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INVESTORS BEWARE: ASSESSING SHAREHOLDER DERIVATIVE LITIGATION IN INDIA AND CHINA

ANN M. SCARLETT*

ABSTRACT

In response to the 2008 financial crisis, the United States government bailed out many business entities in exchange for equity and debt interests in such entities. It also dramatically increased the regulations imposed on businesses. This level of government ownership and intervention in corporations is rare in free-market capitalist systems such as the United States. Government ownership and control, however, are common among historically socialist countries such as India or communist countries such as China. Yet, the United States' recent actions stand in stark contrast to the trend in India and China, which have both been moving toward more capitalist systems by disentangling government from business enterprises, reducing regulations and government interventions, and allowing free markets to develop. One specific example of such change in India and China is their recent acceptance of the shareholder derivative device, which empowers private investors to bring claims on behalf of a corporation when it has been harmed by outside parties or, more typically, by its own management. The shareholder derivative device is widely recognized among developed countries. This Article compares the nature of corporations and shareholder derivative litigation in the United States, India, and China. It specifically examines why India and China have embraced the shareholder derivative device and analyzes whether the device provides real protection for investors in Indian and Chinese

* Associate Professor of Law, Saint Louis University. This Article has benefited from comments by participants at the Midwest Law and Economics Association's Annual Meeting on October 9, 2010 that was sponsored by the University of Colorado School of Law. It has also benefited immeasurably from comments by participants in workshops at the Salmon P. Chase College of Law at Northern Kentucky University and at Saint Louis University School of Law. I thank Nicole Oelrich, Joseph Goedde and Thomas Bussen for their excellent research assistance.

corporations. Finally, this Article considers the lessons that investors, corporations, and the United States should draw from India and China's recognition of shareholder derivative litigation.

1. INTRODUCTION

The United States' response to the financial crisis that struck in 2008 included interventions into private business entities. To ameliorate the disruption to the financial markets, Congress enacted sweeping legislation known as the Emergency Economic Stabilization Act of 2008,[1] which included the well-known Troubled Asset Relief Program (TARP).[2] As its name suggests, TARP authorized the Secretary of the Treasury to purchase troubled assets from financial institutions caught in the turmoil of the mortgage crisis and stock market collapse.[3] As security for the purchase of such troubled assets, TARP required that the Treasury Department receive stock or debt interests in those institutions.[4] TARP further entitled the Treasury Secretary to set corporate governance standards for those financial institutions from which it purchased troubled assets in exchange for equity or debt interests.[5]

The Treasury Department, however, never actually bought troubled assets from financial institutions as directed by TARP. Instead, it simply invested capital into financial institutions in return for equity or debt interests.[6] For example, the Treasury

[1] Emergency Economic Stabilization Act of 2008, 12 U.S.C. §§ 5201–52 (2010).

[2] *Id.* § 5211.

[3] *Id.*

[4] *See id.* § 5223 (requiring as a precondition to aiding troubled assets that the Treasury Department receive warrants to purchase common or preferred stock, or, if the institution's securities are not publicly traded, requiring the Treasury Department receive senior debt instruments).

[5] *See id.* § 5221 (stating that "the Secretary shall require the financial institution meet appropriate standards for . . . corporate governance"). Using that power, the Treasury Secretary limited the executive compensation of participating financial institutions' senior executive officers. *See* Tarp Capital Purchase Program, 31 C.F.R. §§ 30.2–30.3 (2009). The Treasury Department also forbade golden parachutes for senior executive officers in such institutions. *Id.* §§ 30.8–30.9.

[6] *See Testimony on the Troubled Assets Relief Program: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Servs.*, 111th Cong. 3 (2009) (outlining a statement by Herbert M. Allison, Jr., Assistant Secretary for Financial Stability, U.S. Department of the Treasury) (discussing certain treasury programs enacted after the 2008 financial crisis). *See also* Press Release, Dep't of Treasury, HP-1338: Treasury Releases Guidelines for Targeted Investment Program (Jan. 2, 2009), *available at* http://www.treasury.gov/press-center/press-

Department invested $45 billion in Citigroup Inc. in return for warrants to purchase its common shares, which resulted in the government owning a 34% stake in Citigroup's common shares.[7] The Treasury Department has also twice bailed out American International Group Inc. (AIG), an insurance company, which ultimately resulted in the government's 92% current ownership stake.[8] Perhaps more shockingly, the Treasury Department ordered each of the nine largest financial institutions in the United States to accept $125 million, which "most of them did not need or want," and then refused to allow these institutions to repay those funds until it said they were ready to do so.[9]

In addition, two domestic automakers—General Motors Co. and Chrysler Group LLC—and their affiliated financing entities convinced the Secretary of the Treasury to extend $81 billion in TARP funds to them and the Treasury Department again acquired equity and debt interests in return.[10] For example, the Treasury Department invested $50 billion in General Motors as part of the company's bankruptcy reorganization, which resulted in the government owning a 61% majority interest in 2009 and currently a

releases/Pages/hp1338.aspx (discussing the guidelines, justification, and eligibility for the Targeted Investment Program).

[7] *See* Tom Barkley, *TARP Profit on Citigroup: $12.3 Billion*, WALL ST. J., Jan. 27, 2011, http://online.wsj.com/article_email/SB10001424052748703293204576…MyQjAxMTAxMDEwOTExNDkyWj.html?mod=wsj_share_email_bot#printMode (noting the government's profit from selling its warrants to buy Citigroup stock).

[8] *See* Serena Ng & Erik Holm, *AIG Swings to Profit but Problems Persist*, WALL ST. J., Feb. 25, 2011, http://online.wsj.com/article/SB10001424052748703408604576164724143769978.html (detailing AIG's proposed stock offering and the impact it could have on the government's "massive investment in the insurer"); Serena Ng et al., *AIG, U.S. Agree on an Exit Deal; Making It Work Will Be Tougher*, WALL ST. J., Oct. 1, 2010, http://online.wsj.com/article/SB10001424052748704483004575523261932975260.html (regarding the government's sale of AIG shares).

[9] *See* William M. Isaac, *Was TARP Worth It?*, FORBES, Oct. 1, 2010, http://www.forbes.com/sites/billisaac/2010/10/01/was-tarp-worth-it/ (listing the nine financial institutions that were forced to accept the funds: Citigroup, JPMorgan Chase, Wells Fargo, Goldman Sachs, Bank of America, Bank of New York/Mellon, Merrill Lynch, Morgan Stanley, and State Street).

[10] *See* OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS: APRIL 20, 2010, at 114–16 (describing TARP aid to the auto industry); *see also* Josh Mitchell & Sharon Terlep, *U.S. Unlikely to Recoup GM Bailout, Panel Says*, WALL ST. J., Jan. 13, 2011, at B4 ("In all, the government pumped about $81 billion into rescues of [General Motors and Chrysler] and their affiliated credit arms . . . .").

33% stake.[11] However, TARP's express language mentions only "financial institutions," which it defines as a "bank, savings association, credit union, security broker or dealer, or insurance company."[12]

Although these bailouts have been extensively criticized on many grounds, the resulting government ownership interests in private corporations are perhaps the most troubling aspects for the United States' free market system. When faced with a financial crisis, officials in the United States government did not trust the free market system to correct itself. Instead, the United States government rushed in with public funds to rescue business entities allegedly on the brink of disaster. In return, the government took equity and debt interests in these business entities. Such government ownership of private corporations is rare in the history of the United States.[13] Many commentators argue that the government's bailouts give an unfair advantage to businesses that have the clout to lobby for such handouts and thus threaten the competitiveness of other businesses, particularly small ones.[14] Similarly, other critics contend that these government interventions undermine the functioning of the free market system, because businesses are not held responsible for their bad decisions by free market forces.[15] Criticism has also been leveled at the

[11] *See* Mitchell & Terlep, *U.S. Unlikely to Recoup GM Bailout*, *supra* note 10 (elaborating on the government's dim prospects of recovering the money invested in General Motors).

[12] 12 U.S.C. §§ 5202(5), 5211 (2010).

[13] *See, e.g.*, New Panama Canal Company Act of 1902, Pub. L. No. 57-183, 32 Stat. 481 (1902) (detailing how the United States acquired the Panama Canal); Tennessee Valley Authority Act of 1933, 16 U.S.C. § 831 et seq. (1933) (establishing the Tennessee Valley Authority).

[14] *See* Keith Naughton & Alison Fitzgerald, *Ford Objects to Unfair Advantage for Bailed Out GMAC*, WASHINGTON EXAMINER, June 8, 2009, http://washingtonexaminer.com/business/2009/06/ford-objects-unfair-advantage-bailed-out-gmac (arguing Ford was placed at a huge competitive disadvantage compared to General Motors and its financing arm GMAC because the latter received government bailout money; Bloomberg data showed Ford "paid $107.5 million more than GMAC for every $1 billion it borrowed"). *Cf.* Pete Du Pont, *Too Much Energy in the Executive*, WALL ST. J., Feb. 17, 2011, http://online.wsj.com/article/SB10001424052748703373404576148684150871602.html (noting Health and Human Services Department has granted 733 businesses waivers to the new health care law's regulations).

[15] *See* Luca Di Leo & Bradley Davis, *Fed's Hoenig: Easy Money and "Too Big to Fail" Must End*, WALL ST. J., Feb. 23, 2011, http://online.wsj.com/article/SB10001424052748703775704576162541139862146.html (stating that the bailouts insulate institutions "from normal market forces that would otherwise force them

government's extensive creation of new regulations allegedly designed to prevent further harmful conduct by businesses and Wall Street, because these regulations have made a negative impact on private corporations' ability to compete.[16] The more the government intervenes in private corporations through ownership interests or regulatory controls, the more fuel that is added to the argument that the United States is edging away from capitalism.

These recent actions by the United States stand in stark contrast to the trend among emerging economies, of which China and India are among the largest.[17] India and China are moving toward more free market systems, such as that in the United States.[18] India has been liberalizing its prior socialist policies and adopting more capitalist policies to foster private corporations and credit markets.[19] Similarly, China is shifting away from the state-owned enterprises that dominated after the Chinese Communist Party came to power in the 1940s to privately held businesses.[20]

One specific example of the changes occurring in India and China is their recent acceptance of the shareholder derivative

to make more prudent choices"); Jeffrey Sparshott, *TARP Inspector: Citi Remains "Too Big to Fail,"* WALL ST. J., Jan. 13, 2011, http://online.wsj.com/article/SB10001424052748704307404576080193310619166.html (quoting Special Inspector General for TARP as stating that "[u]nless and until institutions like Citigroup can be left to suffer the full consequences of their own folly, the prospect of more bailouts will potentially fuel more bad behavior"); *see also* Matt Cover, *Free Market Economists Reject Bailout as Bad Policy that Could Prolong Slowdown*, CNS NEWS, Sept. 30, 2008, http://www.cnsnews.com/news/article/free-market-economists-reject-bailout-bad-policy-could-prolong-slowdown (criticizing the bailouts for creating a system where "profits are privatized and losses are socialized").

16 *See* Jared A. Favole, *Business Group Frets Over Rules Review*, WALL ST. J., Feb. 2, 2011, http://online.wsj.com/article/SB10001424052748703960804576120503694195830.html (noting the Chamber of Commerce views the Obama administration as enacting excessive regulations); James Inhofe, *O's Quietest Jobs-Killing Machine*, N.Y. POST, Oct. 4, 2010, http://www.nypost.com/p/news/opinion/opedcolumnists/quietest_jobs_killing_machine_xAlRo2nRYjtYKaWKAwe7fN (stating U.S. Senator James Inhofe's opinion that excessive new regulations harm employment).

17 *See World Economic Outlook Database, October 2010*, INTERNATIONAL MONETARY FUND (Oct. 2010), *available at* http://www.imf.org/external/pubs/ft/weo/2010/02/weodata/download.aspx (listing China, India, Russia, and Brazil as the emerging economies among the world's twelve largest economies by gross domestic product using U.S. dollars in 2009, with China first and India third among the emerging economies).

18 *See, e.g.*, SUBHASH CHANDRA JAIN, EMERGING ECONOMIES AND THE TRANSFORMATION OF INTERNATIONAL BUSINESS 384 (2006).

19 *See infra* Section 3.

20 *See infra* Section 4.

device. In 2005, China enacted a statutory provision permitting shareholder derivative litigation for the first time.[21] India has proposed legislation that would also recognize shareholder derivative actions.[22] Shareholder derivative litigation has long been recognized within the United States and most other developed countries,[23] although the most frequent uses of such litigation are in the United States.[24] Shareholder derivative litigation, however, is much maligned in the United States. Many scholars advocate for the abolition of shareholder derivative litigation in the United States,[25] while others propose strict limitations on such litigation.[26] Shareholder derivative litigation has even been criticized by courts[27] and some state legislatures have sought to curtail it through bond and pleading requirements.[28] In addition, some corporations may even attempt

[21] *See infra* Section 4.2.2.

[22] *See infra* Section 3.2.

[23] *See, e.g.*, Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385, 1462–63 (2006) (assessing the legal risks outside directs can expect to face in different countries, including the United States).

[24] *See* Mark J. Loewenstein, *Stakeholder Protection in Germany and Japan*, 76 TUL. L. REV. 1673, 1674 (2002) (claiming that directors of non-U.S. companies are "less accountable to the interests of shareholders" than those of U.S. companies).

[25] *See, e.g.*, STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 8.5, at 404 (2002) (arguing that derivative litigation should be eliminated, or at least discouraged); Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 DICK. L. REV. 355, 367–68 (1994) (discussing that it may be unnecessary to abolish the derivative suit if aspects of procedural law that create incentives for litigation abuse are reformed); Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629, 1682 (2002) (noting some principal-agent theorists have suggested that derivative suits be abolished).

[26] *See, e.g.*, Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 53–54 (1990) (arguing that corporate rules should be determined by private contract and not by courts).

[27] *See* Marx v. Akers, 666 N.E.2d 1034, 1037 (N.Y. 1996) ("By their very nature, shareholder derivative actions infringe upon the managerial discretion of corporate boards . . . . Consequently, we have historically been reluctant to permit shareholder derivative lawsuits, noting that the power of courts to direct the management of a corporation's affairs should be 'exercised with restraint.'"); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (stating that "judges are not business experts" and deferring to directors' decision even though challenged by shareholders).

[28] *See* WRIGHT ET AL., 7C FEDERAL PRACTICE AND PROCEDURE, CIV. 2d § 1835 (2006) (listing Arizona, California, Colorado, Florida, Nebraska, New Jersey, New York, Pennsylvania, and Wisconsin as states requiring shareholder derivative plaintiffs to post a bond to cover defendants' reasonable attorneys' fees and

to escape shareholder derivative litigation by requiring that shareholder disputes be arbitrated.[29] Despite the criticism, shareholder derivative litigation remains one of shareholders' most effective weapons against corporate mismanagement. Indeed, a wave of shareholder derivative actions quickly followed the mortgage crisis and financial meltdown in 2008.[30]

Recent events highlight that the United States may consciously or unconsciously be edging away from its free market system, while the clear trend in recent years in India and China moves toward free market systems. This Article explores this seemingly inverse trend through an examination of the shareholder derivative device. Studying India and China's acceptance of shareholder derivative litigation demonstrates one way in which these emerging economies are seeking to attract domestic and foreign investors, and perhaps shows a means by which they seek to better compete for capital with developed economies, such as the United States. Empowering shareholders to sue derivatively on behalf of corporations reflects China's and India's conscious efforts to increase investors' confidence in their corporate governance and decrease government involvement in business entities. It may also serve as a useful reference point for businesses and governments within the United States as they consider the best ways to compete in the ever-expanding global economy.

Section 2 of this Article explains the nature of corporations and shareholder derivative litigation in the United States. Drawing comparisons to the United States, Section 3 describes the evolution of the corporate structure in India and its recent recognition of the shareholder derivative device. Section 4 then does the same for

expenses); DEL. CH. CT. R. 23.1 (2008) (requiring shareholder derivative plaintiffs to file an affidavit swearing that they will not accept any compensation for serving as a representative).

[29] *See* Andrew J. Sockol, Comment, *A Natural Evolution: Compulsory Arbitration of Shareholder Derivative Suits in Publicly Traded Corporations*, 77 TUL. L. REV. 1095, 1108 (2003) (proposing arbitration as an alternative to judicial resolution of derivative suits); *see also* Scott R. Haiber, *The Economics of Arbitrating Shareholder Derivative Actions*, 4 DEPAUL BUS. L.J. 85, 85 (1991) (noting securities law disputes can be resolved through arbitration rather than litigation).

[30] *See, e.g.*, *In re* Merrill Lynch & Co., Sec., Derivative & ERISA Litig., 2009 WL 4030869 (S.D.N.Y. Mar. 3, 2009); *In re* Citigroup Inc. S'holder Derivative Litig., 2009 WL 2610746 (S.D.N.Y. Aug. 25, 2009); *In re* American International Group, Inc., 700 F. Supp. 2d 419 (S.D.N.Y. 2010) (providing examples of shareholder derivative actions following the financial crisis of 2008 and holding that some such claims are predicated on fraud).

China. In Section 5, the Article analyzes the meaning and likely effect of India's and China's acceptance of shareholder derivative litigation. It examines the reasons motivating India and China to adopt the shareholder derivative device and the basis for the specific forms chosen. In addition, given the existing legal systems in China and India, the Article analyzes the likely effectiveness of the shareholder derivative device either as a preventative measure of ensuring good corporate governance or as a means to remedy injuries suffered by corporations. It will argue that, while India and China have adopted a shareholder derivative device that is similar to the United States in theory, investors in Indian and Chinese companies should be warned that the device will not provide similar safeguards in practice. The Conclusion considers the lessons that investors, corporations, and the United States should draw from India's and China's adoption of shareholder derivative devices.

2. CORPORATIONS AND SHAREHOLDER DERIVATIVE LITIGATION IN THE UNITED STATES

Unlike corporations in both India and China, which are created under the authority of the central government, corporations in the United States are creatures of state law and are incorporated under the laws of a state, not the federal government.[31] Each of the fifty states have enacted statutes that govern the powers and operation of the corporations incorporated under its laws.[32] The states, however, are not equals in corporate law. Delaware, the second smallest state in the United States, is the well-recognized leader in corporate law[33] and is the leader in the state competition for

[31] BAINBRIDGE, *supra* note 25, § 1.2, at 5.

