Challenges Surrounding Directors’ Duty of Care in Chinese Corporate Law

Jui-Chien Cheng
SJD Candidate
Maurer School of Law
Indiana University
Juicheng@indiana.edu

中国公司法中董事注意义务的挑战

郑瑞健
博士候选人
摩利尔法学院
印第安纳大学

Abstract

The concept of fiduciary duty, derived from common law, was introduced to the Company Law of People’s Republic of China in 2005. Even so, few fiduciary lawsuits have been brought to the courts of China since 2005. There are three main reasons for the rarity of fiduciary lawsuits. First, Chinese fiduciary law has neither clear content nor a clear standard of review. Second, the traditionally harmonious culture of China discourages filing lawsuits against directors. Third, Chinese law imposes severe restrictions on derivative lawsuits. This paper presents a detailed description of the regulation of the duty of care in China. The difficulties facing the fiduciary duty in China are examined in light of the history and status quo of the duty of care in Delaware, the outcome of the leading Chinese case regarding the duty of care, the severe restrictions on derivative lawsuits in China, and the influence of China’s social and cultural values.

摘要

2005年，中国公司法首次引入了忠实义务与勤勉义务这两个英美法上的概念；然而，法院所受理的相关诉讼案件并不多。其主要原因有三：第一，忠实义务与勤勉义务的定义与审查基准并不明确。第二，中国“和谐”的文化传统降低了股东提起诉讼的意愿。第三，公司法对股东代表诉讼进行了严格限制。本文详细介绍了与勤勉义务有关的法律规定、评析特拉华州与中国关于董事勤勉义务的重要案例、介绍股东代表诉讼的严格限制、分析中国的社会与文化价值观，从四方面阐述中国董事勤勉义务诉讼所面临的困境。
I. Introduction

The concept of fiduciary duty, derived from common law, was introduced to the Company Law of People’s Republic of China in 2005.\(^1\) The fiduciary duty plays an extremely important role in common law, particularly in U.S. corporate law. For this reason, one might have expected dramatic consequences from its introduction to Chinese law. In reality, however, few fiduciary lawsuits have been brought to the courts of China since 2005.\(^2\) This paper will address the relative absence of duty of care lawsuits.\(^3\)

There are three main reasons for the rarity of due care lawsuits. First, Chinese fiduciary law has neither clear content nor a clear standard of review. This is especially true of the body of fiduciary law that deals with the duty of care. This makes it difficult for lawyers to decide whether pursuing a due care lawsuit is worthwhile and for judges to establish a legal doctrine for applying and enforcing the law. Second, the traditionally harmonious culture of China discourages filing lawsuits against directors. Shareholders thus prefer other ways to solve problems, such as simply selling their stocks. Third, Chinese law imposes severe restrictions on derivative lawsuits. One such restriction is the requirement for shareholder(s) to have held at least 1% of company stock for at least 180 consecutive days in order to be eligible for filing a derivative lawsuit. This paper examines China’s problematic duty of care law and demonstrates that it is in dire need of revision.

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\(^1\) The necessity of introducing the duty of care to Chinese corporate law has been advocated by scholars in 1999. See Daoyang Wang & Hua Li (王道阳，李华), *Lun Gongsi Dongshi De Zhuyi Yiwu* (论公司董事的注意义务) [*Corporate Directors’ Obligation of Diligence*], 5 *HEBEI FAXUE* (河北法学) 50, 52-3 (1999).

\(^2\) Before December 1\(^{st}\) 2010, only 63 fiduciary cases could be found online; however, only five of them are related to the duty of care. See Jun Wang (王军), *Gongsi Jingyingzhe Zhongshii Yiwu He Qinnian Yiwu Susong Yanjiou* (公司经营者忠实和勤勉义务诉讼研究) [*The Research of Lawsuits of Duties of Loyalty and Care against Entrepreneurs of Corporations*], 4 *BEIFANG FAXUE* (北方法学) 24, 28 (2011).

