaintiffs are required to apply to the courts to continue an action.

[B head] 3. The Problem of Cheap Settlements

Another complaint about derivative action in the US is the prevalence of cheap settlements, which bring little benefits to the company but awards the plaintiff's attorney substantial fees. In fact, settlement itself is not a problem, although under a contingent fee agreement a lawyer's preference for settlement conflicts with a plaintiff's preference for judgment.[196] As a matter of fact, settlements of civil disputes are encouraged in different jurisdictions. In China, judicial culture prefers settlement and the Civil Procedure Law 1991 sets aside one chapter to stipulate rules on mediation.[197] The question is whether a settlement is adequate. The common complaint about settlements of derivative actions in the US is that companies receive little or no monetary recovery while attorneys are awarded substantial fees. It is said that more often than not settlements are "cosmetic", only to justify fee awarding.[198]

Cheap settlements and frivolous litigation are actually connected issues. Cheap settlements are a result of frivolous actions and strike suits are brought only because a cheap settlement is expected to be available. If a cheap settlement is not available, it would be unfeasible to extort fee awarding by taking on frivolous suits. It is therefore clear that solving the problem of cheap settlement helps solve the problem of

---

[195] *See* Ferrarini, G., & Giudici, P., 'Financial Scandals and the Role of Private Enforcement: The Parmalat Case', European Corporate Governance Institute (ECGI) - Law Working Paper No. 40/2005 (May 2005).
[196] *See* Coffee (n 163~~3~~6 above).
[197] *See* Civil Procedure Law 1991, Ch 8.
[198] *See* Romano (1991) (n 72~~3~~ above).

frivolous litigation. Put differently, the problem of frivolous litigation can be addressed by tackling the cheap settlement problem. [199]

Another scenario where a cheap settlement arises is that a well-founded claim produces inadequate remedies for the company as a result of collusion (explicit or implicit) between the plaintiff's lawyer and the defendant. It is not difficult to understand why this could happen when lawsuits are funded by contingent fees. For a lawyer working on contingent fees, failing to win a case by trial means that all his efforts (plus any out-of-pocket expenses) would be lost. Though a claim may be well-founded, no one can guarantee that it will be successful in trial. Thus a lawyer has a strong incentive not to proceed to trial but instead to secure a settlement. A lawyer working on fees calculated with the "lodestar" method has an incentive to prolong an action and then is particularly risk-averse.[200] For lawyers working on fees computed by the percentage method, to settle a case as quickly as possible is the most rational option.[201] On the side of the defendant, strong incentives to settle a case also exist. If a settlement is secured, the costs of defending as well as damages could be compensated by insurers or indemnified by the company.[202] If, however, the case is lost, the defendant may have to pay litigation costs as well as damages out of his own pockets. [203] Moreover, a judgment finding a director's wrongdoing is much more damaging to his reputation than a settlement. On the side of the company, it is represented by the defendants and thus has little say in the decision. For minority shareholder plaintiffs, they have only a nominal stake in the outcome of an action and

[199] *See* Hensler & Rowe, Jr., (n 1850 above).
[200] Coffee (n 46-71 above); Coffee (n 1636 above).
[201] *Ibid*.
[202] *See* Moodie, Gordon, 'Forty Years of Charter Competition: A Race to Protect Directors from Liability?' Harvard John M. Olin Centre for Law, Economics and Business Fellows' Discussion Paper Series No. 1 (09/2004); Smith (n 1749 above).
[203] *Ibid*.

it may not be economically rational for them to incur substantial costs to monitor their lawyers. For all these reasons, cheap settlements are not a surprise.

Whatever ~~are~~ the causes are, cheap settlements are a serious problem. If it is not curbed, the derivative action would be called into disrepute and then the goal for it to play a role in corporate governance would not be achieved. There are various suggestions for reform in the US to tackle the cheap settlement problem. One innovative proposal is the auction of plaintiffs' claiming rights[204]: it is auctioned as an asset and awarded to the highest bidder, who pays for the claim rights up front and then takes over to pursue the claim. As a result, the agency relationship between plaintiffs and their attorneys disappears. The winning bidder would prosecute the claim with all best efforts to maximise financial gains and the "sweetheart" settlement problem would thus disappear.