[32] *Id.*

[33] *See* Larry E. Ribstein & Erin Ann O'Hara, *Corporations and the Market for Law*, 2008 U. ILL. L. REV. 661, 678–81 (2008) (explaining Delaware's dominance in corporate law by applying general market rules under which parties choose a state of incorporation based on available laws); *see also* Renee M. Jones, *Legitimacy and Corporate Law: The Case for Regulatory Redundancy*, 86 WASH. U. L. REV. 1273, 1287 n.46 (2009) ("A significant proportion of corporate regulation is handled at the state level, with tiny Delaware being the dominant state in setting corporate law rules."); *see also* Omari Scott Simmons, *Branding the Small Wonder: Delaware's Dominance and the Market for Corporate Law*, 42 U. RICH. L. REV. 1129, 1171–75 (2008) (describing Delaware as a leader in corporate law as a result of its experienced judiciary, its business friendly reputation, and its substantial market share).

corporate charters.[34] A majority of states, however, have enacted corporation statutes based on the Model Business Corporations Act (MBCA),[35] which was drafted by a committee of the American Bar Association in 1950 and substantially revised in 1984.[36]

Despite the different origins of the various states' corporate laws, many of those laws are substantively similar.[37] One key distinction between Delaware and states adopting some version of the MBCA is that Delaware created most of its law on shareholder derivative litigation through common law development by its courts, while the MBCA is a statutory enactment. Courts, however, must still interpret and apply the MBCA's statutory requirements much as the Delaware courts must apply their prior precedents. And, although the MBCA and other states' corporate laws differ in some respects from Delaware's law, the Delaware courts are commonly followed by other states on corporate law matters.[38] Delaware's courts have gained such preeminence because of the large number of corporate opinions they produce, particularly the Delaware Chancery Court whose judges are recognized as having business expertise. Thus, courts in other

[34] *See* Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1061–64 (2000) (arguing that Delaware's success in attracting corporate charters can be explained by the structure and operation of its courts); Franita Tolson, *The Boundaries of Litigating Unconscious Discrimination: Firm–Based Remedies in Response to a Hostile Judiciary*, 33 DEL. J. CORP. L. 347, 403 (2008) ("Delaware is far and away the leader when it comes to attracting corporate charters.").

[35] MODEL BUS. CORP. ACT ANN., at v, ix. (4th ed. 2008); *see also* Jones, *supra* note 33, at 1294 ("Although Delaware is the leader among states in fashioning the law and settling disputes on significant corporate matters, the [MBCA] also has a significant influence on the development of corporate law standards throughout the country.").

[36] *See* Mulder, *Introduction* to ABA-ALI MODEL BUS. CORP. ACT, at iii (1959). The text of the Revised Model Act appears in MODEL BUS. CORP. ACT ANN. (4th ed. 2008).

[37] *See* Fisch, *supra* note 34, at 1062 ("[V]ariations in state corporation laws are minimal.").

[38] *See, e.g.*, Mullen v. Academy Life Ins. Co., 705 F.2d 971, 973 n.3 (8th Cir. 1983) ("Although New Jersey law governs [this case], we discuss Delaware case law as well, because of Delaware's position as a leader in the field of corporate law. The courts of other states commonly look to Delaware law . . . for aid in fashioning rules of corporate law."). *See generally* William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, 48 BUS. LAW. 351 (1992) (celebrating the significance of the Delaware Court of Chancery's contribution to the U.S. judicial system).

states often "follow Delaware law as persuasive authority in many decisions under their own statutes and common law."[39]

2.1. Corporate Legal Structure in the United States

United States corporations have a single board of directors elected by shareholders.[40] The directors of United States corporations usually include a combination of executive officers (inside directors) and independent directors (outside directors).[41] Independent directors currently comprise at least half the boards for publicly traded corporations,[42] although the ability of these directors to effectively supervise management is doubted.[43]

State laws give the board of directors the authority to manage the corporation.[44] Shareholders elect the directors and thus, at least in theory, they may hold those directors accountable for their

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39 Jones, *supra* note 33, at 1287 n.46.

40 *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 211(b), 212(b) (2009) (describing regulations for meetings and votes of shareholders respectively); MODEL BUS. CORP. ACT § 8.03(c) (2008) (providing that directors are elected at annual shareholders' meetings unless the board is staggered).

41 *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 923 (1999) (defining independent directors as outside directors without affiliations to the corporation).

42 Nicola Faith Sharpe, *Rethinking Board Function in the Wake of the 2008 Financial Crisis*, 5 J. BUS. & TECH. L. 99, 109 (2010); Bhagat & Black, *supra* note 41, at 921 ("[T]oday, almost all [U.S. public corporations] have a majority of outside directors and most have a majority of 'independent' directors."); DAVID SKEEL, ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM 183 (2005) ("Most large corporations already have a majority of disinterested directors on their boards."); NASDAQ, INC., STOCK MARKET RULES § 5605(b)(1) (2009) (requiring that a majority of the board be comprised of independent directors); NYSE, INC., LISTED COMPANY MANUAL § 303A.01 (2009) (same).

43 *See, e.g.*, SKEEL, *supra* note 42, at 184 ("All but two of Enron's directors were disinterested . . . yet the directors simply nodded their heads as [the CEO and CFO] spun their web of magnificent promises and prophecies."); Bhagat & Black, *supra* note 41, at 922 ("Independent directors often turn out to be lapdogs rather than watchdogs."); Sharpe, *supra* note 42, at 109 ("Most corporations have boards where a majority of directors are outsiders; however, these boards often are composed of individuals who are not qualified to assess the strategic viability of the corporations they direct.").

44 *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(A) (2009) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors."); MODEL BUS. CORP. ACT § 8.01(b) (2008) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors . . . .").

decisions by electing new directors to the board.[45] Other than electing directors, shareholders possess little power; they cannot initiate corporate action and vote only on dissolution, sales, mergers, and amendments to the articles of incorporation and corporate bylaws.[46] If shareholders believe directors and officers are mismanaging the corporation, failing to exercise proper oversight, or acting in their self-interest, their only recourse, other than selling their shares, may be to file a shareholder derivative lawsuit.

2.2. Shareholder Derivative Litigation in the United States

Courts in the United States have long recognized the shareholder derivative lawsuit, having imported the concept from England.[47] Shareholders may file a shareholder derivative action on behalf of the corporation for an injury to the corporation.[48] Typical shareholder derivative lawsuits include claims for monetary damages based on corporate mismanagement, excessive executive compensation, or corporate rights arising out of contract or tort law.[49] A shareholder may file a direct shareholder lawsuit

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[45] *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 211(b), 212(b) (2009) (describing regulations for meetings and votes of shareholders respectively); MODEL BUS. CORP. ACT § 8.03(c) (2008) (providing that directors are elected at annual shareholders' meetings unless the board is staggered).

[46] *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 105–06 (2004) [hereinafter Bainbridge, *Business Judgment Rule*] (explaining that shareholders have virtually no power to control daily operations of a firm, to control long-term policies, or to initiate corporate action); *see also* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 569–72 (2003) (discussing the weak control rights of shareholders with the view that they are so weak that they "scarcely qualify as part of corporate governance").

[47] *See* Nicholas Calcina Howson, *When "Good" Corporate Governance Makes "Bad" (Financial) Firms: The Global Crisis and the Limits of Private Law*, 108 MICH. L. REV. FIRST IMPRESSIONS 44, 47 (2009) (noting that the shareholder derivative action was imported into U.S. state law from England).

[48] *See, e.g.*, FED. R. CIV. P. 23.1(a) ("This rule applies when one or more shareholders or members of a corporation or an unincorporated association bring a derivative action to enforce a right that the corporation or association may properly assert but has failed to enforce."); MODEL BUS. CORP. ACT § 7.40(1) (2008) (defining a "[d]erivative proceeding" as a civil suit in the corporation's right); BAINBRIDGE, *supra* note 25, § 8.2, at 362 ("[A] 'derivative' suit is one brought by the shareholder on behalf of the corporation. The cause of action belongs to the corporation as an entity and arises out of an injury done to the corporation as an entity.").

[49] BAINBRIDGE, *supra* note 25, § 8.2, at 363.

when the shareholder has suffered an injury directly affecting her in her individual capacity, such as a claim of oppression by a minority shareholder or claims regarding shareholder voting rights or preemptive rights.[50]

Shareholder derivative litigation in the United States faces many disincentives and hurdles. Only shareholders who meet certain standing requirements may file derivative actions within federal and state courts. To initiate or maintain a derivative action, the plaintiff typically must have been a shareholder at the time of the challenged transaction and the plaintiff must also be deemed to fairly and adequately represent the interests of the corporation and its shareholders.[51] Several states require plaintiffs filing derivative actions to post a bond in an amount sufficient to cover the defendants' reasonable attorneys' fees and expenses if the plaintiffs own less than a prescribed amount of stock, measured either by shares or dollars.[52] A bond requirement is obviously a tremendous financial disincentive to filing derivative actions. Even in the absence of any bond requirement, shareholders often have little financial incentive to initiate such litigation, because any monetary recovery from a successful derivative lawsuit belongs to the corporation.[53] The shareholder thus at most benefits only to the extent that the monetary recovery increases the value of their percentage shareholding in the corporation. No financial incentive

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[50] *Id.* § 8.2, at 362–64 (contrasting direct shareholder suits from derivative shareholder litigation).

[51] *See, e.g.*, FED. R. CIV. P. 23.1(a) ("The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation . . . ."); MODEL BUS. CORP. ACT § 7.41(2) (2008) (requiring that a shareholder was an owner at the time of action complained and "fairly and adequately represents the interests of the corporation"). *But cf.* DEL. CH. CT. R. 23.1(a) & (b) (2009) (requiring that plaintiff was a shareholder during the challenged transaction and requiring an affidavit disclaiming any form of compensation from serving as the representative of shareholders).

[52] WRIGHT ET AL., 7C FEDERAL PRACTICE AND PROCEDURE, CIV. 2d § 1835 (2006) (listing Arizona, California, Colorado, Florida, Nebraska, New Jersey, New York, Pennsylvania, and Wisconsin as states adopting security or bond for expense requirements); *see, e.g.*, COLO. REV. STAT. § 7-107-402(3) (2007) (allowing a court to compel a shareholder who owns less than a prescribed amount of stock to post a bond); N.Y. BUS. CORP. § 627 (same).

[53] BAINBRIDGE, *supra* note 25, at § 8.2, at 362–63 (providing the example of derivative shareholder litigation arising from a breach of contract in which the corporation as a whole was hurt and therefore a remedy should benefit all shareholders).

may exist for shareholders contemplating a derivative action seeking only injunctive relief.

In addition, shareholders who lose their derivative actions must bear the expense of their own attorneys' fees pursuant to the so-called "American Rule" that parties to litigation pay their own attorneys' fees.[54] Yet, unlike in many European countries, a losing shareholder in the United States does not pay the defendants' attorneys' fees.[55] Even if the derivative lawsuit is ultimately successful, the shareholder-plaintiff must finance the litigation until settlement or verdict occurs. This financial burden during litigation, however, can be alleviated if the shareholder can find an attorney willing to take the derivative lawsuit on a contingency basis, which is permitted in the United States.[56] When a derivative lawsuit settles, which most do,[57] the plaintiff's attorney may receive a sizeable fee from the fund created by the settlement upon court approval.[58] When the rare derivative lawsuit reaches a final

54 *See, e.g.*, Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 241, 247 (1975) (holding that the Court cannot invade the legislature's province by redistributing litigation costs in a manner contrary to the "American Rule"); John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 6–7 (1999) [hereinafter Coffee, *Privatization*] ("Under the standard 'American Rule,' each side bears its own legal fees (which means that the plaintiff's attorney faces only the loss of time and expenses invested in the action if the action is unsuccessful and is not generally liable for the winner's legal expenses).").

55 *See, e.g.*, Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385, 1406 (2006) (discussing the United Kingdom's loser pays rule as one of many deterrents to derivative litigation); Franklin Gevurtz, *Disney in a Comparative Light*, 55 AM. J. COMP. L. 453, 488 (2007) (discussing Germany's loser pays rule which places a significant financial risk on a complaining shareholder who also recovers nothing personally if the suit is successful).

56 *See* Coffee, *Privatization*, *supra* note 54, at 6 (noting that plaintiffs' attorneys may charge contingent fees in the United States, but that such fees are not authorized in the United Kingdom).

57 *See* John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 9–10 (1985) [hereinafter Coffee, *Unfaithful*] (noting that a majority of shareholder derivative lawsuits are resolved through settlement); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 60 (1991) (finding settlement in about 65% of resolved shareholder derivative lawsuits in a sample study from the late 1960s through 1987).

58 *See, e.g.*, FED. R. CIV. P. 23.1(c) ("A derivative action may be settled, voluntarily dismissed, or compromised only with the court's approval."); Amy M. Koopmann, *A Necessary Gatekeeper: The Fiduciary Duties of the Lead Plaintiff in Shareholder Derivative Litigation*, 34 J. CORP. L. 895, 909 (2009) ("Whether a shareholder derivative suit presents a valid claim or not, the plaintiffs' lawyer

verdict, courts have been quite willing to award the plaintiff's attorney their fees from the monetary recovery.[59]

A significant procedural hurdle for shareholder derivative litigation in the United States is the demand requirement. Generally, the board of directors controls the corporation's litigation, because the board possesses the statutory authority to manage the corporation and its assets, which would include a cause of action.[60] In federal court and most state courts, a shareholder is allowed to file a derivative action only after making demand on the board to rectify the challenged transaction.[61] In

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may stand to receive a large fee from a settlement, even a settlement that brings little or no benefit to the corporation."); Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 DEL. J. CORP. L. 1, 2–3 (1999) [hereinafter Loewenstein, *Shareholder*].

> In recent years, however, the courts have . . . been willing to award attorneys' fees to the plaintiff if the derivative litigation resulted in a 'substantial or common benefit' to the corporation, whether by judgment or settlement. The courts have been quite willing, too willing perhaps, to find a substantial benefit when the derivative action settles, the plaintiff seeks attorneys' fees, and the defendant does not object.

Id.

59 *See, e.g.*, Mills v. Electric Auto-Lite Co., 396 U.S. 375, 392 (1970) (recognizing that successful plaintiffs are entitled to attorneys' fees in derivative litigation because allowing "others to obtain full benefit from the plaintiff's efforts without contributing equally to the litigation expenses would be to enrich the others unjustly at the plaintiff's expense"); *see also* Loewenstein, *Shareholder*, *supra* note 58, at 2 ("[C]ourts have been willing to award attorneys' fees to the plaintiff if the derivative litigation resulted in a 'substantial or common benefit' to the corporation, whether by judgment or settlement.").

60 *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2008); MODEL BUS. CORP. ACT § 8.01(b) (2009).

61 *See, e.g.*, FED. R. CIV. P. 23.1(b)(3).

> The complaint must be verified and must . . . state with particularity . . . (A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort.

Id. *See also* DEL. CH. CT. R. 23.1(a) ("The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort."); MODEL BUS. CORP. ACT § 7.42 (2008).

> No shareholder may commence a derivative proceeding until: (1) a written demand has been made upon the corporation to take suitable action; and (2) 90 days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the

response to the shareholder's demand, a board of directors may: (1) choose to prosecute the litigation itself; (2) resolve the matter through internal means; or (3) reject the demand.[62] If the board rejects the demand, which is the typical board response, the shareholder must demonstrate to the court that the demand was wrongfully rejected before being allowed to proceed with a derivative action.[63] In some states, the shareholder can forego making demand and argue that demand is excused, which requires a showing that demand would be futile.[64]

To establish that demand is futile or that demand was wrongfully rejected by the board, the plaintiff must show that the business judgment rule defense does not apply to the board's decision.[65] As more fully explained below, this defense presumes that directors acted consistent with their fiduciary duties of care,

> corporation would result by waiting for the expiration of the 90-day period.

Id.

[62] *See* Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1349–1350 n.55 (1993) ("If corporate management believes the claims have merit, it may choose to pursue corrective actions or take charge of the litigation. If management disagrees with the shareholder's contentions, the demand requirement gives the corporation the chance to reject the proposed action.")

[63] BAINBRIDGE, *supra* note 25, § 8.5, at 395; *see also* Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 408 (2005) (noting "most boards" decide "not to bring any action" and that "most courts defer to boards on this matter").

[64] *See* Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) (stating that demand is futile and thus excused when officers and directors are under influences that impede their discretion to act on behalf of the corporation). The MBCA, however, states a universal demand requirement. MODEL BUS. CORP. ACT § 7.42 (2008).

[65] *See* Beneville v. York, 769 A.2d 80, 85 n.9 (Del. Ch. 2000).

> [T]he Supreme Court's emphasis on the business judgment rule supports excusing demand in the case of an evenly divided board . . . . And in a situation where a plaintiff shows that the business judgment rule is inapplicable to a board decision, *Aronson* plainly states that "futility of demand has been established by any objective or subjective standard."

Id. (internal citations omitted). *See also* FED. R. CIV. P. 23.1; BAINBRIDGE, *supra* note 25, at 395. Although plaintiffs argue that they cannot allege such facts with particularity before discovery, courts typically state that plaintiffs already possess the tools for gathering sufficient evidence. *See, e.g.*, Grimes v. Donald, 673 A.2d 1207, 1216 n.11 (Del. 1996) (describing shareholders' access to public sources, such as the media and governmental agencies, and the right to inspect corporate records); *see also* DEL. CODE ANN. tit. 8, § 220(b) (2009) (stating shareholder's inspection right); MODEL BUS. CORP. ACT § 16.02 (2008).

loyalty, and good faith.[66] To show the defense does not apply in the demand context, the shareholder typically must show that a majority of directors were financially interested in the challenged decision or were not independent in making that decision.[67] In other words, a trial court will permit a shareholder derivative lawsuit to proceed only when the board of directors is disabled by some conflict of interest because in such circumstances the judge may presume the directors will not sue themselves.