\(^3\) The Chinese equivalent to the duty of care is called the obligation of diligence. This is discussed in more detail in section III.
The paper is organized as follows. In section II, we will summarize the history and status quo of the duty of care in Delaware – an important jurisdiction for corporate law – so that we may gain insight toward understanding China’s duty of care law. Understanding the fiduciary duty of U.S. is important for understanding Chinese fiduciary duty since most Chinese scholars agree that the duties of care and loyalty in Chinese corporate law are derived from common law and U.S. corporate law. Section III describes the regulation of the duty of care in China. Section IV discusses the leading case regarding the duty of care and the restrictions on derivative lawsuits in China. Section V then takes a closer look at problems that Chinese fiduciary law faces. It is difficult enough simply to introduce a common law concept to a civil law jurisdiction. The duty of care in China faces cultural challenges in addition to legal challenges. Section V discusses both of these types of challenges. The section VI concludes the paper.

II. The Duty of Care in Delaware

In common law, nearly all aspects of the relationship between a corporation and its directors are rooted in the fiduciary relationship, which establishes both a standard of care and a standard of loyalty for fiduciaries. When fiduciaries fall short of these standards, they are said to breach the duty of care or the duty of loyalty,

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4 Why choose Delaware? Because the Delaware General Corporate Law is the most important and popular primary authority of the corporate laws in U.S.. “More than 1,000,000 business entities have their legal home in Delaware including more than 50% of all U.S. publicly-traded companies and 64% of the Fortune 500. Businesses choose Delaware because we provide a complete package of incorporation services including modern and flexible corporate laws, our highly-respected Court of Chancery, a business-friendly State Government, and the customer service oriented Staff of the Delaware Division of Corporations.” See State of Delaware Web—the Official Website of the First State, http://corp.delaware.gov/ (last visited Sept. 27 2013).

5 TAMAR FRANKEL, FIDUCIARY LAW 106 (2011).
respectively. A breach of the duty of care always entails an uninformed business decision constituting gross negligence, whereas the duty of loyalty is “the requirement that a director favor the corporation's over her own whenever those interests conflict.”

Following the Delaware Supreme Court’s decision in Smith v. Van Gorkom, the duty of care suddenly caught the public eye. Jerome W. Van Gorkom was Chairman and Chief Executive Officer of Trans Union, a publicly-traded and diversified holding company. Even though “the company had a cash flow of hundreds of millions of dollars annually,” the company was unable to make sufficient taxable income to offset its investment tax credits.

To take advantage of these tax credits, Van Gorkom considered the sale of the business to a 3rd party. The company’s CFO indicated that a reasonable price for Trans Union would be from $50 to $60 dollars per share. Several days after the first meeting, Van Gorkom decided to meet Jay A. Pritzker, a potential acquirer, to sell the company for $55 per share without consulting any other member of the Board or any members of Trans Union's Senior Management except Carl Peterson, the Controller of Trans Union. However, there was no evidence to show that $55 per share represented the intrinsic value of the company. Van Gorkom simply unilaterally decided the price. Pritzker eventually agreed to make a cash-out merger offer of $55 per share after another meeting with Van Gorkom.

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6 It is important to note the distinction between these two duties because the duty of care is protected by the business judgment rule, which “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 Aronson v. Lewis, 473 A. 2d 805, 812 (Del. 1984). As for the scrutiny of the business judgment rule, see Brehm v. Eisner, 746 A. 2d 244, 262 (Del. 2000).

7 See Aronson, 473 A. 2d at 812.


10 Id. at 864.
Van Gorkom then called a special meeting of the Trans Union Board on the following day, and also called a meeting of the senior management. The managers' reaction to the offer was unanimously negative. Despite this rejection by senior management, Van Gorkom insisted that the meeting of the Board be held on time that same day. The directors did not receive any written materials prior to the board meeting. During the board meeting, Van Gorkom orally presented the proposal and outlined the terms of the offer without explaining how he had arrived at the price of $55 per share. The CFO indicated that a second study suggested a reasonable price was between $55 and $65 per share, noting that “$55 was in the range of a fair price, but at the beginning of the range.” Van Gorkom said $55 per share was a fair price and that shareholders should have the chance to decide whether or not to accept the price. The Board eventually accepted the merger agreement. The stockholders of Trans Union also approved the acquisition five months following this special meeting.

The court ruled in favor of the plaintiffs for the following reasons: (1) the board's decision was not an informed business judgment; (2) the board attempted to amend the merger agreement and take other curative actions that were legally and factually ineffectual; and (3) the board failed to disclose all of the material facts before the shareholders ratified the merger. The business judgment rule was rebutted in this case on the following points: (1) the directors lacked the necessary information for establishing the per share purchase price; (2) they did not know the intrinsic value of their own company; and (3) they approved the merger after only two hours of consideration despite having had no prior notification of the proposal.