Besides the argument that it would eliminate the incentive for attorneys to incur search costs and detect legal violations in the first instance,[205] the fundamental problem with such a proposal is the difficulty of implementation.[206] In many cases, a claim is constantly adjusted as litigation continues and facts are discerned step by step. Therefore, it would be very difficult to assess the strength and to define the scope of a claim at the early stage of litigation when an auction is conducted. For some large scaled actions, it was also argued that the number of bidders with sufficient finances

[204] Macey, Jonathan R., & Miller, Geoffrey P., 'The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform' (1991) 58 *University of Chicago Law Review* 1; Thomas, Randall S., & Hansen, Robert G., 'Auctioning Class Action and Derivative Suits' (1993) 87 *Northwest University Law Review* 423; Macey, Jonathan R., & Miller, Geoffrey P., 'Auctioning Class Action and Derivative Suits: A Rejoinder' (1993) 87 *Northwest University Law Review* 458.
[205] *See* John C. Coffee (n ~~46~~ 71 above).
[206] Macey & Miller, (1991[AQ: Could you provide the year of publication?]) (n 203~~4~~ above).

to pay the upfront price may be limited and collusion between bidders to keep prices low would hence be possible. Moreover, what if there is no bidder except the one who originally brings up the action? This would happen with frivolous actions. Thus it is unclear whether the proposed reform is effective to discourage frivolous litigation.

To tackle the cheap settlement problem, we have to look for other realistic solutions. In both England and the US, a settlement of derivative action is required to be sanctioned by the court. Rule 23.1 of the Federal Rules of Civil Procedure in the US provides that "the action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs".[207] Moreover, attorneys claiming their fees are required to file a motion to the court.[208] In England, Rule 19.9(3) is also said to be a requirement that a settlement should be approved by the court.[209] With these provisions, a court can exercise scrutiny over settlements and attorney fee awarding, and thus a mechanism is provided for to check cheap settlements. If contingent fees are introduced into China, solution to the cheap settlement problem also lies in judicial control. While the civil procedure law generally stipulates that the voluntary dismissal of a claim should be approved by the court,[210] it does not specifically say that settlements should approved by the courts. As for lawyer's fee awarding, it is treated as private business and law says nothing about that. This is inadequate – law should explicitly stipulates that a settlement of derivative action and lawyer's fee awarding should be sanctioned by the court. Judicial approval of settlement and lawyers' fee awarding should be made mandatory.

---

[207] *See* Federal Rules of Civil Procedure, r 23.1.
[208] *Ibid*, r 54 (d) (2).
[209] Reisberg, Arad, 'Judicial Control of Derivative Actions' [2005] 8 *International Company and Commercial Law Review* 335.
[210] Civil Procedure Act 1991, Art 131.

But a mere general requirement is not sufficient. To enable the court to decide whether a settlement should be approved and attorneys' fees be awarded, clear rules are needed. To formulate rules on under what circumstances lawyers could be awarded fees, we should understand that the major and most serious complaint about cheap settlements in the US is that a company receives no or little monetary recovery but the plaintiff's lawyer receives substantial fees. That this situation could happen is because of the rule of "substantial benefit", which allows a plaintiff's attorney to be paid when an action brings only non-pecuniary relieves to the company.[211] Thus to address the complaint, the rule needs to be changed. While a wholesale change to preclude plaintiffs' lawyers from being paid when no monetary benefit (or benefit easily susceptible of valuation) have been obtained seems going too far, the rule could be altered and made more detailed to prevent it from being abused. First of all, lawyers should not be entitled to fee awarding where the original claim is monetary or involves properties but a settlement produces only non-monetary remedies.[212] If a monetary claim brings only non-monetary relief, it is arguable that either the claim is actually groundless or the plaintiff lawyer fails to win a good case. In both situations fee awarding is unjustifiable. Indeed it seems unreasonable that a lawyer is awarded substantial fees where a case claiming considerable amounts of damages against directors results in only the board of the company agreeing to "discuss relevant changes in government health care regulations" and to establish a compliance committee, as in *In re Caremark International Inc. Derivative Litigation.*[213] The advantage of this rule is that, on the one hand, it prevents plaintiffs' lawyers from

[211] *Bosch v. Meeker Coop. Light & Power Ass'n*, 257 Minn 362 (1960); *Mills v. Electric Auto-Lite Co.*, 396 US 375 (1970). *See* above discussion on pages 16-19 [AQ: which page?].
[212] *See* Smith (n 1749 above).
[213] *In re Caremark International Inc. Derivative Litigation* 698 A.2d 959 (Del. Ch. 1996).

accepting cosmetic non-monetary settlements and on the other, as a common ground for taking derivative actions is that directors have violated their fiduciary duties and caused damages to the company, a large portion of frivolous suits would be thus discouraged.