Even when a shareholder survives a motion to dismiss based on the demand requirement, a special litigation committee (SLC) composed of independent and disinterested directors may move to dismiss the shareholder's action based on its recommendation that continuing the litigation is not in the best interests of the corporation.[68] Most courts find that the business judgment rule defense protects the SLC's decision[69] and therefore grant the motion to dismiss.[70]

[66] *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."); *see also* McMullin v. Beran, 765 A.2d 910, 916–17 (Del. 2000) (same; noting that the initial burden is on the shareholder to rebut the presumption of the business judgment rule).

[67] *See* Aronson v. Lewis, 473 A.2d 805, 814–15 (Del. 1984) (stating that the court reviews the factual allegations to determine whether the issue involves an "interested" director transaction, in which case the business judgment rule is inapplicable to the board majority approving the transaction); *see also* Beneville v. York, 769 A.2d 80, 85 n.9 (Del. Ch. 2000) (noting that in the case of a board with only two directors, business judgment rule protection is unavailable because the interested director can block the action of the impartial director). For the MBCA provisions for overcoming demand, see MODEL BUS. CORP. ACT § 7.44(c) (2008).

[68] Douglas M. Branson, *The Rule that Isn't a Rule – the Business Judgment Rule*, 36 VAL. U. L. REV. 631, 647–48 (2002) (explaining the procedure for establishing a SLC includes amending the corporation's bylaws to increase the number of directors, appointing "expansion" directors, delegating to the SLC the board's power to deal with the pending action, hiring an independent law firm to conduct an investigation, and preparing a report that may be filed with a motion for summary judgment); *see also* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 279 (1986) (noting a SLC may believe dismissal is in the corporation's best interest, because dismissal may raise the stock price).

[69] In some states, the plaintiff bears the burden of rebutting the business judgment rule presumption with respect to the SLC's decision, and judicial inquiry is limited to the disinterestedness and independence of the committee members and the adequacy of their investigation. *See, e.g.*, Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979); Finley v. Superior Court, 96 Cal. Rptr. 2d 128, 132 (Cal. Ct. App. 2000); Cutshall v. Barker, 733 N.E.2d 973, 978 (Ind. Ct. App. 2000); Janssen v. Best & Flanagan, 662 N.W.2d 876, 884 (Minn. 2003). Other states

Assuming plaintiffs survive these initial motions to dismiss, the directors can again assert the business judgment rule defense in a motion for summary judgment or at trial.[71] The business judgment rule defense is a common law principle that has been recognized by courts in the United States for almost 200 years.[72] An often-stated rationale for the business judgment rule defense is to provide the protection needed for directors to fulfill their responsibility to manage the corporation without fear of shareholders second-guessing their decisions through derivative lawsuits.[73] Thus, the rule allows directors to take calculated business risks[74] by protecting them from liability "for honest

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also give business judgment rule protection to a SLC's recommendation, but place the burden of proof on the defendants. *See, e.g.*, Hasan v. CleveTrust Realty Investors, 729 F.2d 372, 378–79 (6th Cir. 1984); Lewis v. Boyd, 838 S.W.2d 215, 225 (Tenn. Ct. App. 1992). In Delaware, the defendant also bears the burden of proving the independence and good faith of the SLC, but the court may apply its own business judgment in deciding whether to dismiss. Zapata Corp. v. Maldonado, 430 A.2d 779, 787–89 (Del. 1981).

[70] Fairfax, *supra* note 63, at 409 (noting that "in the vast majority of cases courts grant the motion based on the [SLC's] recommendation" (citing Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1356–57 (1993)).

[71] *See* In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 747 (Del. Ch. 2005) (stating that the business judgment rule applies in the absence of fraud, bad faith, self-dealing, or acting in a way that cannot be attributed to a rational business purpose by the directors).

[72] *See* S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 93 (1979) (discussing the idea that the business judgment rule is often misunderstood, despite its long use in corporate law).

[73] *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003) (describing the balance between deference to board of directors' decisions and judicial review as the "defining tension" in corporate governance); A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 cmt. d (1994); Arsht, *supra* note 72, at 95 (stating the business judgment rule recognizes "the need to foster both business and judicial economy by not allowing every corporate transaction to be subject to judicial review at the request of a disagreeing shareholder").

[74] *See* Bainbridge, *Business Judgment Rule*, *supra* note 46, at 110 (referencing the explanation advanced by the drafters of the American Law Institute's Principles of Corporate Governance that the rule protects directors from hindsight reviews of decisions that would stifle innovation); Branson, *supra* note 68, at 637 (stating the business judgment rule is necessary to encourage directors to engage in "informed risk taking that is essential to business success"); Len Costa, *Boss of the Bosses: Delaware's Most Important Judge Takes on Greedy Executives, Congress, and the History of Corporate Law*, LEGAL AFFAIRS 43, 46 (July/Aug. 2005) (stating that Delaware courts do not "second-guess decisions made by informed, disinterested boards, for fear of chilling commerce and innovation").

mistakes of judgment or unpopular business decisions."[75] Other justifications include that directors are "better-suited than courts to make business decisions."[76]

The Delaware Supreme Court articulates the business judgment rule defense as a presumption that directors have acted consistently with their fiduciary duties in making decisions for the corporation.[77] To rebut that presumption, plaintiffs must show a breach of fiduciary duty[78] or demonstrate fraud, illegality, or waste.[79] If the plaintiff cannot rebut the presumption, the business

[75] Arsht, *supra* note 72, at 96; *see also* Bainbridge, *Business Judgment Rule*, *supra* note 46, at 113–14 ("Business decisions . . . typically involve prudential judgments among a number of plausible alternatives. Given the vagaries of business, moreover, even carefully made choices among such alternatives may turn out badly.").

[76] Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919); *see also* Branson, *supra* note 68, at 637 (stating "courts are ill-equipped to review business decisions" because they "often involve intangibles, intuitive insights or surmises as to business matters such as competitive outlook, cost structure, and economic and industry trends"); Fairfax, *supra* note 62, at 410 (stating that directors are "better-suited than courts to make business decisions"). This judicial deference for business decisions is difficult to justify, since courts willingly review decisions of physicians and engineers. *See* Bainbridge, *Business Judgment Rule*, *supra* note 46, at 120 (noting "no 'medical judgment' or 'design judgment' rule precludes judicial review of malpractice or product liability cases"); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 94 (1991) (asking why judges can decide whether engineers have properly designed jet engines but not "whether a manager negligently failed to sack a subordinate who made improvident loans").

[77] *See, e.g.*, In re The Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (describing due care determinations). To invoke the business judgment rule defense, the board must make a decision, which includes a decision to act or a conscious decision not to act. Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984).

[78] *See* Aronson v. Lewis, 473 A.2d 805, 812 n.6 (Del. 1984) (citing Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. Ch. 1972)) (describing directors' duty to inform themselves); *see also* McMullin v. Beran, 765 A.2d 910, 916–17 (Del. 2000).

> Procedurally, the initial burden is on the shareholder plaintiff to rebut the presumption of the business judgment rule. To meet that burden, the shareholder plaintiff must effectively provide evidence that the defendant board of directors, in reaching its challenged decision, breached any *one* of its "triad of fiduciary duties, loyalty, good faith or due care."

Id.

[79] *See, e.g.*, Paglin v. Saztec Int'l, Inc., 834 F. Supp. 1184, 1200 (W.D. Mo. 1993) (dealing with illegality and fraud); In re The Walt Disney Co. Derivative Litig., 906 A.2d 27, 73–74 (Del. 2006) (dealing with allegations of waste); Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (same; defining waste as "a transfer of corporate assets that serves no corporate purpose" or "for which no

judgment rule defense protects the directors from liability for their decision.[80] On the other hand, if the plaintiff can rebut the business judgment rule defense, the directors must then prove that the challenged transaction was fair to the corporation.[81] The MBCA also contains much of the business judgment rule defense within its standards of liability for directors.[82] Judges invoke the business judgment rule defense to protect boards of directors from legal liability in the vast majority of shareholder derivative actions.[83]

Establishing a breach of fiduciary duty thus becomes an important element in most shareholder derivative actions. The fiduciary duties of directors are typically stated as a triad: care, loyalty, and good faith. Delaware courts state that the duty of care is breached when directors fail "to act in an informed and deliberate manner" in making corporate decisions[84] and that directors are liable only if grossly negligent.[85] The combined effect

consideration at all is received"); Shlensky v. Wrigley, 237 N.E.2d 776, 779 (Ill. App. Ct. 1968) (considering the issue of fraud).

80 McMullin v. Beran, 765 A.2d 910, 916–17 (Del. 2000) (describing the business judgment rule attaching to protect director-defendants if the plaintiff-shareholder fails to rebut the presumption provided by the rule); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989) (same).

81 Emerald Partners v. Berlin, 787 A.2d 85, 90–91 (Del. 2001) ("If the presumption of the business judgment rule is rebutted, however, the burden shifts to the director defendants to prove to the *trier of fact* that the challenged transaction was 'entirely fair' to the shareholder plaintiff."); *see also* In re The Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (same).

82 MODEL BUS. CORP. ACT § 8.31 cmt. (2008) (noting the MBCA "does not codify the business judgment rule as a whole" but that "its principal elements . . . are embedded in" § 8.31(a)(2)).

83 *See* Fairfax, *supra* note 63, at 409 ("[T]he tremendous deference courts grant to board decisions means that courts hold directors liable for only the most egregious examples of director misconduct."); *see also* TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 183–84 (2006) (noting "the historical strong protection of corporate boards"); Coffee, *Unfaithful*, *supra* note 57, at 9 (noting that the rare shareholder derivative lawsuits in which judges reach the merits are overwhelmingly decided in the defendant's favor by a ratio of twenty to one).

84 Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. Super. Ct. 1985); *see also* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 369–70 (Del. 1993) (holding directors violated their duty of care because they were not "adequately informed" of all material information reasonably available before approving merger agreement).

85 In re The Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005) (explaining that business decisions are "actionable only if the directors' actions are grossly negligent"); Tomczak v. Morton Thiokol, Inc., 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) (defining gross negligence as a "'reckless indifference to or a deliberate disregard of the whole body of stockholders' or actions which

of the focus on procedural due care and the gross negligence standard is that Delaware courts rarely hold directors liable for breaching their duty of care.[86] Similarly, the MBCA states that directors "shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances,"[87] but it only imposes liability if "the director did not reasonably believe [the decision] to be in the best interests of the corporation" or "the director was not informed to an extent the director reasonably believed appropriate in the circumstances."[88] In addition, directors' financial liability for breaching their duty of care can be effectively eliminated, because all the states have now enacted statutes allowing corporations to limit or eliminate directors' liability for duty of care breaches[89] as well as to purchase insurance to indemnify against such liability.[90]

According to Delaware courts, the duty of loyalty requires that directors make decisions independently based on the merits of the

are 'without the bounds of reason'" (quoting Allaun v. Consol. Oil Co., 147 A. 257, 261 (Del. Ch. 1929)).

[86] *See* In re The Walt Disney Co. Derivative Litig., 907 A.2d 693, 750 (Del. Ch. 2005) ("[D]uty of care violations are rarely found."); *see also* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1790 (2001) (stating that courts "insulate directors from liability whenever they make even a modest attempt to follow the appropriate formalities"); Fairfax, *supra* note 63, at 407–08 ("Over the last twenty years, a variety of mechanisms have contributed to a virtual elimination of legal liability for directors who breach their duty of care under state law."); Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353, 369 (2004) ("*Van Gorkom* is famous, of course, because it marked one of the few times that a court found directors liable for breach of the duty of care."); *cf.* Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 591 n.1–2 (1983) (noting only seven cases holding directors liable for all breaches of fiduciary duty other than self-interested transactions).

[87] MODEL BUS. CORP. ACT § 8.30(b) (2008).

[88] *Id.* § 8.31(a)(2)(ii).

[89] *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2009) (permitting the certificate of incorporation to eliminate or limit a director's personal liability for monetary damages for fiduciary duty breaches except for a breach of the duty of loyalty, "acts or omissions not in good faith," acts involving "intentional misconduct or a knowing violation of law," or "for any transaction from which the director derived an improper personal benefit"); Fairfax, *supra* note 63, at 412 (describing Rule 102(b)(7) as allowing a "corporation to limit or eliminate personal liability for directors who breach their duty of care").

[90] DEL. CODE ANN. tit. 8, § 102(b)(7) (2009).

transaction and that they be disinterested in its outcome.[91] Directors are "interested" in the outcome of a transaction when they "will receive a personal financial benefit from [it] that is not equally shared by the stockholders."[92] Independence requires that directors base their decisions "on the corporate merits of the subject" and not personal considerations.[93] Delaware courts, however, rarely find a director to be controlled by another[94] and never find non-familial relationships to be bias producing.[95] Similarly, the MBCA states the duty of loyalty as "a lack of objectivity due to the director's familial, financial or business relationship with, or a lack of independence due to the director's domination or control by, another person having a material interest in the challenged conduct."[96]

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91 *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993) ("We have generally defined a director as being independent only when the director's decision is based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations."); *see also* Orman v. Cullman, 794 A.2d 5, 22 (Del. Ch. 2002) (stating the business judgment rule is rebutted where a majority of the directors either were "interested in the outcome of the transaction or lacked the independence to consider objectively whether the transaction was in the best interest of its company and all of its shareholders").

92 Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993) (Directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders.").

93 *Id.*; *see also* Telxon Corp. v. Meyerson, 802 A.2d 257, 264–65 (Del. 2002) (defining independence by focusing on whether the director has a familial relationship with someone in the transaction or is controlled by another director who is interested in the transaction).

94 Branson, *supra* note 68, at 640 ("Courts are loathe to find that an otherwise reputable business person is not his or her own person."); *see also* Beam v. Stewart, 845 A.2d 1040, 1052 (Del. 2004).

> To create a reasonable doubt about an outside director's independence, a plaintiff must plead facts that would support the inference that because of the nature of a relationship or additional circumstances other than the interested director's stock ownership or voting power, the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.

Id.

95 Beam v. Stewart, 845 A.2d 1040, 1050 (Del. 2004) ("Allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence."); Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 980–81 (Del. Ch. 2000) (finding allegation that a director was controlled by another director based on their 15-year professional and personal relationship was insufficient to raise a reasonable doubt as to independence).

96 MODEL BUS. CORP. ACT § 8.31(a)(2)(iii) (2008).

The duty of good faith is not viewed by Delaware courts as "an independent fiduciary duty that stands on the same footing as the duties of care and loyalty."[97] The Delaware Supreme Court has defined the duty of good faith by identifying two categories of "bad faith" fiduciary conduct: (1) "subjective bad faith," meaning "fiduciary conduct motivated by an actual intent to do harm,"[98] and (2) "intentional dereliction of duty [or] a conscious disregard for one's responsibilities."[99] The Court, however, has held that a "failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element' . . . 'of the fundamental duty of loyalty.'"[100] By contrast, the MBCA imposes liability on director "action not in good faith."[101]

3. CORPORATIONS AND SHAREHOLDER DERIVATIVE LITIGATION IN INDIA

India has been greatly influenced by England. India was an English colony from 1668 when the British East India Company gained control of Bombay (now Mumbai)[102] until 1947 when India gained its independence from England.[103] Thus, it is not surprising that India's legal system is based on the English legal system, just as the U.S. legal system can be traced to England.[104] In fact, some of India's current laws were codified during British rule.[105] While

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97 Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

98 In re The Walt Disney Co. Derivative Litig., 906 A.2d 27, 64 (Del. 2006).

99 *Id.* at 66 (describing this second category as proscribing fiduciary conduct that does not involve disloyalty but yet is more culpable than gross negligence).

100 Stone v. Ritter, 911 A.2d at 369–70 (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)).

101 MODEL BUS. CORP. ACT § 8.31(a)(2)(i) (2008) ("A director shall not be liable to the corporation or its shareholders . . . unless the party asserting liability in a proceeding establishes that . . . the challenged conduct consisted or was the result of . . . action not in good faith . . . .").

102 BARBARA A. FENELL, A HISTORY OF ENGLISH: A SOCIOLINGUISTIC APPROACH 241 (2001).

103 Afra Afsharipour, *Corporate Governance Convergence: Lessons from the Indian Experience*, 29 NW. J. INT'L L. & BUS. 335, 348 (2009) (describing India's recent economic growth after difficult economic periods following independence in 1947).

104 Rajesh Chakrabarti, *Corporate Governance in India – Evolution and Challenges* 9 (Indian Sch. of Bus., Working Paper, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649857 (describing India's roots in the English common law system).

105 *See* John Armour & Priya Lele, *Law, Finance, and Politics: The Case of India*, 43 LAW & SOC'Y REV. 491, 499 (2009) (citing Indian Penal Code (1860); Indian

an English colony, India had a capital market structure and "inherited what was, at least formally, the best financial market in the developing world."[106] India had four stock exchanges with over 800 companies trading on them, including the Mumbai Stock Exchange established in 1875.[107] Not only did India have a large capital market for an English colony, but it also had a "fairly well-developed . . . banking system."[108]

After gaining independence from England, India turned towards socialist ideas, and corporate governance radically changed.[109] Socialist planners had a set of core policies when they revamped India's laws: develop self-sufficiency by restricting capital flow and imports, channel capital into large-scale "national champion" firms, discriminate against large-scale private sector firms in favor of small-scale firms, and foster development by investing in education.[110] During this socialist era, "the Indian economy languished under what was referred to disparagingly as the 'Hindu rate of growth,' averaging 3% per annum until the early 1980s."[111] This compares to a rate of 6% since liberalization began in the mid-1980s.[112]

Since the mid-1980s, India has liberalized its economic policies and transformed India's capital markets into a prime destination for global investment.[113] India is now hailed as an "emerging giant" and some researchers predict that India's gross domestic product (GDP) will "exceed that of all other major countries in the

Contract Act (1872); Indian Evidence Act (1872); Criminal Procedure Code (1873); Negotiable Instruments Act (1881); Indian Trusts Act (1882); General Clauses Act (1897); Indian Civil Procedure Code (1908) ("[M]any of [India's] laws were in fact codified during British rule.").

106 Afsharipour, *supra* note 103, at 351.

107 *Id.*

108 *Id.* at 352.

109 *See* Chakrabarti, *supra* note 104, at 14–15 (discussing India's turn towards socialism during the decades following independence); *see also* Armour & Lele, *supra* note 105, at 499–500 (noting the socialist agenda implemented by India's post-independence government).