11 Id. at 869.
12 Although the shareholders approved the agreement, it could not cleanse the directors' liabilities. See Id. at 873. (“Certainly in the merger context, a director may not abdicate that duty by leaving to the shareholders alone the decision to approve or disapprove the agreement.”)
13 Id. at 864.
In this last point, the court ruled, the directors were grossly negligent. The directors reportedly settled the case by agreeing to pay $23,500,000 to plaintiffs, but were potentially liable for up to $133,577,580.

The Delaware Supreme Court’s ruling in this case had lasting consequences. It opened the door for the directors of any Delaware-incorporated company to be held personally liable for vast sums of money, thus creating a huge disincentive for anyone considering taking on the role of director. In addition, the premiums for directors and officers (D&O) insurance surged and became very hard to obtain. Because the Delaware Supreme Court’s decision increased the potential liability for breaching the duty of care, it in effect increased the potency of the duty of care.

The turbulence following the Van Gorkom case provoked the Delaware Assembly to attempt to counter the Delaware Supreme Court’s director-unfriendly decision. In particular, it sought to limit the duty care’s reach by passing Delaware General Corporate Law (henceforth DGCL) Section 102(b)(7) in 1986. This law states that a company charter may contain a provision that limits or eliminates directors’ duty-of-care liability as long as this provision is approved at a shareholder meeting. However, such provisions are typically proposed by the directors themselves, who

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14 Id. at 874.
15 Charles R.T. O’Kelley & Robert B. Thompson, Supra note 8 at 346.
17 Id.
18 “Begin with Delaware in 1986, approximately 40 states have now enacted legislation allowing corporations to limit or eliminate directors’ liability for breach of fiduciary duty.” See Charles R.T. O’Kelley & Robert B. Thompson, Supra note 8 at 350.
19 The relevant part of Section 102(b): “In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: ... (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under §174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.” See State of Delaware Web—the Official Website of the First State, http://delcode.delaware.gov/title8/c001/sc01/ (last visited Sept. 29 2013).
recommend that their liability be eliminated altogether rather than merely limited. In practice, shareholders almost always approve such proposals. Thus, the result of DGCL Section 102(b)(7) is that the directors of companies incorporated in Delaware are no longer liable for the breach of the duty of care no matter how incompetent or negligent their decisions may be. In effect, the directors of Delaware-incorporated companies are now only liable for the breach of the duty of loyalty. 20

III. The Fiduciary Duty and its Related Regulations in China

China’s law concerning the fiduciary duty was established in Article 148 of Company Law of People’s Republic of China (henceforth Company Law), which states that directors, supervisors, and senior managers should bear the obligations of fidelity and diligence to the company. 21 The liability for the breach of the fiduciary duty is made enforceable by Article 150, which states that a director, a supervisor, or a senior manager who performs her duty in violation of any law, administrative regulation, or charter shall be liable for the damages if she caused the company’s loss. 22 The debate over the origins of the obligations of fidelity and diligence is settled, since most scholars agree that these obligations are derived from the

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common law duties of loyalty and care, respectively, specifically the duties of loyalty and care as they are defined in the DGCL and the Model Business Corporation Act.\textsuperscript{23}

However, the obligations of fidelity and diligence in China are by no means equivalent to the duties of loyalty and care in the United States. The obligation of fidelity is defined in Article 149 of the Company Law, which enumerates eight ways whereby this obligation can be breached:

1. misappropriating the company's funds;
2. depositing the company’s funds into his/her own account or the account;
3. loaning company funds to others or using them to provide a guarantee to any other person without complying with the charter or without the consent of the shareholders’ meeting, shareholders’ assembly, or the board of directors;
4. self-dealing without complying with the charter or without the consent of the shareholders’ meeting, shareholders’ assembly, or the board of directors;
5. using the company's opportunity without complying with the charter or without the consent of the shareholders’ meeting, shareholders’ assembly, or the board of directors;
6. taking the commission which belongs to the company into his/her own pocket;

(7) disclosing the company's confidentiality without its consent; and

(8) other conducts which breach the obligation of fidelity.24

The obligation of diligence, while not mentioned in the Company Law, is indirectly defined in Paragraph 1 Article 58 of Administrative Measures for the Disclosure of Information of Listed Companies (henceforth AMDI), which states that the directors, supervisors, and senior managers of listed companies are liable for any lack of genuineness, accuracy, completeness, timeliness, or fairness in the information disclosed by their company, unless sufficient evidence shows that they have fulfilled their obligation of diligence.25 Now, this administrative provision does not directly define the obligation of diligence; i.e., it does not say that the obligation of diligence is to be genuine, accurate, complete, etc. But it does give the CSRC the authority to decide whether or not a director has breached her obligation of diligence. It also gives the CSRC the authority to file an administrative sanction against a director who has signed a fraudulent or deceptive report. The burden of proof in such a case will be on the director to show that she has in fact not breached her obligation of diligence.