Secondly, to prevent frivolous suits which do not claim monetary or proprietary relief, it can be stipulated that there should be a strong nexus between the relief sought and the relief obtained.[214] Thus, for example, if a derivative action, seeking to compel directors of a company to submit to the shareholders for a vote on a takeover bid which they have previously turned down, results in the directors agreeing to do that, it is justifiable for fee awarding; but if the action brings a settlement with only the company agreeing, say, to set up an independent committee for considering and recommending future possible bids, lawyer fees should not be allowed.[215] It is reasonable to argue that the plaintiff and his lawyer are actually not successful to win the original case and the complained wrong has not been redressed. The settlement is more to justify fee awarding than to benefit the company.

Thirdly, a distinction should be made between remedies offered by the company and remedies obtained from defendants. In a derivative action, the company is not a defendant in the real sense. Plaintiffs' complaints are not against the company but the individual directors or controlling shareholders. So, if a settlement obtains remedies from the company rather than from those wrongdoers, it is valid to suspect that either the strength of the case is questionable or the plaintiff's lawyer and the defendants collude with each other to secure their own benefits at the cost of the company. Lastly,

[214] *See* Loewenstein, Mark J., 'Shareholder Derivative Litigation and Corporate Governance', ~~[~~(1999)~~]~~ 24(1) *Delaware Journal of Corporate Law* 1.
[215] *Ibid.*

to discourage cheap settlements and collusion, details of a proposed settlement should be given publicity and non-plaintiff shareholders are allowed to challenge. With all these rules in place, the cheap settlement problem could be kept at bay and frivolous litigation accordingly should no longer be a big concern.

Regarding the complaint that in some actions a plaintiff's attorney is awarded exorbitant fees which take up a lion's share of recoveries, this can be addressed by combing the "lodestar" and percentage method for fee calculation. First of all, the "lodestar" method should be used as the primary method for fee calculation. This is to avoid the problems associated with the percentage method that an award bears no relationship to and does not represent the amounts of work done by a lawyer, but is more relevant to the size of a claim which may produce windfalls for a lawyer.[216] At the same time, in order to discourage a lawyer from delaying and expending unnecessary time on a case,[217] a percentage cap upon which a lawyer can be awarded fees out of recoveries should be introduced. With this hybrid method, the problem of disproportionate fees can be resolved. However, in China although hourly fees have been introduced,[218] they are not common. Lawyers usually charge fixed fees or are paid according to a percentage of claim values.[219] Thus, the percentage method would most probably be used in derivative action. To address the windfall concern, a special regulation on lawyer's fees for derivative litigation could provide that the percentage used to calculate fees should be scaled down as the money value of recoveries goes up. A percentage cap could also be introduced. However, lawyer's fees for civil litigation

[216] *See* ALI (n ~~39~~ 64 above), Comment c and Reporter's Note 1-4 on s. 7.17; DeMott (n ~~35~~ 60 above), s 6.17 & s 6.18.
[217] *See* ALI, ~~supra note 39~~(n 64 above), Comment c and Reporter's Note 1-4 on s 7.17.
[218] *See Measures on the Services Fee of Lawyers* (April 2006), Art 10
[219] *See* Ping'an Tian *et al*, n 139 above
~~*See* Zimmerman (n 59 above); Michelson, Ethan, 'The Practice of Law as an Obstacle to Justice: Chinese Lawyers at Work' (2006) 40(1) *Law & Society Review* 1~~.

in China are subject to price control and standards set by governments cannot be said generous. For example, in Guangdong and Shanghai the maximum percentage for civil lawsuits is 6 per cent and 2 per cent of claim values.[220] Moreover, there is a 30 per cent cap on success fees in China for "no win, no fees" agreements.[221] It thus seems that the windfall problem should not be a big concern in China.