110 Armour & Lele, *supra* note 105, at 496.

111 *Id.*; *see also* Afsharipour, *supra* note 103, at 341 ("During much of the post-independence period, India's economy was saddled with socialist policies that led to the slow growth rate often called the 'Hindu rate of growth.'").

112 Armour & Lele, *supra* note 105, at 496.

113 Shardul S. Shroff et al., *An Overview of the Legal Regime Governing Capital Markets in India and Current Developments*, 1720 PLI/CORP 51, 55 (2009).

world, including China" sometime between 2015 and 2020.[114] Especially strong economic areas for India include pharmaceutical and medical services, such as reading x-rays for patients, as well as computer services.[115] India has experienced dramatic changes in its economic structure during the past decade, and its stock markets hit record highs in January 2008.[116] In 2007–2008, 124 companies made public offerings in the markets totaling almost $18 million in U.S. dollars.[117]

Additionally, foreign investment in India has grown exponentially. "Globally, India ranks as one of the most attractive locations for foreign direct investment" and has "a promising growth rate, second only to China."[118] Net foreign direct investment into India amounted to $22.9 billion in U.S. dollars in 2007.[119] Not only is India's economy continuing to grow, but foreign investors have reported success in doing business with India. "About 66 to 75% of all companies involved in business with India report as much success, or even better success than expected."[120]

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[114] ARVIND PANAGARIYA, INDIA: THE EMERGING GIANT 107 (2008).

[115] *See* Afsharipour, *supra* note 103, at 349 (describing changes in "the business of Indian companies" resulting from the need for capital, especially in the pharmaceutical and computer services industries).

[116] *See id.* at 355–56 (discussing reforms in corporate governance in India); *see also* Franklin Allen et al., *Financing Firms in India*, USC FBE Finance Seminar, at 10, Apr. 13, 2007, *available at* http://www.usc.edu/schools/business/FBE/seminars/papers/F_4-13-07_ALLEN-India.pdf (noting that India's Mumbai Stock Exchange was the world's sixteenth largest stock market in terms of market capitalization at the end of 2005 and its National Stock Exchange was eighteenth).

[117] Shroff et al., *supra* note 113, at 56.

> Furthermore, 36 companies raised reserves worth [$5.231 million in U.S. dollars] through the qualified institutional placement . . . [of] external commercial borrowings ('ECBs') amounting to [$22.165 million in U.S. dollars] . . . . India's external debt stock at end-March 2008 amounted to [$221.2 billion in U.S. dollars], reflecting an increase of 30.4% over the previous year.

Id.

[118] *Id.* at 89–90.

[119] *Id.*

[120] Navneet S. Chugh, *Doing Business in India 2009: Critical Legal Issues for U.S. Companies*, 1720 PLI/CORP 377, 381 (2009).

3.1. Corporate Legal Structure in India

Prior to independence from England, India's corporate law derived from the 1850 Joint Stock Companies Act, which was similar to England's 1844 Joint Stock Companies Act.[121] After independence, India continued to base its laws on the English system. Even during India's socialist era, when England amended its corporate laws, India followed suit by establishing a committee to review its corporate laws.[122] So, like English companies and corporations in the United States, Indian corporations have a single board appointed by the shareholders.[123]

3.1.1. India's Corporate Legal Structure during Its Socialist Era

During the socialist era, India's central government firmly controlled corporate governance through various statutes. The 1947 Capital Issues Control Act forced private companies to get government permission to issue new equity, and then the government controlled the price of such equities.[124] A later statute prevented private companies in India from merging or acquiring other companies to realize economies of scale.[125] The government also took control of securities trading and listing requirements for the stock exchanges through the 1956 Securities Contract Regulation Act.[126] The 1956 Companies Act gave the central government (exercised through the Department of Companies Affairs' Company Law Board or the Registrar of Companies) and the judicial system power to regulate and oversee companies,[127]

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[121] Afsharipour, *supra* note 103, at 353.

[122] *See id.* at 353 ("The Bhabha Committee, whose recommendations ultimately formed the basis for the Companies Act, 1956, was convened partly in response to the report of the United Kingdom's Cohen Committee, which recommended far-reaching changes to the English Companies Act, 1929." (internal citations omitted)).

[123] Klaus J. Hopt and Patrick C. Leyens, *Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, 1 ECFR 135, 150 (2004) (discussing the United Kingdom's one-tier board model).

[124] Armour & Lele, *supra* note 105, at 500, tbl.3 (discussing the 1947 Capital Issues Control Act).

[125] *Id.* (discussing the 1969 Monopolies and Restrictive Trade Practices Act).

[126] *Id.* (discussing the 1956 Securities Contract (Regulation) Act).

[127] *Id.* (discussing the 1956 Companies Act).

including the protection of investors' rights.[128] The 1985 Sick Industrial Companies Act created a state agency to take control of firms with negative net assets.[129] In addition, India "put in place a regime and culture of licensing, protection and widespread red-tape that bred corruption and stilted the growth of the corporate sector."[130]

During this period, India lacked strong and developed stock markets. Three development finance institutions (DFIs), state financial corporations, became the main providers of long-term credit to companies. Through such lending, these entities acquired large blocks of shares in the borrowing companies and their large shareholdings entitled them to seats on the companies' boards of directors.[131] Bank executives serving as board members, however, had little incentive to properly appraise the companies' activities or management.[132] At the same time, companies' promoters managed businesses with little equity investment of their own so promoters often "bled the company with impunity, siphoning off funds with the DFI nominee directors mute spectators in their boards."[133] Given this situation, as well as India's slow bankruptcy process[134] and weak creditors' rights,[135] banks often refused to lend except to

[128] Chakrabarti, *supra* note 104, at 14 (noting that the 1956 Companies Act and other laws governed the functioning of joint stock companies and protected investors' rights).

[129] Armour & Lele, *supra* note 105, at 500, tbl.3 (discussing the 1985 Sick Industrial Companies Act).

[130] Chakrabarti, *supra* note 104, at 15.

[131] *See id*. (commenting that the board of directors were nominated by organizations with the highest quantity rather than highest quality of lending).

[132] *See id.* (discussing the nominated directors' routine of "rubber-stamp[ing]" for the management).

[133] *Id.* at 16.

[134] *See id.* (noting the Board for Industrial and Financial Reconstruction's two year timeline to reach a decision); *see also* Armour & Lele, *supra* note 105, at 500-01 (citing to one company's fifty-year winding-up). When the board eroded the company's net worth, it would be considered "sick" under India's bankruptcy reorganization system created by the 1985 Sick Industrial Companies Act. Chakrabarti, *supra* note 104, at 16. The company would be referred to the Board for Industrial and Financial Reconstruction (BIFR). *Id.* Once registered with BIFR, a company was protected from creditors' claims for at least four years. *Id.* There are some problems with the system, including: massive delays in the BIFR reaching a decision, very few companies emerging successfully from BIFR, and a legal process taking over ten years on average for companies that needed to be liquidated. *Id.*

[135] *See* Armour & Lele, *supra* note 105, at 500 (highlighting that creditors had few options other than filing a suit to recover unpaid debts).

blue chip companies and instead invested in government securities.[136] Because financial institutions limited their activities and boards were largely ineffective in monitoring management during the socialist era, minority shareholders were often subject to fraud.[137]

3.1.2. India's Current Corporate Structure

After socialism failed, India began liberalizing its economy in the mid-1980s.[138] India's decision to start liberalizing its economy "is touted as a seminal event in India's history, the moment when it threw off the shackles of Fabian socialism and embraced free markets."[139] Following a currency crisis in 1991,[140] "the government implemented a dramatic reconfiguration of India's economy. The motivating idea was to move decisively away from state control by granting a significant role to the private sector, encouraging competition, developing market-oriented mechanisms, and limiting government intervention."[141] Some goals of corporate governance included increasing investor protection and foreign investment by repealing socialist era laws and by creating new laws to attract investors.[142] Foreign investors had not been allowed to invest in India's companies during the socialist era.[143]

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[136] Chakrabarti, *supra* note 104, at 16.

[137] *Id.* at 17 (discussing instances of both unintentional and deliberate irregular share transfers and registrations that have negatively impacted minority shareholders).

[138] *See* Afsharipour, *supra* note 103, at 349 n.48 ("In the 1980s, the government made some tentative moves towards economic liberalization, although most of the government's reform policies were piecemeal and uncoordinated.").

[139] Amit Varma, *India's Far from Free Markets*, WALL ST. J. ASIA, June 16, 2005, at A9.

[140] *See generally* Valerie Cerra & Sweta Chama Saxena, *What Caused the 1991 Currency Crisis in India?*, 49 IMF STAFF PAPERS 395 (2002), *available at* https://www.imf.org/external/pubs/ft/staffp/2002/03/pdf/cerra.pdf (chronicling the devaluation of the rupee in the early 1990s and a subsequent depletion of international reserves).

[141] Armour & Lele, *supra* note 105, at 501.

[142] *Id.* at 501 (stating that the Capital Issues Control Act and the Sick Industrial Companies Act were repealed, the Foreign Exchange Regulation Act was replaced with the Foreign Exchange Management Act, and the Securities Contract Regulation Act and Monopolies and Restrictive Trade Practices Act were amended to reduce government control of securities activities).

[143] *See id.* at 503 ("Following liberalization, Indian stock markets have been opened to investment by foreign institutional investors, overseas corporate

One of the most important developments was the establishment of the Securities and Exchange Board of India (SEBI) in 1992, because it replaced central government control of the stock exchanges.[144] The SEBI is similar to the U.S. Securities and Exchange Commission; it is an independent regulatory administration and can issue binding regulations on the stock exchanges.[145] The government also built up its securities markets by establishing the National Stock Exchange in 1992, the National Securities Clearing Corporation Limited in 1995, and the National Securities Depository Limited in 1996.[146] These new and independent institutions provided the necessary infrastructure for India's rapidly-growing stock markets and provided a sense of security for foreign investors, who were newly permitted to invest in India's companies after the socialist era.[147] Unfortunately, companies currently face a "fragmented regulatory structure," because the SEBI and the Ministry of Company Affairs share jurisdiction to regulate companies.[148]

While India has done much to revamp equity finance, it lacks major reform in corporate debt leaving creditors without an adequate remedy.[149] To protect creditors, India established the quasi-legal Debt Recovery Tribunal and passed the 2002 Reconstruction of Financial Assets and Enforcement of Security Interest Act and the 2004 Enforcement of Security Interest and

bodies, and nonresident Indians, who have been allowed to invest extensively in Indian companies.").

[144] *See* Chakrabarti, *supra* note 104, at 18 (calling the establishment of the Securities and Exchange Board "perhaps the single most important development in the field of corporate governance and investor protection in India").

[145] Armour & Lele, *supra* note 105, at 502 ("[The SEBI] proceeded to establish a regulatory framework to ensure transparency of trading practices, speedy settlement procedures, enforcement of prudential norms, and full disclosure for investor protection, rather than the prior emphasis on government intervention and control.").

[146] *See id.* at 503 (discussing the establishment of the National Stock Exchange, the National Securities Clearing Corporation, and the National Securities Depository Limited).

[147] *See id.* (highlighting the increase in the number of market participants since the opening of Indian stock markets to foreign investors); *see also id.* at 492 (stating that the regulatory agencies, instead of the legislative or judicial branches, were the most effective method of producing improved legal rules).

[148] Afsharipour, *supra* note 103, at 356.

[149] Armour & Lele, *supra* note 105, at 505 (discussing the limited application of debt enforcement laws to banks and financial institutions; ordinary creditors could still only recovery through civil courts).

Recovery of Debts Laws (Amendment) Act.[150] The effectiveness of the new tribunal and these new laws, however, remains to be seen. According to a 2007 World Bank report, "the completion of a corporate bankruptcy in India still averages ten years—a tie with Chad for the longest bankruptcy completion time in the world."[151]

3.1.3. India's Current Corporate Governance Laws – Article 49

In the early 1990s, India experienced a series of financial scandals, such as the Harshad Mehta stock market scam of 1992.[152] These scandals occurred after brokers purchased stock at extraordinarily low prices, subsequently inflated prices, and then sold the stock at the higher prices causing the stock market to crash.[153] A similar scandal in 2001 again caused the stock market to crash.[154] The brokers were able to arrange these deals with financial institutions because, after the government's control of equities and the stock exchanges was relaxed in the post-socialist era, the laws were too lax to avoid such deals.[155] In addition, a "vanishing companies scam" occurred in the 1990s when more than 4,000 companies raised 54,000 crore rupees (more than $1.2 billion in today's U.S. dollars) from investors and then vanished.[156]

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150 Allen et al., *supra* note 116, at 8 (discussing the measures taken to protect creditors' rights since the beginning of liberalization in India).

151 Armour & Lele, *supra* note 105, at 505 n.16; *see also Country Profile of India*, WORLD BANK http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/INDIAEXTN/0,,menuPK:295589~pagePK:141159~piPK:141110~theSitePK:295584,00.html (last updated Jan. 14, 2011) (providing information on the World Bank's project in and research on India).

152 The scam allegedly defrauded an estimated 20 million people of $1.5 billion. Molly Moore, *Panel Blasts Banks, Regulators in India Stock Scam*, WASH. POST, Dec. 22, 1993, at D3. Harshad Mehta reportedly gave the Indian Prime Minister a suitcase full of cash so that he would overlook all the cash that banks used to flood the Indian stock exchange. *Id.* Mehta, a government official, also supposedly hindered the investigation. BBC SUMMARY OF WORLD BROADCASTS, *Parliamentary Report on Securities Scandal Presented*, Dec. 22, 1993, at pt. 3 Asia.

153 *See* Tania Mazumdar, *Where the Traditional and Modern Collide: Indian Corporate Governance Law*, 16 TUL. J. INT'L & COMP. L. 243, 252 (2008) (describing these "vanishing companies scams" and the need for more stringent corporate governance reform).

154 *See id.* (noting that the Bombay Stock Exchange crashed by 147 points in 2001 due to stock broker scandals).

155 *See id.* (pointing to the SEBI's ineffective oversight and inability to pursue the fraudulent companies, merchants, and brokers).

156 Mazumdar, *supra* note 153, at 252 (discussing how these companies failed to comply with India's listing requirements). Rupee is the basic Indian monetary unit. *See generally* THE CURRENCY CONVERTER,

Following these scandals, the Indian industry led the initial efforts to instill public confidence in corporations and the securities markets through changes in corporate governance.[157] In 1998, the Confederation of Indian Industry set up a voluntary code, called the Desirable Corporate Governance Code, to protect small investors, promote transparency, and take steps toward international standards of disclosure.[158] In the two years following the creation of the Desirable Corporate Governance Code, twenty-five companies voluntarily adopted the code.[159]

While there were many proposals for changing corporate governance, the SEBI developed a new provision that was based on the Confederation of Indian Industry's Desirable Corporate Governance Code.[160] The SEBI adopted Article 49 of the Listing Agreement and the provisions went into effect between March 2001 and March 2003.[161] Although Article 49 only applies to companies that have more than 3 crore rupees (about $660,000 in U.S. dollars) in capital at the time it issued its shares,[162] researchers described Article 49 as a "watershed event in Indian corporate governance."[163] Similar to the Sarbanes Oxley Act of 2002 enacted

http://coinmill.com/INR_USD.html (last visited Feb. 25, 2011) (providing the conversion between the rupee and U.S. dollars, and that 1 crore equals 10 million rupees).

[157] *Id.* at 251; *see also* Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 NEW. ENG. J. INT'L & COMP. L. 1, 4 (2006) (noting that Indian corporate governance calls for transparency and accountability in decision-making).

[158] CONFEDERATION OF INDIAN INDUS., DESIRABLE CORPORATE GOVERNANCE: A CODE (1998), http://www.ecgi.org/codes/documents/desirable_corporate_governance240902.pdf.

[159] Mazumdar, *supra* note 153, at 252.

[160] *See* Afsharipour, *supra* note 103, at 365–75 (discussing the proposed government reforms and their associated implementation and enforcement issues).

[161] Chakrabarti, *supra* note 104, at 19 (stating the three dates in which the Listing Agreements were applied to various types of companies).

[162] *See* Dhammika Dharmapala & Vikramaditya Khanna, *Corporate Governance, Enforcement, and Firm Value: Evidence from India* 2, 6 (U. Mich. L. & Econ., Olin Working Paper No. 08-005, 2011), *available at* http://ssrn.com/abstract=1105732 (emphasizing that Clause 49 was not intended to apply to all listed firms in India). *See generally* THE CURRENCY CONVERTER, http://coinmill.com/INR_USD.html (last visited February 25, 2011) (providing the conversion between the rupee and U.S. dollars, and that 1 crore equals 10 million rupees).

[163] Bernard S. Black & Vikramaditya S. Khanna, *Can Corporate Governance Reforms Increase Firms Market Values? Event Study Evidence from India*, 4 J. EMPIRICAL LEGAL STUD. 749, 757 (2007).

by the United States after a series of corporate scandals,[164] Article 49 imposes stricter standards on directors' independence, requires disclosure of directors' compensation, and, for the first time in India, imposes severe monetary penalties and threats of delistment for public companies that do not follow its mandates.[165] Although Article 49 was perhaps inspired by reform efforts in the United States and England, there is substantial debate on the convergence of the Anglo-American model of corporate governance in India.[166] It appears that "India's political, economic, and social frameworks have created a corporate governance environment that only formally mirrors Anglo-American governance principles."[167]

3.2. Shareholder Derivative Litigation in India

During the socialist era, shareholders could potentially bring a lawsuit for oppression or mismanagement under the 1956 Companies Act.[168] The 1956 Companies Act, however, was unclear regarding whether shareholders could file derivative actions on behalf of the corporation and other shareholders. India's Parliament is currently in the process of enacting a new Companies Bill that would more clearly allow shareholder derivative actions and also permit shareholder class actions.[169] The new Companies

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164 The Sarbanes-Oxley Act of 2002 sought to improve the accuracy and reliability of corporate disclosures. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

165 Mazumdar, *supra* note 153, at 253.

166 *See generally* Afsharipour, *supra* note 103, at 343–47 (discussing various scholars' views on the convergence debate in India).

167 *Id.* at 341.