In contrast, American directors are liable for the breach of the duty of care only if they make an uninformed decision. Furthermore, most of them are protected by the

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exculpatory provision, the DGCL Section 102(b)(7). Thus, directors of Chinese listed companies are clearly held to a higher fiduciary standard than their American counterparts, especially where the obligation of diligence is concerned.26

IV. The Enforcement of the Fiduciary Duty in China

The enforcement of the fiduciary duty in China is quite different from its counterpart in the United States. In theory, directors in China owe a higher level of fiduciary duty to the corporation. In reality, however, they are hardly ever sued by shareholders or punished by the People’s Courts or the China Securities Regulatory Commission (henceforth CSRC).27 In China, there are two main types of courts where fiduciary law is concerned: the civil court and the administrative court. The former hears derivative lawsuits, while the latter hears lawsuits in which a company director is contesting a CSRC sanction. The administrative courts see many more cases than the civil courts because of the power of CSRC and the severe restrictions on derivative lawsuits.

A. The Power of the CSRC

First, the CSRC is eligible to decide that directors of listed companies breach their obligation of diligence and to punish them. Directors could file administrative lawsuits against the CSRC as their judicial relief after being punished, but in doing so, they must prove that they have not breached their obligation of diligence. For example, the leading case28 concerning the breach

26 The Chinese legislators intentionally make Chinese directors owe higher level of obligation of diligence than the duty of care of American directors because the plain meaning of diligence implies the pursuing high level of moral spirit. See Hong Zhang & Wenying Lu, Supra note 23 at 6-7.
27 CSRC only owns the supervision power to listed companies.
28 The important status of this case is approved by official medias such as the Leal Daily (法制日报) [Legal Daily] and the Xinhua Wang (新华网) [Xinhua Net]. See Xinhua Net, http://news.xinhuanet.com/legal/2008-12/07/content_10468336.htm (last visited Sept. 30 2013);
of directors’ obligation of diligence is the Ding Liye case\(^{29}\) (丁力业案), which was brought to the Beijing No.1 Intermediate People’s Court (北京第一中级人民法院) to dispute an administrative sanction\(^{30}\) made by the CSRC. The CRSC had fined the listed company ShenXinTaiFong (深信泰丰) and its directors various amounts ranging from 300,000 to 30,000 RMB (approximately $50,000 to $5,000)\(^{31}\) because its 2003 annual and semiannual reports contained fraudulent and deceptive information. One of the directors, Liye Ding (丁力业), filed an administrative lawsuit against the CSRC to dispute his fine. He claimed that he was not liable for the fraudulent and deceptive reports because he was absent from the directors’ meetings. However, he authorized another director to join the board meeting on behalf of him. Since the director signed the report, Liye Ding was responsible for the report as well.

The court ruled against the plaintiff, citing in its decision Paragraph 1 Article 58 of Administrative Measures for the Disclosure of Information of Listed Companies (上市公司信息披露管理办法) and holding: “The plaintiff, a director of ShenXinTaiFong, has the duty to fulfill the director’s responsibility, to supervise the company for the obedience of its legal duty of disclosure, and to ensure the genuineness, the accuracy and the completeness of directors’ obligation of diligence is the Ding Liye case\(^{29}\) (丁力业案), which was brought to the Beijing No.1 Intermediate People’s Court (北京第一中级人民法院) to dispute an administrative sanction\(^{30}\) made by the CSRC. The CRSC had fined the listed company ShenXinTaiFong (深信泰丰) and its directors various amounts ranging from 300,000 to 30,000 RMB (approximately $50,000 to $5,000)\(^{31}\) because its 2003 annual and semiannual reports contained fraudulent and deceptive information. One of the directors, Liye Ding (丁力业), filed an administrative lawsuit against the CSRC to dispute his fine. He claimed that he was not liable for the fraudulent and deceptive reports because he was absent from the directors’ meetings. However, he authorized another director to join the board meeting on behalf of him. Since the director signed the report, Liye Ding was responsible for the report as well.

