A Comparative Study of Minority Shareholder Protection in China, the US and the Netherlands

Een rechtsvergelijkend onderzoek naar de bescherming van minderheidsaandeelhouders in China, de VS en Nederland

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"*Now faith is confidence in what we hope for and assurance about what we do not see*."- Hebrews 11:1

This thesis is a manifestation of my faith.

Every PhD journey is a very unique and personal experience. Some are full of colors and sunshine, while others might be as "melancholy" as the Dutch weather. Unfortunately, my PhD journey fell into the latter for being very strenuous and tough. However, where there is darkness there must be light. For this thesis to become possible, I have many thank you's to say, starting with the financial support of the China Scholarship Council.

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List of Abbreviations

AEX	Amsterdam Exhange Index
AFM	Dutch Authority for the Financial Markets
ALI	American Law Institute
AMX	Amsterdam Midcap Index
AScX	Amsterdam Smallcap Index
CCGC	Chinese Coporate Governance Code
CCL	Chinese Company Law
CFR	Code of Federal Regulations
CIRC	China Insurance Regulatory Commission
CSL	Chinese Securities Law
CSRC	China Securities Regulatory Commission
DCC	Dutch Civil Code
DCGC	Dutch Corporate Governance Code
DGCL	Delaware General Cororate Law
ESG	Enviroment, Social and Governance
FSA	Financial Supervision Act
IFRS	International Financial Reporting Standards
ISC	China Securities Investor Service Center
MBCA	Model Business Corporation Act
NYSE	New York Stock Exchange
PRC	People’s Republic of China
RMB	Renminbi(Chinese currency)
SASAC	State-owned Assets Supervision and Administration Commission
SA	1933 Securities Act
SEA	1934 Securities Exchange Act
SEC	Securities Exchange Commission
SIPF	Securities Investor Protection Fund
SLUSA	Securities Litigation Uniform Standards Act of 1998
SOE	State-owned Enterprise
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
TFEU	Treaty on the Functioning of the European Union

Chapter 1 Introduction

Since the official establishment of the first stock exchange in 1990, the Chinese securities market has gone through fewer than three decades of development. In 2017, the Shanghai Stock Exchange ranked fifth and the Shenzhen Stock Exchange ranked eighth among the biggest stock exchanges in the world.[1] Despite its huge success, Chinese securities market also faces various challenges, in particular minority shareholder expropriation. As of April 2018, there were 138 million individual investors in China, and 95% of them were small-and-medium investors with a share capital of less than 500 thousand RMB(around $71,365).[2] These millions of investors' interests are closely related to the stability of the securities market. Yan Qingmin, vice president of the China Securities Regulatory Commission, announced that "investor protection, especially protection of small-and-medium investors, is the fundamental task of the Commission".[3] In the Chinese context, the disparity between the numbers and the powers of minority shareholders creates a risk of minority expropriations, which may further interrupt the stability and the growth of Chinese listed companies. Responding to this challenge, a comparative research of minority shareholder protection has both theoretical and practical values.

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[1] See: https://dollarsandsense.sg/10-biggest-stock-exchanges-world-heres-much-theyve-gained-2017/. Last visited February 2019.

[2] See: 投资者保护再添新渠道 (New Channel of Investor Protection), interpretation of policies, available at http://www.gov.cn/zhengce/2018-05/25/content_5293507.htm. Last visited February 2019.
According to Shanghai Stock Exchange's data, the percentage of market capital held by individual shareholders dropped from 48.3% in 2007 to 21.2% in 2017. It is estimated that individual shareholders own a higher percentage of market capital on the Shenzhen Stock Exchange than on the Shanghai Stock Exchange. However, the Shenzhen Stock Exchange does not disclose such specific data. See: 李立峰(Li Lifeng), 2018 年 A 股投资者结构全景图 (A Panorama of A Shares' Investor Structure in 2018), available at https://baijiahao.baidu.com/s?id=1621048711329385867&wfr=spider&for=pc. Last visited February 2019.

[3] Ibid.

1.1 The problem and its origins

Different from Western countries, listed companies in China are a relatively new concept, due to the country's past planned economy system of socialist public ownership. Before the 1978 reform of this system, private business was forbidden, and businessmen were morally condemned as opponents of the communist motto "property should belong to all rather than a small group of people". The 1978 "reform and opening-up" policy, started by Deng Xiaoping, gradually transformed such ways of thinking about private commercial activities, which had been in place since the establishment of the People's Republic of China (hereinafter PRC) in 1949. Progressively, the transition to a socialist market economy, initiated by the 1978 reform, brought about three main changes, which in turn made the emergence of listed companies possible in China.

The first change was the formation of the Chinese securities market, the process of which began in October 1984 when the *Decision on the Economic System Reform*[4] put into operation the shareholding system pilot project (股份制).[5] From this first pilot phase followed the establishment of both the Shanghai Stock Exchange (hereinafter SSE)[6] and the Shenzhen Stock Exchange (hereinafter SZSE)[7] in 1990. In 1993, the *Chinese Company Law*[8] made its debut, and the *Chinese Securities Law*[9] was later enacted in 1998. In 2002, the

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4 《中共中央关于经济体制改革的决定》 (Decision of the Central Committee of the Communist Party of China on Reforming the Economic System), issued by the Central Committee of the Communist Party of China, date of issue 20th October 1984.

5 Ma Qingquan (ed.), *History of Chinese Securities 1978-1998* (Beijing: Citic Publishing House, 2003), p. 35.

6 The Shanghai Stock Exchange (SSE) was founded on November 26th 1990 and started operating on December 19th of the same year. It is a membership institution directly governed by the China Securities Regulatory Commission (CSRC), available at http://english.sse.com.cn/aboutsse/sseoverview/brief/. Last visited February 2019.

7 The Shenzhen Stock Exchange (SZSE), which was found on 1st December 1990, is a self-regulated legal entity supervised by the China Securities Regulatory Commission (CSRC), available at http://www.szse.cn/main/en/AboutSZSE/SZSEOverview/. Last visited February 2019.

8 *Chinese Company Law* was originally promulgated by the Standing Committee of the National People's Congress on 29th December 1993, amended on 25th December 1999, amended on 28th February 2004, amended on 27th October 2005, amended on 28th December 2013 and amended on 26th October 2018. The latest version came into effect on 26th October 2018.

9 The *Chinese Securities Law* was originally promulgated by the Standing Committee of the National People's Congress on 29th December 1998, amended on 28th August 2004, on 27th October 2005, on 29th June 2013 and 31st August 2014. The latest amendment was on 28th December 2019 and will come into effect on 1st March 2020. This PhD thesis was conducted based on its then valid law, i.e. the 2014 *Chinese Securtities Law*. However, relevant updates of the 2020 amendment have been timely incorporated into this thesis.

China Securities Regulatory Commission (hereinafter CSRC)[10] issued the *Measures for the Administration of the Takeover of Listed Companies*.[11] It could be argued that from this moment, the basic foundations of the Chinese securities market were in place.

The second change refers to the reform of state-owned enterprises (hereinafter SOEs). State monopoly began to open up as a result of the “reform and opening-up” policy, as experimenting with a socialist market economy demanded the introduction of elements of privatisation and private economy.[12] As a result, SOE reform went through three phases. A first “enterprisation” phase (1979-1992) aimed at transforming SOEs into business entities, whilst a second “corporatisation” phase (1992-2002) attempted to convert SOEs into shareholding companies. A third “concentration” phase (since 2003-) has seen the state concentrating its exclusive control in several important industries, such as defence, petroleum, telecommunications and coal.[13]

The third change is the split share structure reform. After the establishment of the securities market and the aforementioned SOE reforms, the main remaining obstacle to the growth of listed companies in China was their split share structure, inherited from the previous system. Under this structure, shares in a Chinese listed company were divided into tradable and non-tradable shares,[14] the latter comprised both state shares and legal person

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[10] The China Securities Regulatory Commission (CSRC), a ministerial-level public institution under the direct control of the State Council, was established in October 1992 as the regulatory institution for the Chinese securities and futures market, available at http://www.csrc.gov.cn/pub/csrc_en/about/intro/200811/t20081130_67718.html. Last visited February 2019.

[11] *上市公司收购管理办法* (*Measures for the Administration on Acquisition of Listed Companies)* was originally promulgated by the China Securities Regulatory Commission on 28th September 2002, and it was appealed on 31st July 2006. The new legislation was passed on 17th May 2006, amended on 27th August 2008 and on 14th February 2012, with the latest amendment on 23rd October 2014.

[12] Kjeld Erik Brødsgaard and Xin Li, ‘SOE Reform in China: Past, Present and Future’, 31 (2014) *The Copenhagen Journal of Asian Studies*, pp. 54-78.

[13] Ibid.