168 *See id.* at 355 (observing that the Companies Act focused on cases of oppression and mismanagement, not investor protection). *See generally* The Companies Act, 1956, INDIA CODE, § 397 (1956), *available at* http://indiacode.nic.in/fullact1.asp?tfnm=195601 (noting that oppression refers to conducting the affairs of a company in a manner prejudicial to public interest or interests of the company and its shareholders); *id.* § 398 (stating that mismanagement occurs when the company's affairs are conducted in a manner prejudicial to the interests of the company or the public interest).

169 *See* Soo-Jeong Ahn et al., *Asia / Pacific*, 43 INT'L LAW. 1007, 1013–14 (2009) (listing the intended goals and provisions of the 2008 Companies Bill). *See generally Indian Companies Bill 2009 Likely to be Enacted by Year End*, ASIA PULSE, Feb. 5, 2010 (quoting India's Corporate Affairs Minister: the Companies Bill "will seek to give shareholders, particularly the minority shareholders a voice and balance the interests between the minority and majority shareholders"); Mohan R. Lavi, *Class-Action Suits in the Bill*, BUS. LINE (HINDU), Nov. 26, 2009, at 9 ("Shareholder activism—not much prevalent in India save for a meek shout at an

Bill updates the 1956 Companies Act.[170] It was originally introduced in Parliament during 2008, and the Parliamentary Standing Committee on Finance successfully completed its examination in August 2010.[171] In 2011, the Ministry of Corporate Affairs introduced the new Companies Bill in Parliament's budget session.[172]

At 260 pages, the new Companies Bill covers many different aspects of corporate governance, shareholder protection, and government oversight of companies.[173] While not yet in force, the new Companies Bill will provide for significant changes in Indian corporate governance.[174] The new Companies Bill "seeks to enable the corporate sector in India to operate in a regulatory environment of best international practice that fosters entrepreneurship, investment and growth."[175] As stated by the Ministry of Corporate Affairs, the new Companies Bill "is modern in construction and provides flexibility to respond to the rapid changes in the business environment while incorporating some of the best practices in the field of corporate regulation."[176] It imposes

Annual General Meeting (AGM)—could gain traction with the Companies Bill 2009.").

170 *See* Armour & Lele, *supra* note 105, at 501 (anticipating that the "entire regime will be replaced by the enactment of the [new] Companies Bill"); *see also* The Companies Bill 2009, Bill No. 5 of 2009 (India), *available at* http://www.mca.gov.in/Ministry/actsbills/pdf/Companies_Bill_2009_24Aug2009.pdf [hereinafter India Companies Bill 2009].

171 *See* Press Release, Ministry of Corporate Affairs, *Preparing for Indian Corporates to Play Global,* PRESS INFO. BUREAU, GOV'T OF INDIA (Dec. 24, 2009, 17:18 IST), http://www.pib.nic.in/release/release.asp?relid=56471 (explaining that the new Companies Bill originally introduced in Parliament during 2008 lapsed for parliamentary reasons, and then it was re-introduced as Companies Bill 2009); *see also* Press Release, Ministry of Corporate Affairs, *Promoting the Growth of the Indian Corporate Sector Through Enlightened Regulations*, PRESS INFO. BUREAU, GOV'T OF INDIA (Dec. 23, 2010, 16:40 IST), http://pib.nic.in/release/release.asp?relid=68664 [hereinafter *Promoting*] (stating that the Parliamentary Standing Committee on Finance successfully completed its examination in August 2010).

172 *Promoting*, *supra* note 171.

173 *See generally* India Companies Bill 2009, *supra* note 170.

174 Timothy G. Massad, *Current Developments in India's Capital Markets: Implications for U.S. Investors and Corporations*, *in* CORPORATE LAW AND PRACTICE, DOING BUISNESS IN INDIA 2009, at 33, 42 (2009) (highlighting the Companies Bill, 2008 and other recent reforms and developments in India).

175 Press Release, Ministry of Corporate Affairs, *Companies Bill, 2008 Introduced in Lok Sabha: Bill Intends to Modernize Structure for Corporate Regulation in the Country*, PRESS INFO. BUREAU, GOV'T OF INDIA (Oct. 23, 2008, 13:20 IST), http://www.pib.nic.in/newsite/erelease.aspx?relid=44114.

176 *Promoting*, *supra* note 171.

stricter corporate governance provisions, including disclosure and accountability requirements as well as an independent director requirement.[177] In addition, India's government has touted the new Companies Bill as providing protection of minority shareholder rights and enabling groups of shareholders to take legal action.[178] "The Bill reinforces shareholders democracy, facilities e-Governance in company processes, recognizes the liability of Boards . . . [and] provides for a new scheme for penalties and punishment for non compliance or violation of the law."[179]

Under the new Companies Bill, shareholders may seek judicial redress for oppression or mismanagement if "the affairs of the company have been or are being conducted in a manner prejudicial to public interest or in a manner prejudicial or oppressive to him or any other member or members."[180] They may also apply for redress if:

> the material change, not being a change brought about by, or in the interests of, any creditors, including debenture holders or any class of shareholders of the company, has taken place in the management or control of the company, whether by an alteration in the Board of Directors, or manager, or in the ownership of the company's shares, or if it has no share capital, in its membership, or in any other manner whatsoever, and that by reason of such change, it is likely that the affairs of the company will be conducted in a manner prejudicial to its interests or its members or any class of members . . . .[181]

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[177] *See Indian Companies Bill 2009 Likely to be Enacted by Year End*, *supra* note 169 (quoting India's Corporate Affairs Minister: "India's new Companies Bill with stricter corporate governance norms is expected to be enacted by the end of this year").

[178] *See id.* ("[T]he new legislation . . . will also protect the rights of the minority shareholders, [and] bring about responsible self-regulation with adequate disclosure and accountability . . . .")

[179] Press Release, Ministry of Corporate Affairs for the Gov't of India, Bill Intends to Modernize Structure for Corporate Regulation in the Country (Oct. 23, 2008), *available at* http://www.pib.nic.in/release/release.asp?relid=44114. *See generally* KMPG, COMPANIES BILL 2008 *available at* http://www.in.kpmg.com /TL_Files/Pictures/CompaniesBill_08_p.pdf (containing a summary of the most significant features of India's 2008 Companies Bill).

[180] India Companies Bill 2009, *supra* note 170, § 212(1)(a).

[181] *Id.* § 212(1)(b).

These provisions for oppression and change in shares within the new Companies Bill resemble the United States' formulations of direct shareholder litigation.

The new Companies Bill resembles shareholder derivative actions in the United States to the extent that it permits lawsuits for mismanagement. This resemblance is solidified by the new Companies Bill's definitions of standards of conduct for directors, including duties of care, loyalty, and good faith that are virtually identical to the MBCA provisions adopted by a majority of states in the United States:

> (2) A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interest of the company.
>
> (3) A director of a company shall exercise his duties with due and reasonable care, skill and diligence.
>
> (4) A director of a company shall not involve in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.
>
> (5) A director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates.[182]

The new Companies Bill further provides that directors contravening these provisions "shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees" ($2,200 to $11,000 in U.S. dollars).[183] In addition, any director who receives undue gains must pay those gains to the company.[184]

Only certain shareholders in Indian corporations, however, will have the ability to apply for a judicial remedy. When a company has a share capital, at least one hundred members or one-tenth of the total number of its members, whichever is less, or members

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[182] *Id.* § 147.

[183] *Id.* § 147(7). *See generally* THE CURRENCY CONVERTER, http://coinmill.com/INR_USD.html (last visited February 25, 2011) (providing the conversion between the rupee and U.S. dollars, and that 1 lakh rupee equals 100,000 rupees).

[184] India Companies Bill 2009, *supra* note 170, § 147.

holding at least one-tenth of the issued share capital may apply for a judicial remedy.[185] If a company does not have a share capital, then the members must total at least one-fifth of the total membership to seek redress.[186] The new Companies Bill then states that the Tribunal can waive these ownership requirements upon an application by the shareholders.[187] These ownership requirements and the ability of the Tribunal to waive such requirements resemble the bond provisions required by several U.S. states. Those states impose an ownership requirement as a means of waiving a bond requirement, but the new Companies Bill does not require shareholders to post a bond as security for the defendants' expenses. In addition, no court in the United States requires that the plaintiff obtain consent to sue from the other shareholders, whereas the new Companies Bill seems to require such consent when it states that if one shareholder can make the required ownership showing, it can get consent to sue on behalf of the other shareholders.[188]

The remedies provided by India's new Companies Bill appear broader that those permitted in the United States. In addition to interim orders,[189] if the Tribunal thinks that the affairs have been conducted in an unlawful manner and winding up the company would hurt other members, it has a wide range of remedies: regulate the company's affairs in the future; allow the complaining members' shares to be purchased by the company or by other members with a corresponding reduction in the company's capital; restrict transfers of company shares; and terminate or set aside agreements between the company and a director if the Tribunal finds it just and equitable.[190] Further, the Tribunal has the power to set aside any transfer, delivery of goods, payment, execution or other act relating to the company's property within three months before the application.[191] Similar to powers granted to the U.S. Securities and Exchange Commission, the Tribunal may remove any director from office.[192] The Tribunal, however, also has the

[185] *Id.* § 215(1)(a).
[186] *Id.* § 215(1)(b).
[187] *Id.* § 215(1).
[188] *Id.* § 215(2).
[189] *Id.* § 213(4).
[190] *Id.* § 213(2)(a)–(f).
[191] *Id.* § 213(2)(g).
[192] *Id.* § 213(2)(h).

power to appoint new directors, to dictate how new managers are to be elected, and to impose any other equitable remedy.[193] Finally, the Tribunal may impose costs.[194] This could mean that a winning shareholder may be able to recover their litigation costs, just as can a winning shareholder in the United States. However, this provision could also be read to impose costs upon the losing party, which would be contrary to the American Rule. It also is unclear whether the term "costs" may include attorneys' fees. This uncertainty may deter shareholders from filing derivative lawsuits.

The new Companies Bill also permits a member or creditor to seek a class action remedy if they believe that management is being conducted in a manner prejudicial to the company, members, or creditors' interest.[195] The class may seek an order on the following: restrain an *ultra vires* act; restrain the company from committing breach of its articles; void a resolution altering the articles; restrain action on a resolution; restrain the company from doing any act contrary to its provisions; or restrain the company from taking action contrary to a passed resolution.[196] Any such order is binding and failure to comply is punishable with a fine for the company between five lakh rupees and twenty-five lakh rupees ($11,000 to $55,000 in U.S. dollars).[197] Every officer involved may be punished by up to three years in prison or a fine between twenty-five thousand rupees to one lakh rupees ($550 to $2,200 in U.S. dollars), or both.[198]

[193] *Id.* § 213(2)(i)–(l).

[194] *Id.* § 213(2)(k).

[195] *Id.* § 216.

[196] *Id.* § 216(1)(a)–(f).

[197] *Id.* § 216(2–3). *See generally* THE CURRENCY CONVERTER, http://coinmill.com/INR_USD.html (last visited February 25, 2011) (providing the conversion between the rupee and U.S. dollars, and that 1 lakh rupee equals 100,000 rupees).

[198] India Companies Bill 2009, *supra* note 170, § 216(3). *See generally* THE CURRENCY CONVERTER, http://coinmill.com/INR_USD.html (last visited February 25, 2011) (providing the conversion between the rupee and U.S. dollars, and that 1 lakh rupee equals 100,000 rupees).

4. CORPORATIONS AND SHAREHOLDER DERIVATIVE LITIGATION IN CHINA

In 1700, China had 23.1% of the world income.[199] China established the Shanghai Stock Exchange in 1905, and it was the largest stock exchange in Asia until 1941.[200] After the Chinese Communist Party came to power in 1940s, creating the People's Republic of China (PRC), the country's main economic goal became creating a centrally planned economy.[201] By the end of the 1950s, the government had taken control of all businesses and closed the stock exchanges.[202] Thus, corporations as they are known in the United States disappeared.

In 1981, the PRC revived China's securities activities.[203] In December 1990, the PRC reestablished the Shanghai Stock Exchange and the Shenzhen Stock Exchange to raise capital for Chinese companies.[204] By 2008, China's stock markets were the second largest in Asia after Japan.[205] As of April 2009, there were 1,625 listed companies in China's stock markets with a total capitalization of RMB16.9 trillion (over $2.5 trillion in U.S.

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199 JAIRAM RAMESH, MAKING SENSE OF CHINDIA: REFLECTIONS ON CHINA AND INDIA 57 (2005).

200 *See* Chenxia Shi, *Protecting Investors in China Through Multiple Regulatory Mechanisms and Effective Enforcement*, 24 ARIZ. J. INT'L & COMP. L. 451, 466–68 (2007) (providing a brief history of China's stock exchanges); *see also* Yuwa Wei, *The Development of the Securities Market and Regulations in China*, 27 LOY. L.A. INT'L & COMP. L. REV. 479, 488 (2005) ("Before the 1950s, China had the largest stock market in Asia: the Shanghai Stock Exchange."). For a chronology of the Shanghai Stock Exchange through China's history, see generally W.A. THOMAS, WESTERN CAPITALISM IN CHINA: A HISTORY OF THE SHANGHAI STOCK EXCHANGE (2001); *see also* LI CHANGJIANG (李长江), ZHONGGUO ZHENGQUAN SHICHANG DE LISHI HE FAZHAN (中国证券市场的历史与发展) [THE HISTORY AND DEVELOPMENT OF CHINA'S SECURITY MARKET] 3 (1998) (discussing the development of China's stock exchanges).

201 Wei, *supra* note 200, at 488.

202 *See id.* ("[B]y the end of the 1950s, stock exchanges and securities markets, together with all types of private ownership, were eliminated."); *see also* Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1, 66 (2002) ("When the new China was founded in 1949, business corporations gradually disappeared. This was due to importation of the highly centralized economy model from the former Soviet Union.").

203 Wei, *supra* note 200, at 488 (citing ZHU SANZHU, SECURITIES REGULATION IN CHINA 5 (2000)).

204 Xiao Huang, *Shareholder Revolt: The Statutory Derivative Action in China* COMP. RES. IN L. & POL. ECON. (CLPE Research Paper 49/2009, Vol. 05, No. 09), 2009, at 4–5, *available at* http://ssrn.com/abstract=1516448.

205 Marlon A. Layton, Note, *Is Private Securities Litigation Essential for the Development of China's Stock Markets?*, 83 N.Y.U. L. REV. 1948, 1963 (2008).

dollars).[206] One unusual aspect of Chinese capital markets is the large number of small investors. Small investors, defined as investors with less than RMB1 million (approximately $150,000 in U.S. dollars) in cash or shares, account for 99% of the total number of capital accounts.[207] These shareholders tend to have relatively short investing periods and trade frequently, resulting in an average turnover rate that is seven times higher than rates in mature markets.[208] This high turnover rate has fueled a view that China's stock markets are casinos, rather than serious investments.[209]

4.1. Corporate Legal Structure in China

To understand how the Chinese markets work, one must understand the unusual corporate structures in China. China currently has both state-owned enterprises (SOEs) and private companies. These corporate structures have evolved over time.

4.1.1. China's Historic Corporate Legal Structure

From 1950 to 1984, companies in China were organized as traditional SOEs with the State wholly owning the SOEs and exerting management control over them.[210] The traditional model

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[206] Huang, *supra* note 204, at 5. RMB represents the China Yuan, renminbi or "people's currency." RMB GUIDE, http://www.rmbguide.com/ (last visited February 20, 2011). For the conversion of RMB to U.S. dollars, see *Renminbi Currency Converter*, CHINABILITY, http://www.chinability.com /renminbiconverter.htm (last visited February 25, 2011).

[207] Huang, *supra* note 204, at 5 (citing the figures of Shenzhen Stock Exchange between January, 2007 and March, 2007, in: Zhongguo Zhengquan Jiandu Guanli Weiyuanhui (中国证券监督管理委员会) [CHINA SEC. REGULATORY COMM'N], ZHONGGUO ZIBEN SHICHANG FAZHAN BAOGAO (中国资本市场发展报告) [CHINA CAPITAL MARKETS DEVELOPMENT REPORT], at 269 (2008)).

[208] *See id.*

[209] *See* Barry Livett, *Securities Industry Faces Challenge*, CHINA DAILY, Nov. 25, 2005 (describing the "pervasive 'casino mentality'" of many investors); *see also* Xin Zhiming, *Stock Market Causes Heated Debate*, CHINA DAILY, Mar. 13, 2001 (highlighting economist Wu Jinglian's observation that rampant speculation contributes to the casino-like qualities of the stock market). *But cf.* Li Xiang & Jiao Xiaoyang, *Rise of New Generation of Investors*, CHINA DAILY, Jan. 18, 2010 (arguing that an expanding group of young investors is becoming more sophisticated and focusing on higher yields, rather than viewing the stock market as a casino for quick profits).

[210] Schipani & Liu, *supra* note 202, at 5 ("The traditional model of SOE governance could also be referred to as the State-ownership model, or the State-owned and managed model . . . . Not only did the State have ownership of all the property of the SOEs, but it also enjoyed managerial powers.").

depressed private sector growth and deprived the country of economic independence because it firmly bound the State, SOEs, and employees to each other.[211]

From 1984 to 1993, the SOE form morphed from the traditional model to the transitional model.[212] The goal of the change was that "SOEs should become legal persons that enjoy full management authority and full responsibility for their own profits and losses."[213] In 1988, China enacted the SOEs Law, which resulted in three important changes: (1) allowed SOEs to be run on a day-to-day basis by the factory or company director; (2) provided for local and central government supervision of the enterprise; and (3) created democratic management, such as allowing trade unions.[214] The 1988 SOEs Law decreased government intervention and allowed enterprises to function semi-autonomously, but the transitional model ultimately failed to provide the desired level of reforms.[215]

4.1.2. China's Current Corporate Legal Structure

In 1992, China's late leader, Deng Xiaoping, called for a market economy in China.[216] The government's goal became to "set up [a modern corporate system] in the majority of backbone large and medium-sized SOEs."[217] To achieve that goal, China enacted the 1993 Company Law, which provided the foundation for SOEs to transform into state-owned corporations, closely held corporations,

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[211] *Id.* at 6, 8.

[212] *Id.* at 8 ("The transitional model of SOE governance is also referred to as the State-creditor's rights model or the contracting model.").

[213] *Id.* at 8–9 (quoting a Chinese Communist Party Decision).

[214] *Id.* at 9–10.

[215] *Id.* at 11.