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\(^{30}\) For the content of the administrative sanction, See China Securities and Regulatory Commission, http://www.csrc.gov.cn/pub/zjhpublic/G00306212/200804/t20080418_14224.htm?keywords=%E4%B8%81%E5%8A%A9%E4%B8%9A (last visited Sept. 29 2013).

\(^{31}\) The penalty of 300,000 RMB was for the company. The individual director’s penalty was no more than 50,000 RMB in this case.
of disclosed information.... Moreover, the plaintiff did not submit the evidence to prove that he has fulfilled his obligation of diligence as a director.... Thus, the plaintiff is liable for the fraudulent and deceptive information in the annual report and the semiannual report.”

This case established a rule that a director’s signature on a fraudulent report is in and of itself sufficient to sustain the assumption that the director was not diligent. However, the court did not mention how the director could refute this assumption. The court described how the obligation of diligence is breached without describing how it is fulfilled.

The result of the court’s decision in the DingLiye case is that it is now easier for directors’ liability to be established in administrative courts. In theory, it would also make it easier for shareholders to file and win derivative lawsuits against directors in civil courts, since shareholders would be able to use the decisions of administrative courts to support their cases. However, as we will see in the next section, Chinese law severely restricts the filing of derivative lawsuits, so it ends up being very difficult for shareholders to derive any practical benefit from the DingLiye decision.

B. The Restrictions on Derivative Lawsuits

Although the amounts of the fines imposed by the administrative court in the DingLiye case were quite small, the amount of monetary damages that could be awarded in a derivative lawsuit following an administrative sanction

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32 The content of this verdict can be reached online. See Plato Law, http://www.platolaw.com/article/1310621214515-RGQGY5MXEKBQ.pdf (last visited Oct. 9 2013).

33 The standard of review for the breach of the obligation of diligence is neither the torts law approach nor the business judgment rule. It depends on whether or not the directors signed the documents. See Feng Deng (邓峰), Yewu Panduan Guize De Jinhua Yu Lixing (业务判断规则的进化和理性) [The Improvement and the Rationality of the Business Judgment Rule], 2 FAXUE (法学) 68, 80 (2008).
is potentially quite large. In actuality, however, very few derivative lawsuits against publicly traded companies’ directors for the breach of fiduciary duty are ever filed in contemporary China. The reason for this is that it is too difficult for minority shareholders to file a derivative lawsuit against directors. Article 152 of the Company Law specifies four conditions that must be satisfied in order for a shareholder to be able to file a derivative lawsuit against a director:

1. The director’s conduct must violate Article 150 of the Company Law, which states that a director is liable for the company’s loss caused by her if she has violated any law, administrative regulation or chart while performing her duty to the company.

2. The shareholder(s) in question must continuously hold at least 1% of the company’s total shares more than 180 days.

3. The shareholder(s) must submit a written request to the board of supervisors, asking them to file the lawsuit.

4. After submitting this request to the board of supervisors, the shareholder(s) may proceed to file the lawsuit only if one of the following is true: (1) the board of supervisors refuses to file the lawsuit, (2) the board of supervisors has not filed the lawsuit within 30 days after receiving the written request, or (3) the company is facing an emergency that could lead to unrecoverable loss if the lawsuit is not immediately filed.

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34 Zhejiang Guangxia Konggu Gongsi (浙江广厦控股公司), a famous publicly-traded company, was sued by minority shareholders who held 4.81% and 2.69% of shares of the company in 2007. The total amount of this derivative lawsuit was more than 3 billion RMB. However, the verdict of this case could not be found online. See Xinhua Net, http://news.xinhuanet.com/legal/2008-01/11/content_7403108.htm (last visited Oct. 2 2013).
If any one of these four constraints is not satisfied, no lawsuit can be filed.\(^{35}\)

Thus, despite the assumption of the breach of the obligation of diligence established in Paragraph 1 Article 58 of AMDI, the directors of Chinese listed companies nonetheless enjoy a degree of protection from shareholder litigation. This protection comes in the form of the restrictions on derivative lawsuits discussed above. Even though most shareholder lawsuits would be easily won due to the assumption of the breach of the obligation of diligence, the constraints on derivative lawsuits prevent most lawsuits from ever reaching court in the first place.