[14] “Non-tradable shares” are shares that are not listed on the stock market, and their transfer requires official approval by the CSRC. The division of non-tradable and tradable shares in this research specifically refers to A shares. Shares in China mainly consist of five categories: A shares, which could only be originally purchased by Chinese citizens but can now be owned by foreigners under certain conditions; B shares (purchased with foreign currency),which used to be exclusively issued to foreign investors but can now be owned by Chinese citizens; H shares, which refer to shares listed on the Hong Kong exchange market; N shares, which refer to shares listed on the New York exchange, and, finally, S shares, which refer to shares listed on the Singapore exchange.

shares.[15] For the purposes of state control, non-tradable shares accounted for two-thirds of a listed firm's entire equity on average.[16] This split share structure triggered many problems in practice, such as an inactive securities market, conflicts of interest between holders of tradable and non-tradable shares and inefficient monitoring.[17] To solve these problems, a split share structure reform was launched in 2005 to transform non-tradable shares into tradable ones. It has been claimed that the reform was completed in 2007 and covered 98% of all Chinese listed companies.[18] Theoretically speaking, the former non-tradable shares became tradable after the reform. However, not all converted shares are currently listed on the stock exchange, for a company is free to decide how many will be circulated on the securities market.[19] The latest available data illustrate this situation: at the time of reporting, there were about 3792.89 billion (90.66%) tradable shares and 390.76 billion (9.34%) non-tradable shares on the SSE,[20] and about 1371.32 billion (75%) tradable shares and 454.92 billion (25%) non-tradable shares on the SZSE.[21]

Up to the end of 2018, there were 1450 listed companies on the SSE[22] and 2134 listed companies on the SZSE.[23]

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15 "State shares" are shares that are directly owned by the state or designated state organs. "Legal person" shares are normally shares indirectly owned by the state through SOEs.

16 Joyce, Lee Suet Lin, 'From Non-Tradable to Tradable Shares: Split Share Structure Reform of China's Listed Companies', 8 (2008) *Journal of Corporate Law Studies*, pp. 57-78.

17 Ibid.

18 Chen, Daisong, Legal Development in China's Securities Market during Three Decades of Reform and Opening-Up (2009), Asian Law Institute Working Paper Serious No.005, available at https://law.nus.edu.sg/asli/working_paper_d.aspx?sno=WPS005. Last visited February 2019.

19 In addition, to avoid price chaos on the market, converted shares (from non-tradable to tradable) suffer from the legislative restriction of various "lock-up periods".

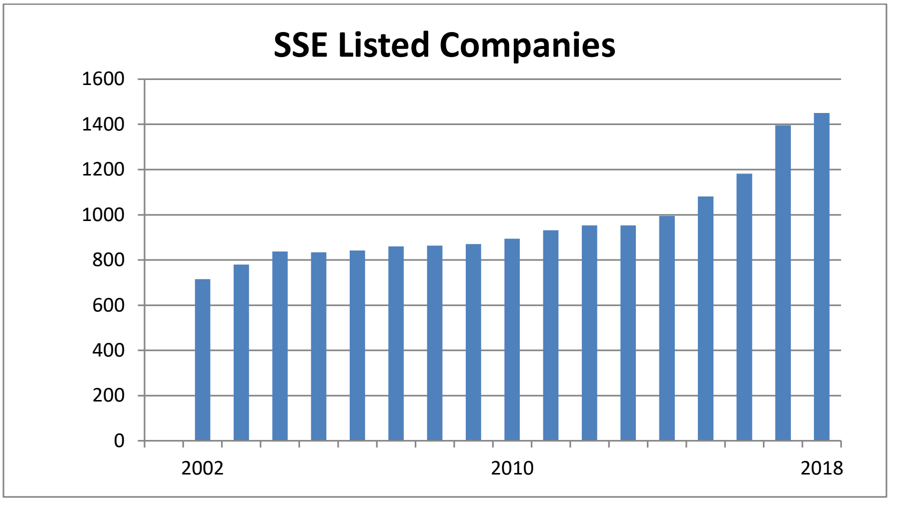
20 Data up to 31st October 2017, available at: http://www.sse.com.cn/market/stockdata/structure/overview/. Last visited November 2017.

21 Data up to 7th November 2017, available at: http://www.szse.cn/main/marketdata/tjsj/jbzb/. Last visited November 2017.

22 Shanghai Stock Exchange Statistics Annual 2019 (data up to the end of 2018), available at http://www.sse.com.cn/aboutus/publication/yearly/documents/c/tjnj_2019.pdf.pdf. Last visited August 2019.

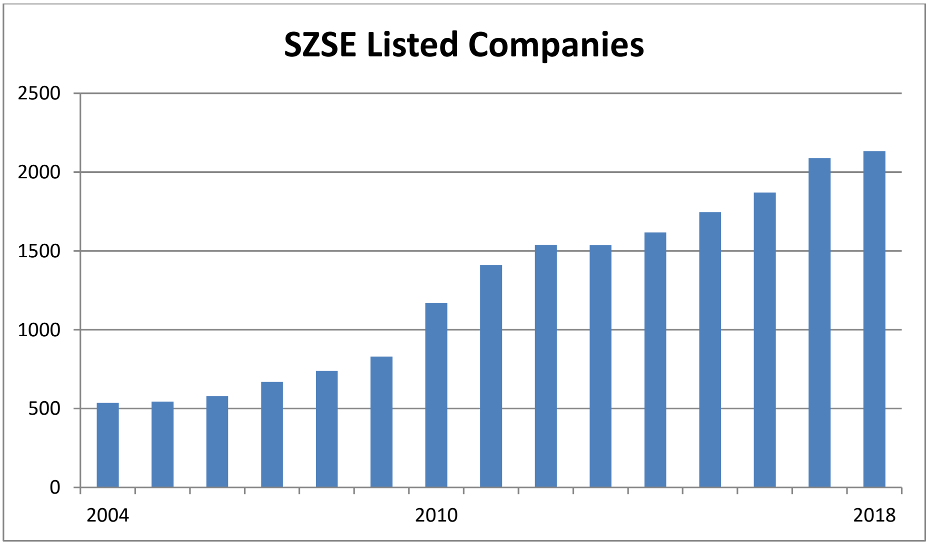
23 Data up to the end of 2018, see: http://www.szse.cn/market/subject/P020181228724258906714.pdf. Last visited August 2019.

Table 1.1 Numbers of Listed Companies on the SSE (2002-2018)



Source: Shanghai Stock Exchange Statistics Annuals[24]

Table 1.2 Numbers of Listed Companies on the SZSE (2004-2018)



Source: Shenzhen Stock Exchange Statistics[25]

Despite the reform, shares of Chinese listed companies remain highly concentrated in the hands of the state as the controlling shareholder.[26]

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[24] Shanghai Stock Exchange Statistics Annuals, available at http://www.sse.com.cn/aboutus/publication/yearly/. Last visited October 2019.

[25] Shenzhen Stock Exchange Statistics, available at http://www.szse.cn/market/subject/index.html. Last visited October 2019.

According to the latest SSE statistics, the top 10 companies with the largest tradable share values, and the top 10 companies with the largest market capitals, are all state-owned.[27] Moreover, in 2013, the capital value of state-owned listed companies accounted for 51.4% of the entire market capital at an amount of 13,710 billion RMB.[28] Moreover, the state has absolute control (more than 50% shares) in 33.33% of central state-owned listed companies[29] and in 28.15% of local state-owned listed companies.[30]

In contrast with this state dominance, there were 212.137 million individual accounts and 662,000 institution accounts on the SSE as of 2018.[31]

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[26] Junyeop Lee, State-Owned Enterprises in China: Reviewing the Evidence, OECD Working Group on Privatization and Corporate Governance of State Owned Assets Occasional Paper, available at http://www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/42095493.pdf. Last visited February 2019.

[27] China's largest market capital companies include: Industrial and Commercial Bank of China, China National Petroleum Corporation, Agricultural Bank of China, Bank of China, Kweichow Moutai Group, Ping'an Insurance, China Life Insurance, Sinopec Group, China Merchants Bank and Shanghai Pudong Development Bank. Data up to 8 November 2017, available at http://www.sse.com.cn/market/stockdata/marketvalue/. Last visited November 2017. A definition of "state-owned" can be found in section 1.5 of this chapter.

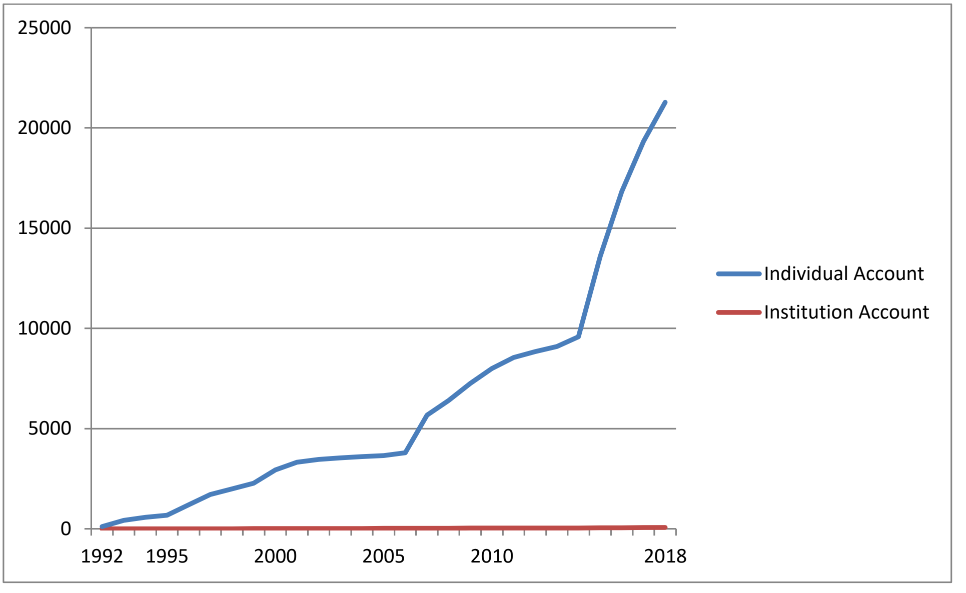
[28] According to information disclosed on 10th January 2013 at the state-owned assets supervision and administration meeting, there were 953 state-controlled listed companies at the end of 2012, which accounts for 38.5% of all the A shares listed companies. However, the capital value of the state-controlled listed companies occupied 51.4% of the entire market capital at 13,710 billion RMB. See: 全国国有资产监督管理工作会议(State-owned Assets Supervision and Administration Meeting), available at http://www.gov.cn/gzdt/2013-01/29/content_2321997.htm. Last visited February 2019. In addition, the amounts of shares of state-owned listed companies accounted for 68.35% of the entire A shares market at the end of 2013. See: Li Yongjun, 纵览国内上市公司股权结构 (An Overview of the Share Structure of Chinese Listed Companies), available at http://www.csteelnews.com/xwzx/djbd/201407/t20140728_250851.html. Last visited February 2019.