> First, it was very difficult to identify a reasonable minimum amount of profit for the SOEs to pay to the State. Second, although most SOEs enjoyed benefits when they were profitable, they were unable to pay the fixed amounts required to the State when they sustained losses. Third, there was a fair amount of exploitation of the assets of SOEs for personal use. Finally, too little SOE profits were retained for development purposes, leaving insufficient resources for future expansion.

Id.

[216] *Id.* at 12.

[217] *Id.* at 12 (quoting 15th CPC Central Committee, *Decision on SOEs Reform*) (internal footnote omitted).

or publicly held corporations.[218] The 1993 Company Law requires corporations to have three governing bodies: (1) shareholders that act as a body at the company's general meeting; (2) a board of directors; and (3) a board of supervisors.[219] Although shareholders act as a body at annual meetings of U.S. corporations, corporations in the United States have only a single board of directors. This two-tier board system is somewhat similar to the German system with a board of directors and a supervisory board, except unlike in the Germany system there is no hierarchy between the boards and both boards are appointed by shareholders.[220] As with most U.S. corporations, Chinese companies must also have a chief executive officer and a chair of the board of directors.[221]

SOEs continue to exist in China and are governed by the 1988 SOEs Law and the 1993 Company Law. SOEs must now meet the following requirements: "(1) clearly establish ownership; (2) provide well-defined rights and responsibilities; (3) separate the enterprise from the government; and (4) employ principles of scientific management."[222] SOEs may now have shareholders and these shareholders receive rights that are similar to those possessed by U.S. shareholders, including rights in proportion to the number of shares they own, entitlement to dividends and to net assets if the corporation is liquidated, and limited liability.[223] While the goal of modern SOEs is to promote separation between the government and the enterprise, this has been difficult to fully achieve.[224]

Since implementing the 1993 Company Law, "China has experienced an unprecedented wave of corporatization and privatisation."[225] Approximately 80% of small and medium-sized

[218] *Id.* at 13; Wei, *supra* note 200, at 492.

[219] Schipani & Liu, *supra* note 202, at 14.

[220] *See id.* at 15–16 (noting that in Germany the supervisory board oversees the board of directors and that the members of the board of directors are appointed by, and may be dismissed by, the supervisory board).

[221] *See id.* at 14 (noting that these were two new statutory corporate positions).

[222] *Id.* at 22.

[223] *See id.* at 22–23 (stating the rights that "shareholders of modern SOEs are entitled to enjoy").

[224] *See id.* at 23–28 (noting that some SOEs are not holding shareholder meetings, some have not established boards of directors, and the government is still playing "decisive roles in fifty-two corporations").

[225] Wei, *supra* note 200, at 492.

SOEs have become corporate entities.[226] There are two types of non-state-owned companies recognized by Chinese law: "closely held corporations" and "publicly held corporations," but these two types have a variety of subcategories.[227] There are different rules on the corporate composition for these two main categories and their corresponding subcategories.[228] Both forms of corporations are organized and controlled under the Company Law.[229] While China now has individual investors, two-thirds of outstanding shares of most public corporations are still "non-tradable, state-owned shares."[230] In 2005, the government began non-tradable share reform, but the reforms have not been as effective as hoped, because only 28% of shares were tradable as of August 2008.[231]

China has passed laws and reformed the SOEs to introduce private corporations and to allow SOEs to have private control. These reforms give the appearance that the current structure of SOEs is being supplanted by a corporate ownership structure similar to U.S. corporations. The government, however, continues to play a key role in Chinese corporations and the securities markets, so the transition is not yet complete.

4.1.3. Corporate Governance in China

There are two commonly asserted concerns about China's corporate governance rules. One, China suffers from insider control, which leads to "mismanagement and asset-stripping."[232] Not only do mismanagement and asset-stripping loot the government due to its large corporate holdings, but they also discourage private investment and results in a loss of capital.[233]

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[226] Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 146–47 (2006).

[227] Schipani & Liu, *supra* note 202, at 16.

[228] *See id.* at 16–22 (describing some of the subcategories of each corporation and briefly explaining the governing rules).

[229] Clarke, *supra* note 226, at 146.

[230] Xiao Huang, *supra* note 204, at 5-6; *see also* Hui Huang, *The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform*, 4 BERKELEY BUS. L.J. 227, 233 (2007) (noting that traditionally more than 60% of all outstanding shares in listed companies were non-tradable, state-owned shares).

[231] Xiao Huang, *supra* note 204, at 6.

[232] Clarke, *supra* note 226, at 147–148.

[233] *See id.* at 148.

> If management commits waste and fraud at the expense of shareholders, this is obviously of direct concern to the state because of its large stake in

Second, many Chinese corporations have majority shareholders that dominate minority shareholders.[234] A 2002 self-reporting study by the China Securities Regulatory Commission (CSRC) and the State Economic and Trade Commission showed that 40% of companies completed related-party transactions with their ten largest shareholders.[235]

To remedy these concerns, various governmental entities have created a number of confusing and potentially conflicting guidelines and requirements. Some Chinese regional governments have passed corporate governance policy statements and guidance documents calling for a specified number of independent directors on each board.[236] Similarly, central government agencies such as the Ministry of Agriculture and the People's Bank of China issued guidelines requiring independent directors on corporate boards.[237] In 2001, the CSRC issued the Guidance Opinion on the Establishment of an Independent Director System in Listed Companies, which called for independent directors for listed companies.[238] The CSRC has also issued guidelines on corporate governance. For example, in 1997, the CSRC issued its "Guidelines for the Articles of Association in Listed Companies," requiring listed companies to adopt provisions with the exact or similar wording of the CSRC guidelines.[239] In January 2002, the CSRC released its "Corporate Governance Principles," although its

> the enterprises being looted. But it is also a government concern where the state is not a significant shareholder because in addition to damaging individual (and institutional) shareholders, mismanagement and asset-stripping will, by discouraging investment in corporations, raise the cost of capital in the economy generally and hinder growth.

Id.

234 *See id.* (stating complaints with respect to Chinese corporation's management).

235 *Id.* ("A related-party transaction is not, of course, necessarily a transaction on unfair terms to the company, but given the lack of institutional safeguards that might ensure fair terms, there are legitimate grounds for concern.").

236 *See id.* at 178–80 (discussing various "regional government initiatives" and reform efforts).

237 *Id.* at 180–81.

238 *See id.* at 128–29 (discussing China Securities Regulatory Comm'n, *Guanyu zai Shangshi Gongsi Jinali Duli Dongshi Zhidua de Zhidao Yijan* [*Guidance Opinion on the Establishment of an Independent Director System in Listed Companies*] § 1(1), issued Aug. 16, 2001).

239 *Id.* at 183.

provisions appear weak.[240] While it is unclear whether implementing the Corporate Governance Principles is mandatory, companies that do not conform to them must disclose to what extent their practices do not conform and the CSRC could pressure companies to change their practices.[241]

4.2. Shareholder Derivative Litigation in China

As discussed above, when the Chinese Communist Party came to power, the government took control of all businesses and they became SOEs. The government owned and served as the ultimate management for those enterprises. Shareholder litigation thus was unnecessary because the only "shareholder" in SOEs was the government.

4.2.1. Shareholder Litigation in China before 2005

China instituted various corporate governance reforms and a shareholder protection system in its 1993 Company Law. The 1993 Company Law, however, only provided weak shareholder remedies and did not directly address shareholder derivative actions or directors' fiduciary duties.[242] In the 1993 Company Law, Article 111 was the only provision granting shareholders the right to bring a legal action:

> If a resolution adopted by the shareholders' general committee or the board of directors violates the relevant national statutes or administrative regulations, or infringes rights and interests of shareholders, a shareholder is

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240 *See id.* at 184. (noting that the provisions relating to independent directors are weak because they do not require independent directors, providing instead only that the company may establish independent directors in accordance with its needs; nor do the provisions "say what the point of having such independent directors might be").

241 *Id.* at 186, 188–89. Among other things, the Principles require companies to establish an independent director system, but the Principles do not provide clear rules on how many independent directors should be on the company's board. *Id.* at 188–89.

242 *Id.*; *see also* Xiao Huang, *supra* note 204, at 6–7 ("The *Company Law* 1993 barely played any role in preventing misconduct by the controlling shareholders and directors and in protecting minority shareholders.").

> entitled to bring a suit to the People's Court to enjoin such illegal act or infringing act.[243]

Article 111 failed to explicitly allow shareholder derivate lawsuits and judicial decisions on Article 111 created complex procedures for shareholders to bring a lawsuit.[244]

Even if Article 111 allowed derivative lawsuits, the only available remedy was an injunction, not compensation.[245] In addition, if a shareholder wished to sue, the defendants and the harm (infringement on shareholder rights) provided by the 1993 Law "were excessively narrow."[246] Despite these limitations, shareholders and company representatives did attempt to bring lawsuits under Article 111, but the lawsuits never reached a judicial decision.[247] For example, an investor sued the directors of Sanjiu Medical & Pharmaceutical Co., but the court dismissed the lawsuit finding that "the legal interests of the shareholders as a whole" should be represented in a shareholder derivative action, and thus the investor needed consent from all shareholders before suing.[248]

Before the 2005 Company Law, shareholders lacked a clear provision to sue a company when its directors or officers committed a scandal.[249] Thus, directors and officers committed many corporate scandals without any consequence "[e]xcept for a public criticism by the CSRC."[250] For example, during the 1996 to

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243 Xiao Huang, *supra* note 204, at 7 (quoting the Company Law, Article 111 (1993)).

244 *See* Jiong Deng, Note, *Building an Investor-Friendly Shareholder Derivative Lawsuit System in China*, 46 HARV. INT'L L.J. 347, 356 (2005) (explaining that Article 111 provides for direct actions, but it is not clear that it provides for shareholder derivative actions); *see also* Xiao Huang, *supra* note 204, at 7 (stating that Article 111 "was vague and obscure . . . since there was no regulation regarding the applicable procedures").

245 *See* Xiao Huang, *supra* note 204, at 7 (noting that the only shareholder remedy was an injunction and "compensations might not be granted").

246 *Id.*

247 *See* Deng, *supra* note 244, at 365, 372 (highlighting difficulties encountered in the course of shareholder derivative litigation).

248 Xiao Huang, *supra* note 204, at 11.

249 *See* Guanghua Yu, *Towards an Institutional Competition Model of Comparative Corporate Governance Studies*, 6 J. CHINESE & COMP. L. 31, 42–43 (2003) (describing the difficulty individual shareholders encountered in attempting to sue companies because of the "[l]ack of clear provisions on derivative actions by shareholders").

250 *Id.* at 42.

1998 time period, the Shanghai Jiabao Industrial Group Co. "engaged in illegal speculative trading of shares in other companies."[251] The Company used "more than 300 individual accounts to circumvent" a government ban on trading and introduced RMB228 million (about $34 million in U.S. dollars) in primary and secondary markets through its activities.[252] After an investigation, the CSRC imposed a minimal administrative fine on the chairman (RMB50,000 or about $7,500 in U.S. dollars), seized the company's small trading gains (RMB840,000 or just over $125,000 in U.S. dollars), and "publicly criticised the [company's] directors."[253] In 2001, a controlling shareholder of the Sanjiu Medical & Pharmaceutical Co. Ltd inappropriately used RMB2.5 billion of company funds (about $380 million in U.S. dollars), which constituted 96% of the company's net assets.[254] The board of directors did not approve the use of the funds by the controlling shareholder.[255] The CSRC publicly criticized the company, but no other action was brought against the controlling shareholder because of the lack of clear provisions on shareholder derivative lawsuits at the time.[256] The list of corporate scandals goes on.[257]

In 2003, however, the shareholder derivative action was introduced to China through its courts. The Shanghai People's Court issued its *Opinion on Some Issues in Trials for Legal Actions Related to Company Dispute (No. 1)* in 2003, setting up the first rules for derivative actions.[258] Shortly afterwards, the Jiangsu High People's Court issued its *Opinion on Some Issues in Trials for Legal Actions Applied with Company Law (Provisional Rules)*, which "set up

[251] *Id*. at 43.

[252] *Id*. For the conversion of RMB to U.S. dollars, see *Real Time Renminbi* (*Chinese yuan) Currency Converter*, CHINABILITY, http://www.chinability.com/renminbiconverter.htm (last visited Oct. 19, 2011).

[253] Yu, *supra* note 249, at 43.

[254] *See id.* at 42 (detailing the CSRC's investigation of a controlling shareholder's allegedly improper actions and the minimal consequences he faced).

[255] *See id.* (mentioning that both Sanjiu's board of directors and supervisory board had not approved the controlling shareholder's actions "for a connected transaction").

[256] *See id.* at 42–43 (attributing the absence of any further actions to the "lack of clear provisions on derivative actions by shareholders").

[257] *See id.* at 40–47 (exploring and listing multiple incidents of questionable corporate activities in China).

[258] *See* Xiao Huang, *supra* note 204, at 12 (citing this as the opinion in which the "derivative action was introduced to China").

the rules for shareholder representative actions."[259] In 2003, the Supreme People's Court also "published the first draft of *Regulations on Some Issues Concerning Trials for Company Dispute (No 1),*" and allowed for public comment.[260] This laid the foundation for the changes in shareholder protections within the 2005 Company Law.

4.2.2. Shareholder Derivative Litigation in China after 2005

After experiencing corporate scandals and realizing the need for stronger shareholder protection, China enacted the 2005 Company Law, which included a provision expressly allowing shareholder derivative litigation. The CSRC adopted new policies in the 2005 Company Law based on the theory that a correlation exists "between capital market development and shareholder protection."[261] In order to increase capital in the Chinese markets, CSRC thus agreed to increase shareholder protections in the 2005 Company Law.[262] Meilun Shi, former CSRC vice chairman, noted the importance of strong shareholder protection in order for the markets to function: "[I]nvestors' confidence and participation are critical to the healthy and stable development of China's capital markets. They have a direct impact on the successful implementation of reform and the Open-Door Policy, as well as on social solidarity."[263] In 2000, the then-current CSRC chairperson stated that investor protection was the top priority for the CSRC.[264]

Additionally, authorities were concerned about protecting minority shareholders. Given the high percentage of state-owned shares, minority shareholders were relatively "powerless" before

[259] *Id.*

[260] *Id.* For a discussion of the Supreme People's Court regulations prior to 2005, see *id.* at 12.

[261] *Id.* at 5. For the 2005 Company Law, see Zhonghua Renmin Gongheguo Gongsi Fa (中华人民共和国公司法) [Co. Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, revised Oct. 27, 2005, effective Jan. 1, 2006), art. 152 (Isinolaw) (China) [hereinafter Chinese 2005 Company Law].

[262] *See* Xiao Huang, *supra* note 204, at 5–6 (describing the focus on investor protection as a "top priority" since 2000).

[263] Deng, *supra* note 244, at 349.

[264] *See id.* at 349 n.13 (discussing a statement made by Zhou Xiaochuan, the chairperson of CSRC in 2000, regarding the importance of "investor protection").

2005.[265] Unlike the United States, Canada, and England, China lacked an effective remedy for oppressed minority shareholders, and thus a shareholder derivative action could "play a more important role" in China than in other countries.[266] The lack of a shareholder remedy contributed "to the weak corporate governance system in China," especially in protecting minority shareholders.[267]

Chinese government officials and commentators also believed that a shareholder derivative lawsuit would promote better corporate governance in China.[268] Given the role of derivative lawsuits in the United States and their impact on corporate governance, there was "almost unanimous understanding" that China had to institute a shareholder derivative system.[269]

The statutory shareholder derivative device created by the 2005 Company Law is similar in some respects to the MBCA in the United States as well as recent statutory enactments in England and Canada.[270] Article 150 of the 2005 Company Law states "a director, a supervisor, or any senior officer shall be liable for any losses of the company if he/she violates any provisions of laws, or administrative regulations, or the articles of [association] of the company in performance of his/her official duties."[271] While Article 150 does not state if minority shareholders can sue majority shareholders, it appears that a controlling shareholder, who violates the interests of the company and causes losses through this

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265 *See* Xiao Huang, *supra* note 204, at 5–6 (noting the large percentage of state-owned shares in comparison to the percentage of tradable shares, especially with regard to some of China's biggest companies).

266 *See id.* at 6 (explaining that China's lack of a "statutory oppression remedy" increases the role of derivative action in China).

267 Yu, *supra* note 249, at 56.

268 *See* Deng, *supra* note 244, at 355 (stating that "[i]t is widely believed" that shareholder derivative lawsuits would provide "for improved corporate governance generally in China").

269 *Id. See generally* Guanghua Yu, *Using Western Law to Improve China's State-Owned Enterprises: Of Takeovers and Securities Fraud*, 39 VAL. U. L. REV. 339, 340 (2004) (exploring the potential benefits of using Western laws on takeovers and securities fraud to diminish the inefficiencies related to Chinese SOEs).

270 *See* Xiao Huang, *supra* note 204, at 1 (describing China's adoption of the derivative law as being part of a greater "codification trend").

271 *Id.* at 7.

violation, can be subject to a shareholder derivative lawsuit under Article 152.[272]

Article 152 of the 2005 Company Law contains procedural rules that distinguish between companies limited by shares (public companies) and closely held companies.[273] In order to file a derivative action, public corporations' shareholders must own, alone or jointly, more than 1% of the company's shares for at least 180 consecutive days before filing an action.[274] For a closely held company, no minimum ownership interests or time constraints are imposed, presumably because abusive shareholder derivative actions are considered rare in such firms.[275] As in the case of India, this ownership requirement for public corporations is similar to those of bond statutes adopted by some U.S. states, although India does not impose a bond requirement. Even if shareholders meet the ownership requirements, they face financial disincentives because China, like the United States, follows the rule that each party bears its own attorney's fees.[276]

Similar to the demand requirement developed in U.S. law, Article 152 of the 2005 Company Law specifically describes three circumstances in which shareholders may commence a derivative lawsuit. First, shareholders demand that a governing body of the

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[272] *See id.* (explaining that while Chinese law does not expressly provide for derivative suits against a controlling shareholder, Article 152 of the 2005 Company Law may nevertheless allow it in certain circumstances).

[273] *See id.* at 8 ("Article 152 distinguishes companies limited by shares (CLS) from limited liability companies (LLC).").