V. The Challenges Facing the Fiduciary Duty in China

The task of introducing a common law concept to a civil law jurisdiction is itself already a very big challenge;\(^{36}\) however, the challenge of introducing the common law fiduciary duty to Chinese corporate law is much greater in China than in other countries because of its harmonious social atmosphere and the defects present in its legislation. Due to these two phenomena, it is likely that very few fiduciary derivative lawsuits will be filed in the next five years in China.

A. The Importance of Harmony in Chinese Culture

Harmony is a strongly entrenched value in China. From signs at construction sites to the names of trains, slogans containing the word *harmony*

\(^{35}\)For more critiques of derivative lawsuits in China, see Yingshuang Liu (刘迎霜), *Gudong Dui Dongshi Susongzhong De Shangye Panduan Guize* ([The Business Judgment Rule of Shareholders’ Lawsuits against Corporate Directors]) *FAXUE (法学)* 142, 143-44 (2009).

\(^{36}\)“As for the research of obligation of diligence, the related foreign legal theories are important; however, introducing these theories to China has to fit in the social situation of China.” See Hong Zhang & Wenyiing Lu, Supra note 23 at 9.
are everywhere. Although Chinese citizens always make fun of the
pervasiveness of this value, they nonetheless end up adhering to it in practice.

In a fiduciary dispute, the spirit of harmony manifests itself in two distinct
dimensions, the minority shareholders’ habits and the majority shareholders’
negotiating power. First, minority shareholders may simply sell out their own
stocks when they are unsatisfied with the company. Chinese people generally
see lawsuits as utterly miserable affairs to be avoided at all costs. Most would
choose to sell out their stock rather than endure the pain of a lawsuit. Second,
the majority shareholders have leverage to negotiate with directors and
influence their decisions without having to resort to a lawsuit. Moreover, they
can always sell their stocks if negotiations fail. The directors also have an
incentive to establish harmonious relations with majority shareholders, since
the cost (including time and money) of negotiation is always less than the cost
of a lawsuit.

B. Defects in the Legislation

Even if shareholders overcome all the restrictions on derivative lawsuits
and the constraints of a harmony-emphasizing social order, they face many
unexpected problems stemming from the defects in the Chinese legal system.
Even if we set aside for the moment the substantial problems caused by the
ambiguous definition and standard of the fiduciary duty, there is still the
problem that the court can dismiss a derivative lawsuit during the format
examination. For example, Article 152 of the Company Law stipulates that
shareholder(s) have to have constantly held at least 1% of the company’s stock
for 180 days before starting the process of filing the lawsuit. However, it does
not specify what sort of stocks must be owned by the shareholder(s). Suppose,
for instance, that a company issued 1,000,000 shares of common stocks. Then a shareholder would have to hold at least 10,000 shares in order to file a derivative lawsuit. But what if this same company issued another 10,000,000 shares of preferred stocks? How many shares would the shareholder then be required to own for the purposes of filing a lawsuit? One possibility is that the preferred stock doesn’t count, and 10,000 shares are thus still sufficient. Another possibility is that preferred stock does count along with the common, and that the shareholder would therefore need to have held at least 110,000 shares of stocks for a half year. A court could choose either of these options. Nothing but the arbitrary biases and inclinations of a particular court would favor one interpretation over the other. One court, for example, may wish to defend the harmony of society and the market. It could then adopt the latter interpretation and legally dismiss the derivative lawsuit on the grounds that the defendants did not fulfill one of the requirements of the derivative lawsuit, namely that of constantly holding more than 1% of the company’s stock for 180 days. There are many surprises in the Company Act. These surprises can either be advantages or disadvantages to the shareholders depending on whether or not they are on the same side of something important or someone powerful.

VI. Conclusion

In China, the obligation of diligence does not have a clear definition and standard of review. Without the substantial content of the obligation of diligence, it is unreasonable to expect directors to obey this obligation and judges to apply it
consistently. In theory it is not difficult for a court to rule that a director has breached of the obligation of diligence. In practice, however, due to legal and cultural restrictions, it is very difficult to file a derivative lawsuit against directors in the first place. These restrictions provide directors with a degree of safety. However, the rare derivative lawsuit that is successfully filed can be disastrous for directors, since directors are essentially without protection once a lawsuit gets passed the filing barrier.