[29] Among central state-owned listed companies, 22.3% of companies with 40%-50% shares are owned by the biggest shareholder; 15% of companies whose controller held 30%-40% shares; 20.8% companies with 20%-30% shares dominated by the biggest shareholder; 8.3% companies with the biggest shareholder owned fewer than 20% shares. See: ibid.

[30] Among local state-owned listed companies, 18.92% companies with 40%-50% shares owned by the biggest shareholder; 21.85% companies whose controller held 30%-40% shares; 21.08% companies with 20%-30% shares dominated by the biggest shareholder; 10% companies with the biggest shareholder owned less than 20% shares. See: supra. 28..

[31] Data of Shareholder Accounts of the A shares up to 31 December 2018, Shanghai Stock Exchange Statistics Annual 2019, available at http://www.sse.com.cn/aboutus/publication/yearly/documents/c/tjnj_2019.pdf.pdf. Last visited October 2019.

Table 1.3 A-Shares Shareholder Account Numbers (10K)



Source: Shanghai Stock Exchange Statistics Annual 2019[32]

Given such large numbers of individual shareholders in a highly concentrated market, investor protection has become one of the prime concerns of the Chinese government. In fact, the notion of "strengthen the protection of investors, small investors in particular" has been promoted as a basic principle on the CSRC's official website.[33] In addition, in 2013, the State Council General Office issued an *Opinion on Further Enhancing the Protection of Legitimate Rights and Interests of Small and Medium-sized Investors in the Capital Market* (hereinafter *Small- and Medium-sized Investors Opinion*),[34] which puts minority shareholder protection into the spotlight. The *Small- and Medium-sized Investors Opinion* acknowledges that small and medium-sized investors (that is, minority shareholders) are the main participants in the Chinese capital market[35] and that they face huge risks of infringement due to their weak position in terms of information availability, anti-risk capability and

[32] Shanghai Stock Exchange Statistics Annual 2019, available at http://www.sse.com.cn/aboutus/publication/yearly/documents/c/tjnj_2019.pdf.pdf Last visited October 2019.
[33] 中国证券监督管理委员会 (China Securities Regulatory Commission), available at http://www.csrc.gov.cn/pub/csrc_en/. Last visited November 2017.
[34] *国务院办公厅关于进一步加强资本市场中小投资者合法权益保护工作的意见* (*Opinion on Further Enhancing the Protection of Legitimate Rights and Interests of Small- and Medium-sized Investors in the Capital Market*), the State Council General Office, date of issue December 27th 2013.
[35] Ibid.

self-protection. As a result, the *Opinion* sets objectives to improve their level of protection.[36]

1.2 Problem statement and research questions

Chinese economic reforms gradually gave rise to a special ownership structure, namely highly concentrated and dominated by the state. Generally speaking, a concentrated structure has both advantages and disadvantages. On the one hand, a controlling shareholder may have a positive influence on the company through enhanced monitoring. On the other hand, a controlling shareholder may seek private benefits at the expense of minority shareholders.[37] When the state is a controlling shareholder, minority shareholders may face different challenges.[38]

Various company scandals in China have demonstrated the dangers of minority expropriations. A notable example is that of Hou Wang (HW 猴王), a SZSE-listed company that produced welding materials and equipment. HW's ownership consisted of 37.84% state-owned shares, 25.92% legal person shares and 36.24% individual shares. Hou Wang Qi Ye (HWQY 猴王企业), a state-owned enterprise, was the controlling shareholder of HW. However, after listing HW, the controlling shareholder HWQY abused HW's listed status for direct funding and then redirected the raised money to help its subsidiaries (other SOEs).[39] Eventually, HW faced a financial loss of 67.7020 million RMB

[36] Supra. 34.

[37] Zheng Zhigang and Sun Juanjuan, '我国上市公司治理发展历史与现状评估(Historical Development of Corporate Governance of Chinese Listed Companies and Evaluation on the Present Situation)', 10 (2009) *金融研究* (*Journal of Financial Research*), pp. 118-132. See Chapter 2 of this research for further discussion.

[38] More discussion can be found in section 2.4 of Chapter 2.

[39] HWQY, the controlling shareholder, applied various approaches to the expropriation. First, it appropriated through bank loans; for example, 193.67 million RMB of HW's bank loans were under the control of HWQY. HW's assets were also used to provide guarantees for HWQY. Second, HWQY successfully embezzled 930.54 million RMB from HW through related-party transactions. For instance, HW tried to take over 11 subsidiaries from HWQY with a transaction price which equated to the overdue debts that HWQY owed to HW. At the same time, renting contracts had been signed between the two parties so that the 11 subsidiaries were still under the control of HWQY. As a result, HW was declared bankrupt in 2002. See: Liao Li (ed.), *公司治理与独立董事案例* (*Cases on Corporate Governance and Independent Directors*) (Beijing: Qinghua Daxue Chubanshe, 2003), p. 172.

and subsequent bankruptcy. This incident caused great losses to the company, particularly to its individual investors.[40]

In another well-known case, Zhengzhou Baiwen (ZBW 郑州百文), which started in stationary wholesale, went from being a successful state-owned listed company during the SOE reform to a complete failure with more than 1.5 billion RMB losses and 2.5 billion RMB overdue bank loans. Reporters' investigations revealed that the ZBW "legend" was nothing but balance sheet manipulation and fraudulent financial accounting. In spite of its excessive debts, however, ZBW was very generous to its managers, and many of those in senior positions sat on private fortunes of more than a million or even 10 million RMB. Even a manager from one of ZBW's local branches possessed luxury cars worth millions, as well as luxury villas. In this case, too, ZBW's minority shareholders' economic interests were severely damaged.[41]

Different from the two cases just mentioned, the Zhong Ke Chuang Ye (ZKCY 中科创业) stock manipulation case happened in a non-state-owned listed company that produced fodder and raised chickens. Lv Liang (LL 吕梁), after becoming the de facto controller of ZKCY, successfully appointed seven out of 11 members of the board of directors during a re-election.[42] By establishing a "Zhong Ke" group with other listed companies, LL manipulated ZKCY's share price through mutual guarantees among listed companies, bank loans and other capital accumulation approaches. Unsurprisingly, this "artificial" share price could not last for long, and so ten months later, it dropped dramatically and two-thirds of ZKCY's assets were lost.[43] As a result, countless individual investors suffered great losses, due to the stock manipulation of the company controller.

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[40] Liao Li (ed.), *公司治理与独立董事案例* (*Cases on Corporate Governance and Independent Directors*) (Beijing: Qinghua Daxue Chubanshe, 2003), p. 172.

[41] A bankruptcy lawsuit of ZBW was filed at court in 2000. Xie Dengke, 郑百文：假典型巨额亏空的背后 (Zheng Baiwen: Behind the Fraudulent Financial Losses), available at http://www.people.com.cn/GB/channel3/24/20001030/292544.html.
Also available at http://finance.qq.com/zt2010/zbw/. Last visited February 2019.

[42] Zhang Xudong, 崩裂的 54 亿元资金链-中科创股价事件始末 (The Broken Capital Chain of 5.4 Billion Yuan-Details of the Zhong Ke Chuang Share Price Incident), available at http://www.people.com.cn/GB/paper2086/7316/704942.html. Last visited February 2019.

[43] In 2002, the Beijing Intermediate People's Court opened a hearing into the ZKCY case. 中科创业股票操纵案 (Zhongke venture stock manipulation case), available at http://baike.baidu.com/view/11579443.html. Last visited February 2019.

These scandals vividly depict the typical conflicts of interest in Chinese listed companies, namely between the state as the controlling shareholder and minority shareholders, between management and minority shareholders and between private controlling shareholders and minority shareholders. The first two scandals emerged in the context of state-owned listed companies. The HW case has shown that the state controller may inflict heavy damage on minority shareholders by misappropriating the assets of a listed company for other SOEs. The ZBW case demonstrates that without proper monitoring of the state controller, managers can easily abuse their management powers and place minority shareholders into great danger. In the third case, the ZKCY scandal illustrates the conflict which may arise between a private controller and minority shareholders.

Accordingly, this research will explore and answer the following key question: how could minority shareholder protection in Chinese listed companies be improved in comparison to that in the US and the Dutch systems?

To answer the main research question, four sub-research questions are raised.

First, how are minority shareholders protected by shareholder rights according to the law in China, the US and the Netherlands?

Second, how are minority shareholders protected by monitoring mechanisms, focusing on disclosure and independence, in China, the US and the Netherlands?

Third, how are minority shareholders protected in takeovers, especially by courts, in China, the US and the Netherlands?

Fourth, what can China learn from the US and the Netherlands to improve minority shareholder protection in Chinese listed companies?