[A head] G. The Cost Of Filing Fees In China

Unlike in the UK or US, litigants in China need to pay a substantial amount of court fees if their claims are monetary or involve property. There are two types of court fees: filing fees and court expenses.[222] Filing fees are the fees a court charges when a litigant files a claim or counterclaim or an appeal, or applies for a freezing injunction order or for enforcement of a judgment. Court expenses include the costs of appraisal, survey, verification, identification, translation, giving pubic notice, etc; costs of travelling, accommodation, living allowances and subsidies paid to witnesses, translators, etc attending a trial.[223] Court expenses are charged according to the amounts actually incurred.[224] Filing fees are charged at~~on~~ a percentage of the value of claim, counterclaim, etc. The applicable percentage is scaled down as the amounts of value go up. For fees of filing a claim or counterclaim, the maximum percentage is 2.5 per cent for value below 10,000 RMB and the minimum 0.5 per cent for value above 20 million RMB.[225] The maximum percentage for fees for filing enforcement is

[220] Price Bureau and Bureau of Justice of Gongdong Province, *Lushi Fuwu Shoufei Guanli Shishi Banfa (Implementation Measures on Administration of Lawyers' Fees)* (December 2006), Appendix; Price Bureau and Bureau of Justice of Shanghai, *Lushi Fuwu Shoufei Zhenfu Zhidaojia Biaozhun (zanding) (Government-Guided Standards of Lawyers' fees) (Temporary)* (November 2001), s 1(2).
[221] *See Measures on the Services Fee of Lawyers* (April 2006), Art 13.
[222] *Measures of Charging Litigation Fees* (the State Council 2006), Art 6.
[223] But *see* n 138 above. ~~*Ibid*, Arts 11 & 12.~~
[224] *Measures of Charging Litigation Fees* (the State Council 2006)~~*Ibid*~~, Art 11.
[225] *Ibid*, Art 13.

1.5 per cent and the minimum 0.1 per cent[226] and 1 per cent and 0.5 per cent for fees for applying for freezing orders.[227]

Filing fees are payable when a court accepts a filing or application. A litigant should pay his fees within seven days of receiving notice;[228] otherwise, a filing is dismissed as if it were withdrawn by the litigant.[229] Filing fees are borne by the losing party.[230] Thus, a plaintiff could recover filing fees he has paid to the court from the defendant, if he wins his case. But the defendant may be impecunious, or hide his assets and, in the event where the prevailing plaintiff cannot recover his filing fees from the defendant, the court will not refund the filing fees.[231]

Derivative actions are a complex form of litigation. The value at stake in a derivative action with respect to listed companies is inevitably huge and, therefore, the filing fees are accordingly huge. For example, if a plaintiff files a suit claiming for damages of 10 million RMB – this amount is not exceptional and in some cases listed companies have been robbed of billions,[232] he would have to pay 81,800 RMB for filing fees.[233] He may be lucky enough to win his case at the first instance of court and not need to appeal. ~~But, necessarily he will have to apply for enforcement and pay~~

[226] *Ibid*, Art 14.
[227] *Ibid*.
[228] *Ibid*, Art 22.
[229] *Ibid*.
[230] *Ibid*, Art 29.
[231] This has been changed since April 2007. A court will refund a plaintiff filing fees that have been advanced if he wins his case and then tax a losing defendant fees. *See* the Supreme People's Court, *Notice on the Application of 'Measures of Charging Litigation Fees'* (20 April 2007), s 3.
[232] For example, in the dismissed derivative action that was mentioned in Section B (Sanjiu Yiyao), 2.5 billion Yuan were channelled out of the company to the controlling company and 1.1 billion Yuan were 'lent' to one of its sister companies. Nevertheless, the plaintiff claimed only 20 thousand Yuan, most probably because he could not pay such a huge amount of filing fees. *See* ~~the report by *Shanghai Zhengquan Bao* (*Shanghai Securities News*), 22 April 2003, with the title~~ "Jujiao 'Sanjiu Yiyao' Gudong Daibiao Susong An (Focus on the Shareholder Derivative Action Involving 'Sanjiu Yiyao)', *Shanghai Zhengquan Bao* (*Shanghai Securities News*), 22 April 2003.
[233] *Measures of Charging Litigation Fees* (the State Council 2006)~~*Ibid*~~, Art 13.