[274] *See id.* (listing the specific standing requirements for all shareholders wishing to sue under Article 152 of the 2005 Company Law).

[275] *See id.* (suggesting that stringent standing requirements may not be required for closely held limited liability companies because the more public the company, the greater the need for legislation regarding corporate governance) (citing Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1784–85 (2004)).

[276] In China, the losing party bears court-determined filing and litigation fees. Xiao Huang, *supra* note 204, at 9 (citing Supreme People Court's (SPC) *Measures on the People's Courts' Acceptance of Litigation Fees* 1989, art. 19). *Accord* Donald C. Clarke, *The Private Attorney-General in China: Potential and Pitfalls*, 8 WASH. U. GLOB. STUD. L. REV. 241, 253 (2009) ("In China, as in the United States, the general rule is that parties bear their own attorney's fees."); Virginia E. Harper Ho, *From Contracts to Compliance? An Early Look at Implementation Under China's New Labor Legislation*, 23 COLUM. J. ASIAN L. 35, 101 n.290 (2009) ("China has a general no-fee-shifting rule on attorney fees, although court costs are borne either by the losing party or jointly."). *Cf.* Elizabeth Ann Hunt, Note, *Made in China: Who Bears the Loss and Why?*, 27 PENN ST. INT'L L. REV. 915, 920 (2009) (explaining that attorney's fees and low damage awards deter many Chinese citizens from filing claims).

company brings an action and that body refuses.[277] Second, the governing body "fails to raise a lawsuit within 30 days upon" receiving the shareholders' request.[278] Third, if urgent circumstances exist where the failure to implement a legal action would cause "unrecoverable damages to the interests of the company."[279] This formulation of the demand requirement clearly resembles the MBCA provision adopted by many U.S. states.[280]

In April 2006, the Supreme People's Court of China issued the *Provisions of Several Issues Concerning the Application of the PRC Company Law*, which is the Court's initial interpretation of the 2005 Company Law and addresses some of the procedural issues in shareholder derivative actions.[281] In addition to the 2005 Company Law, the CSRC has issued numerous regulations to improve corporate governance and increase shareholder rights.[282] For example, the 2002 Corporate Governance Code empowers shareholders to take legal action when a board or shareholder meeting violates shareholder rights or violates laws or administrative regulations.[283]

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277 *See* Chinese 2005 Company Law, *supra* note 261, art. 152 (stating the specific requirements for bringing a derivative suit in China).

278 *Id.*

279 *Id.*

280 MODEL BUS. CORP. ACT § 7.42 (2008).

> No shareholder may commence a derivative proceeding until: (1) a written demand has been made upon the corporation to take suitable action; and (2) 90 days have expired from the date delivery of the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

Id.

281 *See* Xiao Huang, *supra* note 204, at 12–13 (noting that the Supreme People's Court announced that this guidance would be introduced in several installments so forthcoming interpretations may explain additional procedures).

282 For a listing of these guidelines, see *id.* at 10.

> Guidelines for Articles of Association of Listed Companies 1997, General Requirements of Shareholders' Meeting of Listed Companies 2000, Guidelines for Independent Directors to the Board of Directors of Listed Companies 2001, The Code of Corporate Governance for Listed Companies 2002, and the Regulations for the Protection of Individual Shareholders' Rights 2004.

Id.

283 See *id.* at 10–11 (citing *Zhengjianfa No.1 of 2002* [*Code of Corp. Governance for Listed Cos.] (*promulgated by the China Sec. Regulatory Comm'n, Jan. 7, 2001,

Nothing in the 2005 Company Law, however, addresses the substantive fiduciary duties of directors.[284] Thus it remains unclear what duties directors owe to the company and when they have violated those duties. One commentator observed that "Chinese law and regulatory practice remains unclear on the issue of standards of liability for independent directors, and indeed for directors in general."[285] Shareholder derivative actions filed under the 2005 Company Law, however, may flesh out such duties as a means of further promoting corporate governance reform in China.[286]

5. THE EFFECTIVENESS OF SHAREHOLDER DERIVATIVE LITIGATION FOR INVESTORS IN INDIAN AND CHINESE CORPORATIONS

As Sections 2 and 3 discussed, both India and China have taken substantial steps toward establishing free market economies since the mid-1980s. India has abandoned the Fabian socialism that it had adopted following its independence from England in 1947. Similarly, China has moved away from its centrally planned economy that the Communist Chinese Party implemented after gaining power in the 1940s. As part of the process of moving toward free markets, both countries have decreased state control of corporations by increasing private ownership within existing corporate structures and by encouraging entrepreneurship. Both countries have also replaced central government control of their stock exchanges and developed market oriented mechanisms to encourage capital formation. More recently, both countries have moved to recognize shareholder derivative lawsuits. Section 5.1 addresses the rationales for this change and the basis for the specific derivative device chosen by each country. Section 5.2 then

effective Jan. 7, 2001), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69223.htm, art. 4 (China).

[284] *See* Chao Xi, *In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China*, 22 CONN. J. INT'L L. 1, 22–23 (2007) (suggesting that the 2005 Company Law would be improved by detailing the substance of the general duties of loyalty and due diligence that directors owe to the company) (citing Chinese 2005 Company Law, *supra* note 261, art. 148).

[285] Clarke, *supra* note 226, app. 1 at 224.

[286] *See* Deng, *supra* note 244, at 355 (supporting the idea that although China does not follow common law, shareholder derivative lawsuits may "play an important role in enhancing corporate governance" in China, as judicial decisions clarify what constitutes "permissible conduct").

discusses the potential problems that India will face in implementing effective shareholder derivative litigation. Section 5.3 discusses the likely implementation problems for shareholder derivative actions in China.

5.1. The Rationales for Recognizing Shareholder Derivative Lawsuits

Within the evolving global economy, corporations must compete to raise capital from investors. Many investors want to invest in foreign corporations and entire investment companies are devoted to investing in international markets and emerging markets specifically.[287] Indeed, in the ever-increasing global economy, investors in the developed world are now investing significant amounts of capital into emerging economies.[288] Foreign institutional investors' investments in emerging markets have risen "from $25 billion in 1990 to $300 billion in 2005."[289]

Naturally, India and China sought to tap into investors' desire to invest in foreign and emerging markets. Both countries have already taken many steps to attract foreign investors, including modernization of their corporate legal structures and their stock exchanges. The motivating force for now accepting the shareholder derivative device appears to be a desire to increase protections for shareholders, especially minority shareholders, as a means of attracting more foreign capital investments. In addition, recognizing shareholder derivative lawsuits is a method for overcoming domestic investors' skepticism about these countries'

[287] *See, e.g.*, INT'L FIN. CORP., FUNDING OPERATIONS 3 (Sept. 2009), *available at* http://www.ifc.org/ifcext/treasury.nsf/AttachmentsByTitle/RoadShowPresentation-Sept2009/$FILE/FUNDING+PRESENTATION+September-2009.pdf. (showing a presentation of the International Finance Corporation that includes details on its funding operations and its goal of "catalyzing private sector investment in developing countries"); *see also* ISI EMERGING MARKETS, http://www.securities.com/ (last visited Oct. 19, 2011) (providing data on emerging international markets).

[288] *See generally* P. Krishna Prasanna, *Foreign Institutional Investors: Investment Preference in India*, 3 J. ADMIN. & GOVERNANCE, 40, 41 (2008), *available at* http://www.joaag.com/uploads/4_PrasannaFinal3_2_.pdf (detailing how transnational capitalism has led to a significant flow of capital from developed countries to emerging economies, like in India).

[289] Todd Moss et al., *Why Doesn't Africa Get More Equity Investment? Frontier Stock Markets, Firm Size and Asset Allocation of Global Emerging Market Funds* 1 (Ctr. for Global Dev., Working Paper No. 112, 2007), *available at* http://www.cgdev.org/content/publications/detail/12773/.

corporate entities and capital markets, thus increasing domestic investments within their corporate structures.

As described in Section 3.2, India's Ministry of Corporate Affairs has described its proposed shareholder derivative device as providing protection for minority shareholder rights. Empowering investors to bring shareholder derivative actions potentially gives minority shareholders the power to protect themselves. The provision of India's new Companies Bill that enables shareholders to take legal action, however, is not well defined. The provision does not delineate the causes of action for which derivative actions may be instituted beyond oppression, mismanagement, and changes to share rights, as explained in Section 3.2. Further, the new Companies Bill defines standards of conduct for directors by stating the fiduciary duties of care, loyalty, and good faith that are similar to those defined in U.S. states adopting the MBCA. However, it does not empower shareholders to file derivative actions for a breach of those duties nor does it define how those duties could be breached. Despite the similar definition of fiduciary duties, India's proposed new Companies Bill does not closely resemble the shareholder derivative laws of either the United States or England.[290] The new Companies Bill thus appears to adopt the shareholder derivative device, but without sufficient definition to truly enable minority shareholders to protect themselves. This is but one of many problems that India faces in implementing shareholder derivative litigation; Section 5.2 will explain other practical problems of implementation.

China's 2005 Company Law was expressly adopted to increase investor protections and thus improve China's capital markets, as described in Section 4.2.2. China had a unique concern for minority shareholders, given the continuing high percentage of state-owned shares even within private corporations. It also expressed a belief that empowering shareholders to file derivative lawsuits on behalf of corporations would improve corporate governance. Unlike India, China's shareholder derivative provisions resemble the MBCA adopted by many U.S. states, as well as the recent statutory enactments in England and Canada. Perhaps this is not surprising since so many lawyers and bureaucrats in China are trained in the United States and

[290] *Compare* India Companies Bill 2009, *supra* note 170, *with* Companies Act, 2006, c. 46, §§ 260–264 (U.K.) (specifying circumstances under which a court will authorize a derivative claim in England, Wales, or Northern Ireland).

England.[291] Despite China's decision to adopt statutory provisions similar to those that have been well tested in the United States, putting shareholder derivative litigation in practice will prove extremely difficult within China's current legal system.

5.2. *Problems Implementing Effective Shareholder Litigation in India*

While India has adopted many new corporate governance laws, such as Article 49, that seem to provide strong rights on paper, India struggles with effective enforcement. "India is not a country known for vigorous enforcement of legislation. Thus far, the enforcement of [Article 49] has mirrored the lax enforcement efforts of other major legislative reforms."[292] While Article 49 went into effect in 2001, it took six years before the SEBI brought its first enforcement action[293] despite a record of noncompliance with its provisions.[294] The weak enforcement of Article 49 may be explained by the lack of provisions requiring disclosures and accountability to shareholders.[295] Issues of ineffective enforcement will likely persist for the new Companies Bill's shareholder derivative provisions.

Most countries' legal systems are rooted in one of four legal systems: "English common law, French civil law, German civil law [or] Scandinavian civil law."[296] Researchers utilize two indexes to compare the laws in these countries: a shareholder rights index

291 *See generally* David J. Lynch, *More of China's Best, Brightest Return Home*, USA TODAY, Mar. 7, 2003, (Money), at 1B, *available at* 2003 WLNR 6107628 (reporting on the increased numbers of Chinese students and professionals returning to China to seek opportunity in China's new "embrace of market-oriented economic policies"); *Reaping Rich Dividends*, FIN. EXPRESS, Dec. 16, 2005, *available at* 2005 WLNR 20348532 (comparing successful Chinese efforts to attract the return of western-educated students and professionals with India's inability to combat this 'brain drain').

292 Afsharipour, *supra* note 103, at 388.

293 *Id.* at 390. While there is weak enforcement overall, the SEBI has brought enforcement actions. *See id.* at 390–91 (outlining enforcement proceedings brought by the SEBI).

294 *See* Dharmapala & Khanna, *supra* note 162, at 10 (reporting a lack of Article 49 enforcement actions even though "compliance with Clause 49 is far from universal").

295 *See generally* Mazumdar, *supra* note 153, at 254 (concluding that lack of disclosure and accountability are "major areas of ineffective governance," which "diminish investor confidence" and hold back "development of emerging markets").

296 Chakrabarti, *supra* note 104, at 8–9.

that scores countries from zero (low) to six (high), and a rule of law index that scores countries from zero (low) to ten (high).[297] Of the four systems, English common law countries generally have the highest scores on the shareholder rights index, indicating that these countries offer the best protection of shareholder rights.[298] India's shareholder rights system scores a five, which is equal to that of other English-origin countries including the United States, the United Kingdom, Canada, Hong Kong, Pakistan, and South Africa, and better than forty-two other countries including France, Germany, Japan, and Switzerland.[299]

India, however, scores very low on the rule of law index compared to other countries.[300] The Scandinavian-origin countries had an average score of 10, the German-origin countries 8.68, English-origin countries 6.46, and French-origin countries 6.05.[301] In the rule of law index, advanced countries tend to have high scores on the index, while developing countries usually have low scores.[302] India has a rule of law score of 4.17, and ranks 41 out of 49 countries studied.[303] "Thus, it appears that Indian laws provide great protection of shareholders' rights on paper while the application and enforcement of those laws are lamentable."[304] Enforcement of laws, however, plays a greater role in corporate governance than simply creating the laws, especially in facilitating security markets that are not riddled with insider trading scams.[305]

Like the U.S. legal system, Indian laws accord "a significant role for the judiciary."[306] India's courts, however, are incredibly

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[297] *See id.* at 9 (describing the indexes used to compare the four primary legal systems).

[298] *See id.* (reporting that "[t]he English common law countries lead the four systems in the shareholder rights index with an average score of 4").

[299] *Id.*; *see also* Allen et al., *supra* note 116, at 12 (observing a strong degree of investor protections in India but finding such protection less effective in practice due to corruption and inefficiency).

[300] Chakrabarti, *supra* note 104, at 9.

[301] *Id.*

[302] *Id.*

[303] *Id.* (noting that of the forty-nine countries studied, India received a score higher than only Nigeria, Sri Lanka, Pakistan, Zimbabwe, Colombia, Indonesia, Peru, and the Philippines).

[304] *Id.* at 9–10.

[305] *See id.* at 10–11 (arguing that effective enforcement of shareholder protection laws is more essential than mere well-designed shareholder protection laws on the books, which are poorly enforced).

[306] Afsharipour, *supra* note 103, at 359.

slow and backlogged. A 2001 study found that twenty million cases were awaiting final judgment in India's courts, including almost 22,000 in the Supreme Court.[307] The results of this backlog are devastating for shareholders seeking a remedy. A 2004 World Bank report noted that it is common to wait six years for a first hearing and twenty years for a final judgment.[308] When India enacted the Companies (Second Amendment) Act in 2002, it created the National Company Law Tribunal and the National Company Law Appellate Tribunal to enforce the Companies Act and other related matters such as "dismantling unprofitable companies."[309] While these courts were promising steps toward better enforcement, a recent study shows that these courts' powers are rarely utilized.[310]

Indian businesses have also shown a lack of faith in the legal system. In a 2005 survey, 50% of firms surveyed said they do not have a regular legal advisor and "of the half that does, less than [fifty percent] . . . have 'legal advisors' with a law degree or a license to practice law."[311] The majority of business leaders lacking a legal advisor reasoned that they did not need one because they trust their business partners.[312] "Clearly, the formal legal system takes a back seat while reputation, trust and informal personal relationships are the driving factors in screening counter-parties to do business with."[313]

307 *See* Varun Bhat, *Corporate Governance in India: Past, Present, and Suggestions for the Future*, 92 IOWA L. REV. 1429, 1448–49 (2007) (citing statistics from a 2001 study reporting on India's judicial backlog).

308 WORLD BANK & INT'L MONETARY FUND, REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC): CORPORATE GOVERNANCE COUNTRY ASSESSMENT: INDIA 6 (2004), *available at* http://www.worldbank.org/ifa/rosc_cg_ind.pdf. The report noted some satisfactory aspects of India's corporate-governance framework, including basic rights of shareholders, disclosures, and transparency. *Id.* at 2–14 (evaluating India's compliance with Organization for Economic Co-Operation and Development corporate governance principals).

309 Afsharipour, *supra* note 103, at 360–361 (explaining that the Nat'l Company Law Tribunal inherited most of its powers from its predecessor the Company Law Board and consolidated some additional powers previously enforced by various government bodies) (citing the Companies (Second Amendment) Act, 2002, No. 11, Acts of Parliament, 2003).

310 *Id.* at 361.

311 Allen et al., *supra* note 116, at 23–24.

312 *Id.* at 24 ("When pressed for a reason, 63% of respondents who did not have legal advisors claimed they did not need lawyers as they knew all their business partners and could deal with them fairly.").

313 *Id.*

In post-independence India, unlike most developed countries and typical of emerging economies, company ownership is highly concentrated in the hands of family business groups.[314] A 2006 study found that almost 60% of India's largest 500 companies were affiliated with family business groups, and an additional 11% were owned, either in whole or in significant part, by the federal or state governments.[315] In other large companies, promoters played a key and persuasive role in corporate finance because, after liberalization, many promoters owned half or more than half of the company.[316] In 2002, "the average shareholding of promoters in all Indian companies was as high as 48.1%."[317] Dominant shareholders in India, such as promoters, seriously threaten effective corporate governance because directors become company insiders.[318]

In addition, smaller companies rarely rely on the legal system and "exhibit symptoms of a low investor protection regime (e.g. ownership concentration, dividend ratio, and valuation) more than the large firms."[319] These companies often do not seek formal financing sources, but rather rely on alternative funding sources

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314 *See* Afsharipour, *supra* note 103, at 362–63 (explaining that family ownership is a "mainstay" of India's corporate environment and a primary reason for a lack of disclosure and governance requirements under the Companies Act).

315 *See* Rajesh Chakrabarti et al., *Corporate Governance in India*, 20 J. APPLIED CORP. FIN. 59, 59 (2008) (exploring governance challenges resulting from this concentrated ownership).

316 *See* Afsharipour, *supra* note 103, at 363–64 (observing a shift during the 1990s where promoters began to increase their stakes in companies under their control); *see also* K.S. Chalapati Rao & Atulan Guha, *Ownership Pattern of the Indian Corporate Sector: Implications for Corporate Governance* 1, 11 (Inst. for Stud. in Indus. Dev., Working Paper No. 2006/09, 2006), *available at* http://isidev.nic.in/pdf/wp0609.pdf (stating that promoters own nearly half of total market capitalization).