1.3 Methodology

This research mainly builds on the comparative methodology, which consists of six typical methods.[44] The functional method pinpoints two elements of a shared societal problem and legal solutions in different jurisdictions, in order to seek better solutions.[45] The analytical method intends to identify

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[44] Mark van Hoecke, 'Methodology of Comparative Legal Research', 12 (2015) *Law and Method*, pp. 1-35.
[45] Konrad Zweigert and Hein Kötz, *Introduction to comparative law* (Oxford: Clarendon Press, 1998), p. 15.

similarities and differences by analysing legal concepts and rules in different jurisdictions and by evaluating these concepts and rules based on “ideal types”.[46] The historical method underlines how a nation’s past background shapes its law and explains how historical roots are related to the similarities and differences among different legal systems.[47] The structural method provides an approach whereby the researcher inspects an observed phenomenon through its hidden structures, which can be systematically related or simply interrelated.[48] The law-in-context method broadens the examination to cover also social reality, legal context, institutional context, implied patterns and other implicit factors.[49] The common core method attempts to name commonalities of solutions within a certain area and amongst various jurisdictions, and to discuss the possibility of harmonisation.[50]

These methods are not strictly separated from each other, but they do correlate with one another. Applying the functional method, this research targets the problem of minority shareholder expropriation and examines solutions provided in three different jurisdictions. In order to achieve this goal, the work draws on the experiences of two other countries, namely the US and the Netherlands, to make proposals which could improve the protection of minority shareholders in Chinese listed companies. The US has been selected for this comparison for two main reasons: first, *Chinese Company Law* has absorbed many legal rules from the US model, and second, US corporate law, specifically Delaware corporate law, is currently one of the most advanced systems in the world.

Although not holding the same primacy as the US, the case of the Netherlands has been selected for its growing “attractiveness” to foreign listed companies that increasingly decide to relocate to the country, due to the favourable business environment put in place by Dutch corporate law. It has been further reported that the Dutch securities market seems to become more “concentrated”.[51] These recent developments make the Netherlands an

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46 Mark van Hoecke, ‘Methodology of Comparative Legal Research’, 12 (2015) *Law and Method*, pp. 1-35.
47 Ibid.
48 Geoffrey Samuel, *An Introduction to Comparative Law Theory and Method* (Oxford: Hart Publishing: 2014), pp. 81-82.
49 Supra. 46.
50 Ibid.
51 Eumedion, ‘Position of Minority Shareholders in Companies with A Controlling Shareholder’, available at https://www.eumedion.nl/en/public/knowledgenetwork/position-papers/2016-06-position-paper-minority-shareholders-final-version.pdf. Last visited February 2019.

interesting case for a comparison with China. Besides, since this PhD research is conducted in the Netherlands, the practical concern is one of the reasons behind the choice.

Applying the structural method, this research employs the principal-agent cost as well as the principal-principal cost[52] as structures through which to analyse the phenomenon of minority shareholder expropriation. Specifically, conflicts of interest are investigated by following the rights of the principal and monitoring of the agent structures, to explain and assess how a country's corporate governance system balances the power between the "principal" and the "agent".

Applying the analytical method, this research focuses on both first and secondary legal sources, and thus legislation, case law, legal and economic research and commentaries. The main Chinese legal sources of investigation include the *Chinese Company Law*, the *Chinese Securities Law* and the *Chinese Corporate Governance Code*. The main US legal sources encompass federal securities regulations and Delaware state corporate law (both statutory and case law), while the main Dutch legal sources cover the *Dutch Civil Code*, the *Dutch Corporate Governance Code*, the *Financial Supervision Act* and Dutch case law.

These legal sources provide the foundations on which to conduct "doctrinal" legal analysis. Despite the absence of a universal definition, three essential characteristics of doctrinal legal analysis are summarised herein: first, arguments are based on authoritative sources, such as legislation, case law and academic publications, second, the law is examined as a coherent system and third, discretion in individual cases should be limited by the consistency of the system.[53] By applying doctrinal legal analysis with a broad scope, this research mainly examines legal sources of statutory laws, case laws and legal studies, but it also refers to other relevant sources, such as statistics, surveys, empirical research, economic research and social scientific evidence, to deepen its understanding on the research subject.

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[52] The traditional understanding of the principal-agent cost refers to the conflicts of interest between shareholders and management, while the principal-principal cost refers to the conflicts of interest between minority shareholders and the controlling shareholder. More details can be found in Chapter 2.

[53] Namely, judges' interpretation of law in a case-by-case analysis should be bounded by precedents and should be consistent with the legal system. See: Rob Van Gestel and Hans-W. Micklitz, 'Revitalizing Doctrinal Legal Research in Europe: What About Methodology?' 5 (2011) EUI Working Papers, available at http://cadmus.eui.eu/handle/1814/16825. Last visited February 2019.

By inspecting the legislations of the three studied countries, the research first individuates how each country's company law designs the power between the principal and the agent. Second, the research examines how monitoring mechanisms of disclosure and supervision are deployed in each country to even out the power discrepancy between the principal and the agent. Third, the research maps out the judicial remedies in place to protect minority shareholders in mergers and acquisitions in each selected country. Applying the law-in-context method, this thesis pays particular attention to the implementation and practical effects of legal measures in each of the selected countries by drawing on secondary academic sources, such as legal, economic and empirical studies.

These methodologies and comparative approaches allow this thesis to contribute to existing research in at least three fundamental ways. First, the subjects of comparison connect three key countries that represent common law, European continental civil law and East Asian civil law. Second, and different from most of the legal research on minority shareholder protection, which focuses on one specific minority-friendly legal rule or one particular area, this thesis endeavours to explore protection that could be provided to minority shareholders by establishing a balanced corporate governance system in China. Third, through comparisons, this thesis strives to analyse the discrepancy between law in the books and law in action in China and further make recommendations to meet the practical need of consolidating corporate governance with Chinese characteristics. However, also due to its design, this thesis unavoidably has some limitations; for instance, the compared countries have different legal and institutional contexts, the comparison structures make it impossible to cover all details, the evidence of law in action mainly relies on secondary legal sources and the study of Dutch law is primarily based on English-language sources.

1.4 Structure of the research

This work consists of seven chapters. The first chapter presents the problem statement, research questions, methodologies, the research structure and key notions of the research. The second chapter begins with an introduction to the agency theory, ownership structure and legal strategies for minority shareholder protection, as well as how these theories play out in the context of minority shareholder protection in China. The third chapter discusses minority shareholder protection in Chinese listed companies from the perspectives of shareholder rights, disclosure, supervision and judicial remedy in mergers and acquisitions. The fourth chapter follows a similar structure to analyse minority shareholder protection in the US, and likewise, the fifth chapter provides an outline of the Dutch legal context on the subject of protection of minority shareholders.

Drawing on the detailed and descriptive analyses of the previous chapters, the sixth chapter summarises and discusses the outcomes of the thesis' comparative account on how the law protects minority shareholders in China, the US and the Netherlands. Subsequently, the chapter draws on such analyses to elaborate a list of proposals relating to minority shareholder protection in the Chinese context. The findings of this work are discussed in the light of China's differences and similarities with the US and Dutch contexts. The last chapter summarises and concludes the research.

1.5 Key concepts of the research

This thesis defines the main concepts as follows, in order to smooth out the process of comparison.

There are two types of companies in China, namely the limited liability company and the company limited by shares (also known as the "joint stock" company).[54] Of the two, only the company limited by shares, whose stocks are listed and traded on a securities exchange, is qualified to become a listed company.[55] The "Chinese listed companies" in this research refer to companies which are established according to the *Chinese Company Law* and

[54] Article 2, *Chinese Company Law*.

[55] Article 120, *Chinese Company Law*. Concerning shares of Chinese listed companies, generally two types of shares, namely A shares and B shares, are listed on the SSE and the SZSE. With the establishment of the 'Shanghai-Hong Kong Stock Interconnection' on November 17th 2014, it is now possible for certain H shares to be traded through the SSE. Specifically, A shares refers to shares issued by Chinese listed companies, denominated in, subscribed for and traded in RMBs, and B shares covers shares denominated in RMBs but subscribed for and traded in foreign currencies. H shares refer to shares of Chinese companies that are listed on the Hong Kong exchange.

listed on either the SSE or the SZSE pursuant to the *Chinese Securities Law*, stock exchange regulations and other related rules.[56]

Furthermore, this research divides Chinese listed companies into state-owned listed companies and non-state-owned listed companies. Before going into detail, it is necessary to clarify related notions from the outset. Though expressions such as "state-owned enterprises" (SOEs) and "state-owned companies" (SOCs) have been widely used, there is no uniform legal definition regarding either of these concepts. In fact, the meanings of these concepts in different legislations are still a matter of debate. The narrow interpretation exclusively limits the concept of "a state-owned company" to "a wholly state-owned company".[57] The medium definition extends "state-owned companies" to also include the "absolute state control", in which the state holds more than 50% of the company shares.[58] The broad definition covers both "absolute control", with a 50% or a more than 50% shareholding, and "relative control", with a less than 50% shareholding but with the possibility to impose a material influence on the general meeting through voting rights.[59] Specifically, the controlling right of a listed company has been defined by any of the following five situations: absolute control with more than 50% shares, actual control of more than 30% of voting rights, the possibility to elect more than half of the directors through his or her actual control of voting rights, the possibility to exert significant influence on the general meeting through the actual control of voting rights and any situation recognised by the CSRC.[60]

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[56] The concept of 'listed companies' in this research only refers to companies that are listed in the country of incorporation.