~~additional filing fees for enforcement.~~[234] ~~-~~But i~~I~~f he is not ~~lucky enough to win his case in the first instance~~ and decides to appeal, then he would have to pay the same amount of filing fees again – a total of 163,600 RMB. This amount does not even cover court expenses ~~or~~ and the possible fees for applying for freezing orders ~~and enforcement~~. For an individual plaintiff of a derivative action, this is prohibitive. It is unlikely that a plaintiff would pay such an amount in order to take an action from which he might only derive negligible gains. Even a lawyer would think twice before filing a claim, if he were required to pay a significant amount out of his own pockets before he can gain any concrete benefits. Indeed, a plaintiff has the right to recover filing fees ~~from the defendant~~ when he wins a case, but he must consider the risk that the filing fees will not be recovered in the event that the case is lost ~~or the losing defendant cannot pay~~.

Experience from Japan tells that, if substantial filing fees are required, the facility of derivative action would become merely a legal decoration. Since 1950, Japan has boasted of the facility of derivative action which was transplanted from the US by the Allied Occupation legal reformers,[235] but until 1993, when the rule of charging filing fees was changed, derivative action was disused in reality, with less than 20 derivative suits being filed in Japan between 1950 and 1990.[236] In 1993 the rule of percentage calculation of filing fees, like China's, was changed and filing fees were reduced to a small fixed amount. There was immediately an explosion of derivative suits and, by

[234] *Ibid*, Art 14.
[235] *See* West, Mark D., 'The Pricing of Shareholder Derivative Actions in Japan and the United States' ~~[~~(1994)~~]~~ 88 *Northwest University Law Review* 1436.
[236] *See* West, Mark D., 'Why Shareholders Sue: The Evidence from Japan' ~~[~~(2001)~~]~~ 30 *Journal Legal Studies* 351.

the end of 1993, 84 suits were pending in Japanese courts. By 1996, that number rose to 174, and by the end of 1999, there were 286 such suits.[237]

From the Japanese experience, it is clear that filing fees have a big ~~role~~ impact on whether derivative cases will be pursued or not. Therefore, if derivative action is to become a tool of corporate governance in China, the barrier of filing fees has to be removed. Existing unreasonable percentage fees should be changed to a fixed, small fee or, if that is too ambitious, the percentage should be considerably reduced. This is a significant change that is not easy to achieve. But it is not impossible and the experience of Japan demonstrates that. The key is the government's determination to improve corporate governance and make use of derivative action as a mechanism to achieve that end. In short, the filing fees are one of the biggest obstacle to the pursuance of derivative actions in China. The other one is the one per cent minimum shareholding requirement. If these two barriers are not cleared, it is just an illusion that the derivative action can play a role in corporate governance in China.

[A head] H. Conclusion

The derivative action, which was introduced into China in 2005 when the Company Law 1993 was extensively amended, has been expected to play an important role in corporate governance in China. But the new Company Law does not provide for how derivative actions should be financed. Considering the huge disproportion between benefits and costs that a derivative action would bring to a minority shareholder plaintiff, this omission is a critical failure foretelling that derivative actions would actually rarely be taken in China. For the derivative action to deliver on the promise to be a useful corporate governance tool in China, proper

[237] *Ibid*.

rules should be in place to alleviate shareholders' concern for litigation costs. By way of a comparative study, this article finds that the English indemnity order is inherently defective, because it entails that judges impose financial obligations on a company before the merit of an underlying claim is ascertained. Relatively, the American contingent fee is most disposed to encourage derivative actions and the associated problem of frivolous litigation and cheap settlement could be addressed by reforming the established rules in different ways. The arrangement is compatible with the current law and practice of litigation funding in China, but first of all, legislation is needed to provide that a plaintiff is entitled to be compensated for his litigation costs where a derivative action brought by him generates benefits for the company. Secondly, lawyers should be allowed to fund derivative actions. Last, the special barrier of filing fees in China has to be removed before derivative actions can be a realistic corporate governance tool.