317 Chakrabarti, *supra* note 104, at 11–12.

> It is believed that this is a result of the ineffectiveness of the legal system in protecting property rights. Concentrated ownership and family control are important in countries where legal protection of property rights is relatively weak. Weak property rights are also behind the prevalence of family-owned businesses – organization forms that reduce transaction costs and asymmetric information problems.

Id.

318 Mohanty, *supra* note 157, at 234.

319 Franklin Allen et al., The Financial Systems Capacity in China and India 4 (Nov. 2007) (unpublished manuscript), *available at* http://www.icrier.org/pdf/6dec07/Paper_%20Rajesh%20Chakrabarti_Session1.pdf.

such as friends, family, business partners, and informal trade creditors.[320] Only 26% of funds are obtained from formal sources, which reduce the need for companies and creditors to rely on legal remedies.[321]

Another significant concern is corruption, which riddles India's legal system in general, and the enforcement of corporate laws in particular.[322] For example, there is rampant tax evasion and a significant shadow economy, which accounts for about 23% of India's GDP.[323] While India may have weak enforcement of its laws, it does punish under-performing CEOs because, "CEOs are more likely to lose their jobs when corporate performance is poorer."[324]

Until India more consistently implements its laws through judicial enforcement, the shareholder litigation rights created in the new Companies Bill will likely prove ineffective. If India's judicial system cannot more expeditiously render judgments, then shareholders will simply choose not to seek a remedy through the courts. Similarly, if shareholders believe India's judicial system is corrupt, they will not seek judicial remedies. Although India is seeking to implement shareholder litigation rights to increase investor confidence in India's companies, its judicial system may undermine that effort. Consequently, domestic and foreign investment in Indian companies may not reach the levels India seeks until judicial reform occurs.

5.3. Problems Implementing Effective Shareholder Litigation in China

One issue with passing sweeping national corporate governance reform is that the CSRC regulatory power "has trespassed into the traditional territories of both the Company Law and Securities Law. This is particularly true in the area of corporate governance."[325] Consequently, the division between the supervisory powers of the CSRC and the authority of the stock

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320 *Id.*

321 *Id.* at 5.

322 *See* Chakrabarti, *supra* note 104, at 15 (discussing the rise of continued widespread corruption in the Indian corporate sector since the 1950s).

323 Allen et al., *supra* note 116, at 8.

324 Chakrabarti, *supra* note 104, at 13.

325 Wei, *supra* note 200, at 494 ("For instance, because the Company Law does not provide detailed provisions on corporate governance, the CSRC has endeavored to fill this gap.").

exchanges is unclear, leading to confusion in regulation of companies and securities markets.[326] Uncertainty in the law leads to confusion over corporate governance rules. For example, it is unclear what duties directors owe to the company. "Chinese law and regulatory practice remains unclear on the issue of standards of liability for independent directors, and indeed for directors in general."[327] In addition, "the lack of detailed procedures for shareholder actions and civil remedies may lead to enforcement difficulties."[328] Shareholder derivative lawsuits, however, may serve as one way to promote corporate governance reform in China if the law can be sufficiently clarified to allow effective enforcement.[329] While China is not a common law country judicial decisions in shareholder derivative lawsuits can "clarify the scope of permissible conduct, and that may . . . be generalized by the CSRC, the [Supreme People's Court], or other Chinese authorities."[330]

5.3.1. A Struggling Legal System

No matter the period of rule in China, policy has been emphasized over law. During the Maoist period, the government believed that laws were too rigid and would hamper the revolution.[331] Policy ruled the country, and legislation only served as "a rubber stamp" upon government policy.[332] During the Maoist period, the State directed judges "to decide cases according to policy goals rather than legal principles."[333]

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[326] *See id.* at 503 (describing that while China theoretically has a system of both government supervision and self-regulation, in practice government supervision is paramount and stock exchange self-regulation is marginal); *see also* Shi, *supra* note 200, at 477–79 (explaining the CSRC's pervasive regulatory presence over Chinese stock exchanges which has "constrained [the stock exchanges'] independent operation").

[327] Clarke, *supra* note 226, at 224 app. 1.

[328] Shi, *supra* note 200, at 485.

[329] *See* Deng, *supra* note 244, at 355 (indicating that a well-instituted shareholder litigation system would improve governance in China).

[330] *Id.*

[331] *See* Layton, *supra* note 205, at 1959 (noting Mao Zedong's view of the law as rigid) (citing Stanley Lubman, *Looking for Law in China*, 20 COLUM. J. ASIAN L. 1, 29 (2006)).

[332] *Id.*

[333] *Id.*

Modern China continues to have little judicial independence because the judiciary is "parallel to, rather than superior to, other units of the Chinese bureaucracy."[334] Not only are courts financed by the level of government that created them, but they are also "administratively and institutionally accountable"[335] to the government.[336] For example, the Chinese Communist Party supervises judges performing government administrative functions such as tax collection.[337] In addition, many judges in the provinces "are not legally trained."[338] This lack of independence as well as reliance on policy over law engenders a biased judiciary that often favors local defendants.[339] The Chinese Communist Party has announced that it will elevate the prominence of its laws, but this elevation will only occur "vis-à-vis policy."[340] However, most laws and regulations continue to be an embodiment of Chinese Communist Party policy.[341] Thus, whether the shareholder derivative provisions of the 2005 Company Law will improve corporate governance and truly permit shareholders to

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334 *Id.* at 1957–58.

335 *Id.* at 1958 (quoting Randall Peerenboom, *Judicial Independence and Judicial Accountability: An Empirical Study of Individual Case Supervision,* 55 CHINA J. 67, 71 (2006).

336 *See id.* ("[Courts] are subject to supervision from [China Communist Party] organizations and procuratorates, have limited adjudicative authority, are charged with other responsibilities such as tax collection, and primarily employ judges who are not legally trained.").

337 Donald C. Clarke, *Empirical Research into the Chinese Judicial System*, *in* BEYOND COMMON KNOWLEDGE: EMPIRICAL AFPPROACHES TO THE RULE OF LAW 164, 174–75 (Erik G. Jensen & Thomas C. Heller eds., 2003) (stating that "local governments often enlist judges in the work of birth control, tax collecting, urban beautification, and the physical expulsion of beggars").

338 Layton, *supra* note 205, at 1958. The "percentage of judges with 'proper L.L.B. degrees' is estimated at less than ten percent and applicants for judgeships were not required to take national bar examination until 2002." *Id.* n.73 (citing Stanley Lubman, *Looking for Law in China*, 20 COLUM. J. ASIAN L. 1, 29 (2006).

339 *See id.* (describing conditions which pressure Chinese "judges to favor local defendants in court proceedings")

340 *Id.* at 1959. In 1996, the president of China formally adopted a policy of ruling China in accordance with the rule of law. *Id.* n.83

341 *Id.* at 1959–60 ("Policies still trump laws, as exemplified by the [Chinese Communist Party]'s extralegal interference with 'day-to-day governance,' the use of internal [Chinese Communist Party] rules instead of judicial sanctions to punish party members for legal violations, and judges' use of 'ideological discretion' when deciding cases." (internal citations omitted)).

recover for mismanagement remains uncertain due to the doubtful ability of Chinese courts to enforce the new law.[342]

Not only do Chinese courts struggle to remain independent, they also struggle to enforce judgments in civil actions. "[U]p to fifty percent of civil judgments [in China] go unenforced]."[343] Judgments go unenforced because courts lack sufficient personnel and judges—who are selected and paid by local governments—often refuse to enforce actions against powerful local parties.[344] Additionally, other government agencies have proven unwilling to assist courts in enforcing civil judgments.[345]

To the extent China's judicial system hampers effective implementation of shareholder derivative lawsuits, other alternatives may be needed. Public enforcement measures might be preferable to lawsuits since "[China] has traditionally placed greater emphasis on [its public enforcement] laws to maintain 'control and discipline.'"[346] Similarly, China may consider utilizing private enforcement mechanisms rather than relying solely upon shareholder derivative lawsuits. Parties in China often use mediation (a private dispute resolution mechanism) because it is endorsed by the government and is less expensive than civil lawsuits.[347]

In addition to judicial problems, shareholders will likely face difficulty in finding adequate representation to file shareholder derivative actions. China lacks a sufficient number of legally trained professionals to act as lawyers and judges.[348] Lawyers represent clients in only about 10 to 25% of civil cases and only about 4% of Chinese business entities retain regular legal

342 *See* Shi, *supra* note 200, at 452 ("But it remains to be seen whether improved legislation will change practices, as law enforcement has been a long-standing concern in China."); *id.* at 484–85 ("Clearly, poor legal enforcement has been a problem for China.").

343 Layton, *supra* note 205, at 1958–59.

344 *See id.* at 1959 (explaining why many judgments are not enforced in China).

345 *See id.* at 1959 (using the example of state-owned banks refusing or delaying requests to freeze accounts).

346 *Id.* at 1960.

347 *Id.* (observing that "extrajudicial means, such as mediation continue to play an important role [in China] due to government encouragement") (footnote omitted).

348 Eric W. Orts, *The Rule of Law in China*, 34 VAND. J. TRANSNAT'L L. 43, 64 (2000).

advisors.[349] Moreover, even if a shareholder obtained a lawyer, a Chinese lawyer might hesitate to even file a shareholder derivative action. China's Ministry of Justice "has authority over lawyers and bar associations and controls their professional licenses through a system of annual renewal."[350] By denying re-registration to an attorney, the judicial authorities avoid the procedures required for formal suspension or withdrawal. Therefore, because lawyers' licenses to practice law must be registered annually, lawyers may avoid accepting cases that challenge the government in some way. Such cases may include actions against SOEs or actions against private Chinese corporations if the government is a significant shareholder. Even filing cases can be difficult for lawyers, because courts have much discretion in accepting cases and often apply both political and legal criteria to determine whether to accept cases.[351] This may further dissuade attorneys from prosecuting shareholder derivative actions as permitted by the 2005 Company Law.

5.3.2. Unclear and Problematic Procedures

China's legal system generally is criticized as "a bewildering and inconsistent array of laws, regulations, provisions, measures, directives, notices, decisions, explanations, and so forth, all claiming to be normatively binding."[352] It thus is not surprising that commentators have been quick to criticize the procedures outlined in Article 152 of the 2005 Company Law.[353] One critic has noted that the 2005 Company Law may face enforcement problems because it "does not spell out the procedures for taking such an action, nor does it elaborate on the types of remedies available to shareholders apart from compensation."[354] In addition, Professor Huang has argued that the 2005 Law poses standing issues since only current shareholders are allowed to file lawsuits.[355] Unlike

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349 *Id.*

350 *China: Rights Lawyers Face Disbarment Threats*, HUMAN RIGHTS WATCH, (May 30, 2008), http://www.hrw.org/news/2008/05/28/china-rights-lawyers-face-disbarment-threats.

351 *Id.*

352 Orts, *supra* note 348, at 68.

353 *See* Huang, *supra* note 230, at 242–49 (providing detailed criticism of the procedures in Article 152 and suggesting potential reforms).

354 Shi, *supra* note 200, at 495.

355 Huang, *supra* note 230, at 242 (arguing that China's approach to standing in derivative lawsuits is both under-inclusive and over-inclusive).

shareholder lawsuits in Australia and Canada, former shareholders may not bring lawsuits.[356] However, only current shareholders are allowed to file shareholder derivative lawsuits in U.S. state and federal courts.

The 2005 Company Law also does not specify a statute of limitations. By applying the 1986 General Principles of the Civil Law, however, the applicable statute of limitations is likely two years from when the company knew or should have known that its rights were infringed.[357] Since it is the company's knowledge rather than the shareholders' knowledge, that triggers the statute of limitations, the current law may prove unfair to shareholders.[358] Company officials with knowledge of the infringement may simply allow the statute of limitations to lapse without taking actions because they could be defendants in a derivative lawsuit.[359]

In addition, shareholder derivative litigation costs have also dissuaded shareholders in China from filing lawsuits. Litigation costs in China include filing fees, attorneys' fees, and sometimes "[c]ertain under-the-table sweeteners."[360] Article 19 of the Supreme People Court's Measures on the People's Courts' Acceptance of Litigation Fees, written in 1989, requires the losing party to pay filing fees and litigation costs, but each party still pays its own attorneys' fees.[361] This measure could be applied to shareholder derivative lawsuits, because the 2005 Company Law does not dictate how attorneys' fees and litigation costs are to be paid and clearly does not provide financial incentives for shareholders to bring shareholder derivative lawsuits.[362] However, the matter is uncertain. Given China's high turnover rate for investments, a rational investor in a Chinese corporation may prefer to simply sell his shares rather than litigate in the absence of such financial incentives.[363]

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[356] *See id.* at 242–43 (comparing China's standing procedures in derivative lawsuits to those of Australia and Canada).

[357] Huang, *supra* note 204, at 9–10.

[358] *See id.* at 10 (noting that minority shareholders may be prejudiced because they are not often "immediately aware of the harm done to the company").

[359] *Id.*

[360] *Id.* at 9 n.42.

[361] *Id.* at 9.

[362] *Id.* at 16.

[363] *Id.* at 13 (noting that litigation costs will detract most rational shareholders from bringing derivative lawsuits rather than simply selling their shares).

The likelihood and effectiveness of shareholder derivative lawsuits could increase if China amends the 2005 Company Law in key ways. For instance, shareholders would be more willing to bring derivative lawsuits if an indemnity provision safeguarded losing shareholders against paying litigation costs and the corporation's attorneys' fees where such lawsuits were brought "in good faith and in the best interest of the company."[364] Other commentators have offered suggestions for funding Chinese derivative lawsuits based on financing mechanisms in other countries.[365] To facilitate shareholder derivative lawsuits, courts could also provide shareholders early access to the company's documents rather than requiring them to wait for the documents until during discovery or at trial.[366] Shareholders in the United States, for instance, typically possess a right to inspect the company's records.[367] In addition, the 2005 Company Law lacks any settlement provision. Typically, settlements are not subject to court supervision in China, which increases the chances of frivolous lawsuits.[368] To prevent this yet permit meritorious shareholder derivative lawsuits, China's courts should monitor settlements.[369]

6. CONCLUSION

Shareholder derivative litigation has been recognized for hundreds of years within the United States. Most states have adopted statutory provisions explicitly empowering shareholders to file derivative actions on behalf of corporations and defining directors' fiduciary duties. Despite much criticism, shareholder

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[364] *Id.* at 15.

[365] *See* Zhong Zhang, *Making Shareholder Derivative Actions Happen in China: How Should Lawsuits be Funded?*, 38 H.K. L.J. 523, 530–37 (2008) (analogizing the several Western approaches to funding shareholder derivative lawsuits as providing potential guidance for funding derivative lawsuits in China).

[366] *See* Huang, *supra* note 204, at 17 (suggesting that shareholders' "pre-trial access" to company documents may serve as a beneficial reform to China's derivative lawsuit system).

[367] *See id.* at 17 n.74 (discussing the shareholder demand for inspection of records provision under Delaware law).

[368] *See id.* at 10 (noting that Chinese courts are not required to approve settlements and further explaining why "settlement[s] without a court's supervision may cause frivolous lawsuits").

[369] *See id.* (recommending that Chinese courts should "play an active role in approving settlements of derivative lawsuits").

derivative actions are frequently litigated in the United States and thus continue to play an important role in corporate governance. Criticism of shareholder derivative litigation in the United States has not deterred either India or China from recognizing shareholder derivative litigation. China has adopted statutory provisions that closely resemble the MBCA, which has been enacted by a majority of U.S. states. India has proposed a statutory provision that also recognizes derivative actions, although only its formulation of directors' fiduciary duties bears any resemblance to United States law.

India and China are both focused on developing a free market system of private investment in corporate entities. Both countries have recognized derivative actions for the purpose of increasing investor protections and, in turn, for increasing investors' willingness to invest in their corporations. To some extent, both countries may anticipate that statutory provisions for shareholder derivative actions may improve corporate governance, either as a preventative measure to deter bad conduct by managers or to remedy injuries suffered by corporations from such conduct. Thus, China and India's pursuit of a free market system has motivated them to empower shareholders to file derivative actions on behalf of corporations.

Shareholder derivative litigation in India and China, however, faces significant challenges that may suggest the likelihood and effectiveness of such litigation is marginal in the near future. India will need to clarify the causes of action on which shareholders may file derivative actions and also clarify for the procedures for doing so. India's legal system will also need to provide more prompt adjudications for shareholder derivative litigation to be useful in holding directors accountable or improving future decision-making by directors. China also will need to improve its judicial system. Both countries will need to develop explicit procedures to guide shareholder derivative litigation and perhaps to encourage shareholders to bring such lawsuits. Similarly, both countries also must develop their definitions of fiduciary duties for shareholder derivative litigation to be effective and also to guide directors' conduct.

This comparative analysis offers insights for investors and corporations in the United States, as well as for the states. First, investors should recognize that the shareholder derivative devices as expressed by India and China does not offer the same protections as it does in the United States, particularly given their existing legal systems. Although the recognition of derivative litigation by India and China is appealing for symbolic reasons, it provides only false comfort because their current legal systems are unable to resolve the internal corporate disputes presented by such litigation. Until substantial judicial reform occurs, the simple message is buyer beware.

Corporations that adopt arbitration provisions to eliminate investors' ability to file shareholder derivative litigation may place themselves at a competitive disadvantage. To the extent that corporations feel shareholder derivative litigation is broken, then corporations should work with investors to improve the current system. As recent developments in India and China demonstrate, such efforts will likely influence other countries, especially in light of efforts to harmonize corporate governance standards within the global economy.

Finally, this Article offers a broader message on the direction that the United States should be moving within the global economy. Two of the largest and fastest growing markets in the world, India and China, have been decisively moving toward free market systems and away from their prior socialist and communist systems, respectively. Both countries have been disentangling government from business enterprises, reducing regulations, minimizing government interventions in the markets, and seeking methods for better protecting investors' interests. The changes that they have implemented toward free market systems have proven tremendously successful. To the extent that the United States is edging away from its free market system through recent bailouts and extensive new regulations, it is moving in the wrong direction and is out of step with the global economy. The United States must carefully consider the likely consequences of intervening in private corporations and the capital markets. The United States' ability to effectively compete for capital in the global economy likely depends on its continued support of the free market principles that are being so widely adopted by other countries.