[57] *最高人民法院关于如何认定国有控股、参股股份有限公司中的国有公司、企业人员的解释* (*Interpretation of the Supreme People's Court on the Identification of Employees of State-Owned Companies or Enterprises at Companies in Which the State Has a Controlling or Non-controlling Stake*), Supreme People's Court, date of issue August 1st 2005.
Similarly, the OECD working paper also adopts the narrow definition of 'state-owned enterprises', which only refers to "wholly state-funded firms". See: Junyeop Lee, 'State Owned Enterprises in China: Reviewing the Evidence', OECD Working Group on Privatization and Corporate Governance of State-Owned Assets Occasional Paper, available at
http://www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/42095493.pdf. Last visited February 2019.

[58] *财政部关于国有企业认定问题有关意见的函* (*Opinions of the Ministry of Finance on the Determination of State-owned Enterprises*), Ministry of Finance, date of issue April 23rd 2003.

[59] Article 216, *Chinese Company Law*.

[60] Article 84, *上市公司收购管理办法* (*The Administrative Measures for the Takeover of Listed Companies*), was enacted by the China Securities Regulatory Commission on 17th May 2006, subsequently amended on 27th August 2008, 14th February 2012 and most recently on 23rd October 2014.

This research follows the broad definition of both absolute and relative control, i.e. a controlling shareholder is someone who owns 50% or more shares, or who owns fewer than 50% shares but in fact dominates more than 30% voting rights, or in fact elects more than half of the board, or is capable to significantly impact the general meeting or fits into other situations determined by the CSRC. Subsequently, the term “state-owned listed companies” in this research equates to “state-controlled listed companies”, i.e. a listed company that is under the absolute or relative control of the state.[61] Moreover, the state shareholder can be represented by the State Council, local government, the state-owned assets supervision and administration bodies under the State Council or local governments, departments or bodies authorised by the State Council or local governments, wholly state-owned enterprises, or a limited liability company or company limited by shares whose investors are all wholly state-owned enterprises, or a limited liability company or company limited by shares[62] and which is controlled by the state.[63]

Likewise, existing Chinese legislation does not provide an explicit concept of minority shareholders, and there is no special international definition for small- and medium-sized investors. The classification of investors is mainly based on the needs of regulatory supervision and market risk management.[64] As opposed to the legislative definition of “controlling shareholders”,[65] “minority shareholders” in this research refer to “non-controlling shareholders”

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[61] Correspondingly, “non-state-owned listed companies” is the opposite of “state-owned listed companies”, i.e. a listed company that is not under the absolute or relative control of the state.
[62] Includes companies limited by shares that are listed on the stock exchange, i.e. listed companies.
[63] See: Article 4 and Article 11, *中华人民共和国企业国有资产法* (*Law of the People's Republic of China on the State-Owned Assets of Enterprises*), Standing Committee of the National People's Congress, date of issue October 28th 2008.
《关于施行〈上市公司国有股东标识管理暂行规定〉有关问题的函》(*Letter on Related Issues regarding Implementation of the Provisional Regulation on Management of State-owned Shareholder Indication of Listed Companies*), State-owned Assets Supervision and Administration Commission of the State Council, date of issue March 4th 2008.
Accordingly, the state-owned listed company can be categorised as a “central state-owned listed company” and a “local state-owned listed company”, depending on whether the role of the contributor is performed by the state council or local government.
[64] Bearing Protection of the Legitimate Rights and Interests of Small- and Medium-sized Investors in Mind when Implementing Regulatory Activities-Speech by Chairman Xiao Gang at the CSRC’s Working Conference on the Protection of Small- and Medium-sized Investors (January 6, 2014), available at http://www.csrc.gov.cn/pub/csrc_en/Informations/phgall/201402/t20140211_243678.html. Last visited February 2019.
[65] Article 216, *Chinese Company Law*.
Article 84,*上市公司收购管理办法* (*The Administrative Measures for the Takeover of Listed Companies*), was enacted by the China Securities Regulatory Commission on 17th May 2006, subsequently amended on 27th August 2008, 14th February 2012 and most recently on 23rd October 2014.

i.e. a shareholder who is incapable of exercising any form of company control. Normally, a Chinese listed company's capital aligns with its control,[66] and a minority shareholder owns a small or medium amount of shares. Exceptionally, when a shareholder with only a small or medium amount of shares can in fact dominate with more than 30% voting rights, or in fact elects more than half of the board, or in fact has a big influence on the general meeting or is found by the CSRC to be the company controller, this shareholder is not regarded as a minority but a controlling shareholder. Moreover, this research divides minority shareholders into "retail minority shareholders", also be known as "individual minority shareholders", and "qualified minority shareholders", also known as "relatively big minority shareholders", i.e. they may either individually or jointly exert certain influence on the company.

[66] Article 103 of the *Chinese Company Law* follows the "one share, one vote" principle

Chapter 2 Theoretical Chapter

2.1 Introduction

Minority shareholders, due to their weak positions, face a high risk of expropriation in many circumstances. In modern companies, the infringement of minority shareholders' rights is no longer a simple issue that involves only minority interests. As a matter of fact, insufficient minority shareholder protection distorts the investor-company relationship and also discourages external financing from the securities market.

As an emerging challenge for modern companies, minority shareholder expropriation has drawn substantial academic attention. Particularly in the field of corporate governance, some of the literature appears to agree on the need to strengthen minority shareholder protection. To address this issue, existing studies have often applied the theoretical "agency costs" framework[67] to analyse conflicts of interest in listed companies. Another recurring theme in the literature is the interconnectedness of a country's ownership structure and the situation of minority shareholder protection.[68] Based on such insights, scholars have also proposed various legal strategies for minority shareholder protection.[69] This chapter's main aim is to review these works, in order to

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[67] The "separation of ownership and control" concept was introduced by Berle and Mean, while "agency cost" caused by the separation of ownership and control was elaborated by Jensen and Meckling. Subsequently, agency costs have been widely used in the literature to analyse the conflicts of interest that exist in a modern company. This theory will be explored in more detail later in this chapter. See: Adolf Augustus Berle, and Gardiner Coit Means, *The Modern Corporation and Private Property* (Transaction Publishers, 1991), pp. 10-18; Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', 3 (1976) *Journal of Financial Economics*, pp. 305-360.

[68] See for example Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Shleifer, 'Corporate Ownership around the World', 54 (1999) *Journal of Finance*, pp. 471-517.

[69] See for example Reiner Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Mariana Pargendler, Wolf-Georg Ringe and Edward Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press, 2017), pp. 29-37.

build a theoretical framework with which to understand a comparative investigation of minority shareholder protection in China, the US and the Netherlands. This chapter will examine the existing literature from four angles, starting with a discussion on the agency cost framework, which unfolds conflicts of interest between both the principal and the agent, and between the principal and the principal. Second, it will provide an overview of the main theories in use, to explain the dynamics at play in matters of minority shareholder protection: the legal origin theory, the path dependence theory, the political determinant theory, the minority expropriation theory, the optimal reward theory and the idiosyncratic vision theory. Third, it will review the existing literature and summarise different legal strategies for the principal-agent and the principal-principal conflicts. Since these theories and literature are mainly based on evidence from the Western context, the fourth part of this chapter will focus on how these theories can apply to the case of minority shareholder protection in Chinese listed companies.

2.2 Agency costs

The notion of agency cost, generally understood as the agent pursuing its own interests at the expense of the principal, has been applied in the academic literature to corporate governance. Three types of agency costs in modern companies are normally discussed: the first type occurs between shareholders and management, type two is between controlling and minority shareholders and type three is between the company and other stakeholders. Due to its focus on minority shareholder protection, this chapter will only discuss the first two types of agency cost, i.e. the "principal-agent" and the "principal-principal".

The "principal-agent" cost refers to the conflicts of interest between shareholders and management. Berle and Mean first elucidated that with the development of modern companies, especially dispersed listed companies, it has become impractical to submit every company decision to a general meeting, which consists of hundreds and thousands of shareholders. As a

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Marina Martynova and Luc Renneboog, 'A Corporate Governance Index: Convergence and Diversity of National Corporate Governance Regulations', CentER Discussion Paper Series No. 2010-17; TILEC Discussion Pare No. 2010-012, available at http://ssrn.com/abstract=1557627. Last visited February 2019.

solution, in modern companies, shareholders' controlling powers are devolved to the board of directors. In turn, the board, as the "agent", is tasked with serving the interests of the "principal", i.e. the shareholders. The effect of this "division of powers" is a "separation of ownership and control".[70]

Jensen and Meckling's work further elaborates on the agency cost.[71] As their argument goes, if a manager enjoys 100% ownership of a company, he or she has no incentive to conduct an expropriation considering the alignment of personal and company interests. However, if the manager transfers part of his or her shares to outside investors, then he or she will have to share the company's interests with others. The act of sharing ownership with other shareholders may give rise to a conflict of interest between the manager and outside investors. Due to such conflicts of interest, the agency cost between the management and the shareholders will consequently grow.[72]

Based on their observations of US practices, Baums and Scott show how a principal-agent cost can be imposed in a direct manner, such as embezzlement and misappropriation, or in a less direct manner, such as self-dealing, excessive management compensation and the appropriation of company opportunities.[73] The authors note that among all of these indirect ways of imposing a principal-agent cost, self-dealing is the most significant example in the US.[74]

In contrast, a concentrated ownership structure breeds a "conflicts of interest" between controlling and minority shareholders. The company controller may pursue what have been defined as "private benefits of control", understood as those parts of interests that are exclusively enjoyed by the controlling shareholder at the expense of minority shareholders.[75] Academic studies have illustrated the significance of this "principal-principal" cost owing to the prevalence of the concentrated ownership structure. Sampling on large companies from 27 wealthy countries, La Porta et al. demonstrated, for

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[70] Adolf Augustus Berle and Gardiner Coit Means, *The Modern Corporation and Private Property* (Transaction Publishers, 1991), pp. 10-18.
[71] Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', 3 (1976) *Journal of Financial Economics*, pp. 305-360.
[72] Ibid.
[73] Theodor Baums and Kenneth E. Scott, 'Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany', 53 (2005) *American Journal of Comparative Law*, pp. 31-75.
[74] Ibid.
[75] Alexander Dyck and Luigi Zingales, 'Private Benefits of Control: An International Comparison', 59 (2004) *The Journal of Finance*, pp. 537-600.

example, that widely-held companies often exist in countries with advanced shareholder protection, while concentrated ownership structure is more popular in the rest of the world.[76] Shleifer and Vishny confirm this worldwide prevalance of large shareholders.[77] In practice, controlling-minority expropriation can be conducted in various ways. Wolfenzon, for instance, shows how a pyramid management structure is usually correlated with weak shareholder protection,[78] and apart from a pyramid structure, La Porta et al. illustrate other devices for expropriation: management appointment manipulation, cross-ownership and dual-class shares.[79] Johnson et al. draw attention to the tunnelling that is carried out through methods such as related-party transactions, the expropriation of company opportunities, loan guarantees and the dilution of minority shareholdings.[80]

What crucially emerges from the abovementioned scholarship is that different structures of ownership may entail different agency cost problems related to minority shareholder protection. These differences may also entail different solutions for the protection of minority shareholders. The next section will elaborate on this matter and attempt to identify those factors which may influence the effectiveness of minority shareholder protection. As will be further seen, such strategies very much vary across different countries.

2.3 Theories on and strategies of shareholder protection

A number of academic studies have tried to map the elements influencing shareholder protection in different contexts. In 1989, Eisenhardt evaluated the

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[76] Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Shleifer, 'Corporate Ownership around the World', 54 (1999) *Journal of Finance*, pp. 471-517.

[77] Andrei Shleifer and Robert W. Vishny, 'Large Shareholders and Corporate Control', 94 (1986) *Journal of Political Economy*, pp. 461-488.

[78] Daniel Wolfenzon, 'A Theory of Pyramidal Ownership', Unpublished Working Paper, Harvard University Press: Cambridge, MA (1999), available at https://pdfs.semanticscholar.org/f60d/6eff454e77461370946d733c8479c6f49b85.pdf. Last visited February 2019.

[79] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, 'Law and Finance', 106 (1998) *Journal of Political Economy*, pp. 1113-1155.

[80] Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'Tunneling', 90 (2000) *The American Economic Review*, pp. 22-27.
More discussion on tunelling can be found in section 2.4 of this chapter.

agency theory and confirmed its value in analysing the corporate principal-agent issue.[81]

Based on their survey of various corporate governance mechanisms, Shleifer and Vishny identified two essential approaches in corporate governance across their surveyed countries.[82] The "extra care" approach refers to the existence of legal protection that empowers shareholders, while the "self-strengthening" approach, which could resemble a "self-help" method employed by shareholders, is instead characterised by ownership concentration.[83] According to such a method, shareholders endeavour to accumulate their shares in order to achieve larger shareholdings, from which they strengthen their control over the company. The evident advantage of shareholding concentration is that large or controlling shareholders have the incentive to collect information, in order to monitor management, and the controlling power to make a difference. Shleifer and Vishny further clarify that the concentration of shareholding is never a one-sided story, and despite the benefits of better monitoring, ownership concentration may in fact create greater risks of minority shareholder expropriation.[84]

Scholars have further tried to establish the basis of these two different approaches in the world of corporate governance. According to a study by La Porta et al., ownership structure is one of the most important factors behind shareholder protection discrepancies in different countries. This issue is addressed by their so called "legal origin theory".[85] Based on the observation

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[81] Eisenhardt raises 10 propositions, mainly from five aspects, to apply behaviour-based or outcome-based contracts to regulate agency costs. In a nutshell: (1) an outcome-based contract is more efficient in regulating agents' actions; (2) second, the information system plays a significant role in regulating the agent, namely the more well-informed the principal, the better the agent behaves. And the information strategy works better in behaviour-based contracts; (3) if the outcome is difficult to predict, then the behaviour-based contract is more popular. Similarly, if the task is easy to program, then the behaviour contract prevails; (4) an outcome-based contract can transfer risks to the agent, and it may be adopted in less agent-risk-aversion situations and (5) if the principal-agent relationship is a short-term one, then an outcome-based contract is more beneficial to protect the principal from opportunistic agent.
See: Kathleen M. Eisenhardt, 'Agency Theory: An Assessment and Review', 14 (1989) *Academy of Management Review*, pp. 57-74.

[82] Andrei Shleifer and Robert W Vishny, 'A Survey of Corporate Governance', 52 (1997) *Journal of Finance*, pp. 737-783.

[83] It is clarified here that the terms "extra care" and "self-strengthening" were adopted by this research in order to provide a clear explanation. Shleifer and Vishny's research merely mentioned the two approaches to the legal protection of investors and ownership concentration.

[84] Supra. 82.

[85] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, 'Law and Finance', 106 (1998) *Journal of Political Economy*, pp. 1113-1155.

of different ownership structures, the authors argue that there exists a negative relationship between concentrated ownership and investor protection.[86] Their idea is that in a poorly protected environment, large shareholders are able to shield themselves from managerial costs by accumulating shares. This accumulation of shares directly contributes to the formation of concentrated ownership. Meanwhile, minority shareholders are either unwilling to purchase shares, considering the high expropriation risk, or only purchase when the cost is low. As a result, companies have fewer incentives to issue new shares. In turn, this inactive issuance of new shares indirectly strengthens the concentrated ownership structure. Namely, concentrated ownership becomes the market's plan B in confronting the failure of shareholder protection law.[87]

In a subsequent study, the same authors illustrate how the concentration structure further increases the difficulties of legal reform. First of all, controlling shareholders are very cautious about the sale of shares and will do everything to guarantee the control of the company out of fear of becoming a minority shareholder and being exploited. Second, the private benefits of control constitute a substantial part of the entire fortune of a controlling shareholder. Unsurprisingly, the controllers reject any reform to enhance minority shareholder rights.[88] In this context, a "minority expropriation theory" has been proposed by Goshen and Hamdani to describe the controlling shareholder as the expropriator seeking private benefits of control at the expense of minority shareholders.[89] Normally, senior managers are affiliated to the controlling shareholder, and they also have the power and incentives to exploit minority shareholders.[90]

La Porta et al. conducted an empirical study on listed companies in 49 countries and found that common law countries have the most investor-friendly laws, German and Scandinavian civil law countries rank in between, while French civil law countries provide the least protection. However, when it comes to enforcement, the order was moderately changed, i.e. the German and Scandinavian civil law countries ranked the first, followed by the common law countries, and the French civil law countries still remained at the bottom.

[86] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, 'Law and Finance', 106 (1998) *Journal of Political Economy*, pp. 1113-1155.

[87] Ibid.

[88] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'Corporate Ownership around the World', 54 (1999) *Journal of Finance*, pp. 471-517.

[89] Zohar Goshen and Assaf Hamdani, 'Corporate Control and Idiosyncratic Vision', 125 (2016) *Yale Law Journa*l, pp. 560-617.

[90] Supra. 88.

By comparing common law countries with civil law countries, the advocates of the "legal origin theory"[91] find that the former provides better legal protection to their shareholders than the latter. Legal traditions determine the different approaches chosen by either legal system. When it comes to problem-solving, common law countries are found to prefer a "market-oriented" approach under judicial supervision, while civil law countries tend to emphasise the role of the government. According to the legal origin theory, this distinction has led to opposing results, in that government-influenced ownership and regulation in civil law origin are negatively related to market performance and cause side-effects such as corruption, unemployment and an immature economy. In contrast, the judicial system of a common law country, entailing less procedural formalism and higher independence, is the origin of better property protection and more efficient contract enforcement, each of which supports the functioning of the market-oriented approach.[92] Instruments such as "private contracting, market discipline and standardized disclosure", as well as "market-friendly" liability standards and better-founded private litigation systems, further contribute to the success of the market-oriented approach in common law countries.[93] Compared with strong government interference, extensive disclosure obligations and clear liability standards result in the better protection of minority shareholders.[94]

For advocates of the legal origin theory, the solution for the better protection of minority shareholders lies in three fundamental matters: disclosure, liability standards and anti-director rights.[95] More specifically, for La Porta et al. the prospectus disclosure should uncover management compensation, insider ownership, irregular contracts and related-party transactions. The authors recommend that the name and the shareholding of a large shareholder who holds more than 10% voting shares should be revealed to the public. They also identify three-level liability standards relating to misleading statements in a prospectus. The "friendliest" standard only requires shareholders to demonstrate the existence of any misleading statements, while the medium

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[91] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'The Economic Consequences of Legal Origins', 46 (2008) *Journal of Economic Literature*, pp. 285-332.
[92] Ibid.
[93] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'What Works in Securities Laws?', 61 (2006) *Journal of Finance*, pp. 1-32.
[94] Empirical evidences have proven that disclosure and liability standards are positively related to developed financial markets. See: ibid.
[95] Supra. 93.

standard additionally commands shareholders to prove their reliance on misleading information and the causation between the damage and the misleading information. The strictest standard, over and above the medium one, also entails director negligence. Last, based on a previous study,[96] La Porta et al. propose an anti-director index, which should consist of "proxy voting, no deposition of shares before the general meeting, cumulative voting or proportional minority representation on the board of directors, remedial mechanisms of oppressed minority shareholders, the right to call for an extraordinary shareholder meeting with less than or equal to 10% shares, a pre-emptive right that only can be abandoned by shareholders themselves".[97]

Addressing the same aim of reducing the principal-agent cost, based on empirical observation, Kraakman et. al mapped five strategies.[98] First, the "decision right strategy" authorises the principal to introduce proposals to the board of directors, intervene in decisions made by the board of directors and ratify managerial decisions in certain circumstances. Second, the "appointment right strategy" advocates legal instruments such as cumulative voting and mandatory minority shareholder representation on the board of directors. Third, the "trusteeship strategy" emphasises the participation of independent trustees, such as independent directors. Fourth, the "transparency strategy" aims at reducing information asymmetry by imposing specific disclosure obligations on the agent, particularly in related-party transactions. Last, the "affiliation strategy" calls for a fair entry and exit for the principal, such as the appraisal right.[99]

Moving on from this five strategies model, Martynova and Renneboog have argued that two general legal strategies can be identified, namely "incentive"[100] and "monitoring",[101] to regulate the principal-agent cost.[102]

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[96] La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, 'Legal determinants of external finance', 52 (1997) *Journal of Finance*, pp. 1131–1150.
[97] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'What Works in Securities Laws?', 61 (2006) *Journal of Finance*, pp. 1-32.
[98] The five strategies mentioned above were summarised by this research based on Kraakman et al.'s work. See: Reiner Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Mariana Pargendler, Wolf-Georg Ringe and Edward Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press, 2017), pp. 79-88.
[99] Ibid.
[100] For example, the "incentive" can be achieved by teaming up the interests of management with those of shareholders through instruments, for example the executive compensation contract.
[101] "Monitoring" refers to both better internal supervision of management and external supervision, for instance through the takeover market.

According to these scholars, shareholders' decision right should be limited in certain circumstances, to avoid unnecessary interference in managerial decision-making.[103] Martynova and Renneboog propose to integrate the appointment right strategy with "facilitating" and "removing obstacle" approaches.[104] The facilitating approach covers various instruments, from participation in general meetings, to exercising voting rights.[105] The removing-obstacle approach argues instead that co-determination dilutes shareholders' representation on the board; cross-shareholding between a company and its subsidiary can easily be abused by management and should be restricted by regulations, whilst a short-term employment contract can regularly examine directors and also pressurise them into performing better. Moreover, the authors emphasise that the separation between executive and non-executive officers is the key to the trusteeship strategy. In the one-tier board system, independence between managing directors and independent directors would be essential, while in a two-tier board system, it would be the the supervisory board that keeps an eye on management.[106] Transparency requirements would also be key in this respect, particularly concerning four aspects: disclosure of management compensation, related-party transactions, financial reports and "comply or explain" rules.

Yet, not all scholars agree with the argument that a concentrated ownership structure is simply caused by weak minority shareholder protection law – as posited by the legal origin theory. According to Bebchuk and Roe, a country's

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[102] Marina Martynova and Luc Renneboog, A Corporate Governance Index: Convergence and Diversity of National Corporate Governance Regulations, CentER Discussion Paper Series No. 2010-17; TILEC Discussion Pare No. 2010-012, available at http://ssrn.com/abstract=1557627. Last visited February 2019.

[103] For example, in takeovers, for the sake of job-saving, management may oppose any offer regardless of shareholders' interests. Accordingly, it is necessary to grant shareholders the approval right on anti-takeover measures. Besides, in less extreme situations, when shareholders notice any unusual patterns in managerial decisions, shareholders should have the right to initiate an extraordinary general meeting to discuss the disputed issue. And the shareholding requirement to exercise such a right should not be too high. Moreover, the research clarifies its opposition to voting caps. One of the advantages brought about by big block holders is the continuous better monitoring of management. However, if instruments such as voting caps are permitted, then management can easily mitigate large shareholders' monitoring.

[104] The terms "facilitating" and "removing obstacle" are adopted by this research in order to provide a clear explanation. Martynova and Renneboog's research did not use the exact terms.

[105] For instance, before the general meeting, no extra limitation, i.e. registration or deposition, should be imposed on the shares. And in the voting process, proxy voting by mail should be allowed, in order to guarantee shareholders' voting rights.

[106] In some countries, an additional auditory board has been established to provide an extra guarantee for disclosure quality.

ownership structure depends on how it was originally set up.[107] This argument has been developed into what they frame as a "path dependence theory", whereby "path dependence" can be divided into "structure-driven"[108] and "rule-driven".[109] If a country initially has a concentrated ownership structure, due to what they describe as a "structure-driven dependence", the country maintains this concentration for "efficiency" and "rent-seeking" reasons. In other words, the transformation from concentrated to dispersed ownership will inevitably generate huge costs, and the controlling shareholder will obstruct any change that may take away his or her private benefits of control. Moreover, "rule-driven dependence" will defend the concentrated market due to "efficiency" and "group politics". In other words, for a concentrated market, it is efficient to design legal rules that will continuously support the concentration structure, and the political group that represents controlling shareholders' interests will push the enactment of concentration-friendly legal rules, and vice versa. If a country initially has a dispersed market, "path dependence" will sustain this dispersed ownership both structurally and legally. Bebchuk and Roe further remark that such path dependence does not exclude efficiency, because despite the risk of inefficient legal rules or corporate structures, a path-dependent ownership structure and path-dependent corporate rules, if properly designed, can be efficient.[110] Another research study, led by Roe further underlines the significance of a country's political environment in shaping ownership structure through what is known as the "political determinant theory".[111] More specifically, Roe observes that when a country's political orientation and policies are more socially concerned, then a concentrated ownership type is the best alternative for shareholders to secure their dominance on the board and to reduce managerial costs.[112] The association between a country's political orientation and its corporations' ownership structure has a consequence that legal reforms which are in line

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[107] Lucian A. Bebchuk and Mark J. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance', 52 (1999) *Stanford Law Review*, pp. 127-170.

[108] The "structure-driven path dependence" indicates that the initial ownership structure directly affects a country's subsequent ownership structure. See: ibid.

[109] "Rule-driven path dependence" indicates that the initial ownership structure has an impact on corporate rules, and these rules influence a country's subsequent ownership structure. See: supra. 107.

[110] Supra. 107.

[111] Mark J. Roe, 'Political Determinants of Corporate Governance', The Harvard John M. Olin Discussion Paper Serie, available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/451.pdf. Last visited February 2019.

[112] Ibid.

with the political context may face less resistance and have a greater chance of success.[113]

While Bebchuk and Roe emphasise the importance between a country's initial ownership/political orientation and its corporations' ownership structure in accessing minority shareholder protection, Goshen and Hamdani further demonstrated that a concentrated ownership structure is not necessarily linked with poor minority shareholder protection.[114] They put forward the notion of "optimal-reward theory", which recognises the value of the concentrated ownership structure, whereby the controlling shareholder has the power and incentive to impose stricter monitoring on the company. This point is shared also by Gilson and Schwartz, who argue that controlling shareholders can be a powerful alternative to market-based supervision of management. In return, it is acceptable to compensate the company controller with a reasonable amount of private benefits of control.[115] Gilson further clarified that controlling shareholders can be efficient or inefficient, while a legal system which supports both concentrated and dispersed structures ought to be considered as "good law". On the contrary, a legal system which exclusively favours the company controller ought to be regarded as "bad law".[116]

Goshen and Hamdani further advance the idea through what they describe as an "idiosyncratic vision theory", which is based on the notion that the value of control goes beyond the private benefits of control and extends to commercial freedom and long-term fulfillment.[117] The idea is that a controlling shareholder seeks to control a company, not to exploit minority shareholders but to enjoy the freedom to lead the company and to fulfill his or her long-term vision in the interest of the company. As a result, the concentration

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113 Mark J. Roe, 'Political Determinants of Corporate Governance', The Harvard John M. Olin Discussion Paper Serie, available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/451.pdf. Last visited February 2019.

114 Zohar Goshen and Assaf Hamdani, 'Corporate Control and Idiosyncratic Vision', 125 (2016) *Yale Law Journa*l, pp. 560-617.

115 If the controlling shareholder provides a larger return to minority shareholders than the private benefits of control that he or she extracts, then this amount of private benefit of control is considered reasonable. See: Ronald J. Gilson and Alan Schwartz, 'Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review', 169 (2013) *Journal of Institutional and Theoretical Economics JITE*, pp. 160-183.

116 Ronald Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy', 119 (2006) *Harvard Law Review*, pp. 1641-1679.

117 Supra. 114.

structure should in fact align the interests of controlling and minority shareholders, alsongside corporate law's task to strike a balance between the controller's freedom to pursue his/her idiosyncratic vision and minority shareholders' call for protection.[118]

Yet, the so-called "problem of the collective action", namely conflicting interests among different parties that may discourage a joint action which would have been beneficial to all parties, remains. Becht, Bolton and Roell identified five forms of mitigation in relation to this problem,[119] which illustrates the dilemma of concentrated ownership.[120] The authors conclude that the core concern of corporate governance is to strike a balance between managerial discretion and minority shareholder protection, and to place certain restrictions on the power of active or large shareholders.[121]

In a similar vein, Peng and Sauerwald illustrate that the concentrated ownership structure is not in itself a disadvantage. Nevertheless, concentrated ownership in a poor institutional environment may generate a "principal-principal" conflict between the controlling and minority shareholders.[122] Peng and Sauerwald propose two solutions to the matter of minority shareholder protection, each of which relates to the external and internal aspects of corporate governance. The former mainly refers to the legal design, such as shareholder protection rules and regulations, while the internal governance aspect has to do with the existence of a coalition of multiple blockholders. For Peng and Sauerwald, the alignment of multiple and relatively

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[118] Supra. 114.

[119] The collective action problem may be mitigated through (i) large shareholders, which can be banks, institutional investors or a holding company, etc.; (ii) the board of directors which should serve in the interests of its principals, and the CEO, should be held accountable; (iii) the takeover market, through which acquirers can remove inefficient management or large shareholders by employing tools such as a proxy battle; (iv) the alignment of shareholder interests and management through executive compensation contracts and (v) clearly defined fiduciary duty as well as class actions.

[120] The "ownership concentration" approach may give rise to controlling shareholders. And the controller may conspire with the management to exploit jointly minority interests, and it may also lower the liquidity of the capital market. If the law chooses to protect minority shareholders by restraining the power of large shareholders, it may nurture another expropriator, i.e. management may abuse the broadened discretion and infringe upon the company and its minority shareholders' interests.

[121] Marco Becht, Patrick Bolton and Alisa Roell, 'Corporate Governance and Control' (October 2002). ECGI - Finance Working Paper No. 02/2002, available at SSRN: http://ssrn.com/abstract=343461. Last visited February 2019.

[122] Mike W. Peng and Steve Sauerwald, 'Corporate Governance and Principal-Principal Conflicts', in Mike Wright, Donald S. Siegel, Klevin Keasey and Igor Filatotchev (eds), *The Oxford Handbook of Corporate Governance* (Oxford: Oxford University Press, 2013), pp. 658-672.

"large" minority shareholders can form a considerable force to counter the controlling shareholder and, accordingly, strengthen internal supervision.[123]

Based on a comparative study of national corporate governance systems in 30 European countries and the US, covering data from 1990-2005, Martynova and Renneboog identified regulatory solutions for the principal-principal cost from two angles: the enhancement of minority shareholder rights and the restriction of the controlling shareholder's private benefit of control.[124] The former can be enforced by directly granting rights to minority shareholders or by giving them extra powers in mergers and acquisitions. The latter can instead be achieved by imposing an obligation on the controlling shareholder to disclose his or her ownership status, as well as by applying the one-share-one-vote principle.[125]

Martynova and Renneboog further illustrate four legal strategies. First, the authors propose a "decision right strategy", which would call for a "supermajority" rule and the right to convene an extraordinary meeting. The former would aim at protecting minority interests in decision-making. In order to avoid any abuse of such a measure, the authors suggest that such a supermajority rule should be limited to major events. At the same time, the right to convene an extraordinary meeting would afford shareholders the ability to challenge problematic managerial decisions and would encourage minority shareholder participation and supervision over management.[126]

Second, for Martynova and Renneboog, minority shareholder protection could be strengthened through an appointment strategy organised along three axes. The first would award minority shareholders the power to nominate their own representatives on both one-tier and two-tier boards. Such mandatory minority representation on the board may allow minority shareholders to voice their opinion and deter the board from following the one-sided view of the controlling shareholder. The second would restrict the controlling shareholder's power through voting caps. Different from the mandatory minority representation strategy, which directly empowers minority shareholders, the introduction of voting caps would aim at limiting the

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[123] Ibid.

[124] Marina Martynova and Luc Renneboog, A Corporate Governance Index: Convergence and Diversity of National Corporate Governance Regulations, CentER Discussion Paper Series No. 2010-17; TILEC Discussion Pare No. 2010-012, available at http://ssrn.com/abstract=1557627. Last visited February 2019.

[125] Ibid.

[126] Ibid.

controller's influence on the board so that it may facilitate minority participation. And the third would avoid deviations from the one-share-one-vote principle, such as the dual-class shares which create a discrepancy between the cash flow rights and the control rights.[127]

Next, for the authors, minority shareholder protection could be advanced through what they refer to as a "trusteeship strategy", which describes directors as trustees of minority shareholders and independent from the controlling shareholder. The idea behind this strategy would be to nominate non-executive officers through minority shareholders, and managing directors should be separated from independent directors on one-tier boards while directors should be separated from supervisors on two-tier boards.[128]

Last, Martynova and Renneboog highlight an "affiliation right strategy", which promotes the fair entry and exit of minority shareholders. For the entry element, the disclosure of a large shareholding may curtail the agency cost ex ante and may also facilitate the supervision of blockholders. Legal tools for a fair minority exit in takeovers could include the mandatory bid rule, the sell-out right, the break-through rule and the equal treatment of shareholders and other legal devices. Moreover, a minority claim may empower minority shareholders to confront managerial resolutions, especially when they suspect a fair exit of the company is impossible, due to the manipulation of insiders.[129]

To summarise the literature discussed above, the "legal origin theory" and the "path dependence theory" depict two different relationships between a country's ownership structure and its minority shareholder protection. According to the legal origin theory, the common law system has better investor protection law, which leads to a dispersed ownership structure. Meanwhile, the civil law system has weaker minority shareholder protection law, which leads to a concentrated ownership structure. Related to the legal origin theory, the "minority expropriation theory" describes minority shareholder expropriations by the controlling shareholder in a concentrated ownership structure. Advocates of this notion further pinpoint three solutions to the minority expropriation problem through disclosure, liability standards and anti-director rights.

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[127] Ibid.
[128] Ibid.
[129] Ibid.

In contrast, the path dependence and the political determinant theories argue that the initial ownership structure and the political environment determine a country's ownership structure. The concentrated ownership structure is not necessarily linked to poor minority shareholder protection; instead, both the "optimal-reward theory" and the "idiosyncratic vision theory" illustrate the benefits of concentrated ownership. In order to restrain the principal-principal cost in a concentrated ownership setting, academics propose tackling the issue by enhancing the legal protection of minority shareholders and encouraging a coalition of relatively "large" minority shareholders. Additionally, a minority shareholder protection index has been raised based on the decision right strategy, the appointment right strategy, the trusteeship strategy and the affiliation strategy.

2.4 Theoretical analysis of minority shareholder protection in China

If we do not wish the law to be nothing but an empty promise on the books, a country's legal rules should be compatible with its legal environment.[130] Research has applied the agency theory framework to conflicts of interest within Chinese listed companies and has discussed the complexities of having the state often acting as the controlling shareholder in the country.[131] With its own characteristics, particularly the participation of the party organization in corporate governance,[132] China does not seem to fall exclusively into one specific category, and thus a more complicated Chinese reality should be taken into account when applying Western theories.

According to the traditional understanding of the agency cost, a principal-principal cost normally exists between the controlling shareholder and minority shareholders in a concentrated company, while the principal-agent cost normally exists between shareholders and management in a dispersed company.

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[130] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'The Economic Consequences of Legal Origins', 46 (2008) *Journal of Economic Literature*, pp. 285-332.

[131] Donald C. Clarke, 'The Role of Non-legal Institutions in Chinese Corporate Governance', in H Kanda, K S Kim and C J Mihaupt (eds.), *Transforming Corporate Governance in East Asia* (Oxon: Routledge, 2008), p. 168.

[132] More discussion on the party organization can be found in chapter 3 section 3.2.2.

Despite the concentrated ownership structure, two main elements may cause the principal-agent cost in Chinese state-owned listed companies. As scholars have argued, the "over proportion of State-owned shares" and the resulting "absence of owner"[133] problem are the leading reasons behind insider control,[134] i.e. the control of the company is de facto or de jure captured by management whose interests orient the company's decision-making processes.[135] When compared with private shareholders, the state controller may not have sufficient incentive, information or professional knowledge to monitor management in a timely manner.[136] Li, Feng and Cao demonstrated how this "absence of owner" phenomenon worsens the "insider control" issue.[137] The "special identity" of the state controlling shareholder may prevent minority shareholders benefiting from the reward of a concentrated ownership structure, namely an enhanced monitoring of management. Research conducted by Chen et al. also found that the more shares held by the state, the more severe insider control is in Chinese state-owned listed companies.[138]

Scholars have further illustrated that another issue which worsens the "insider control" problem is "political connections",[139] due to the fact that in

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133 所有者缺位 (absent owner "i.e. monitoring individuals being locally employed and salaried and therefore dependent to local government, which might have other corporate policies such as high employment, while the formal ownership of shares is lodged in a higher level of government; a monitoring individual who works in a government agency is less able to distinguish good from bad corporate policy than a monitoring individual who works for a business-oriented institutional shareholder; individual monitoring on behalf of the state less likely to have someone at some point above him in the chain of command making a strong demand for good corporate performance in companies held by the state, which deprived the large shareholder in his role he plays in corporate governance regarding vertical agency problems"). See: Knut Benjamin Pissler, and Liu Junhai, 'Corporate Governance of Business Organizations in the People's Republic of China: The Legal Framework After the Revision of the Company Law in 2005', China: Corporate governance of business organizations, in: Klaus J. Hopt, Andreas M. Fleckner (Hg.), *Comparative Corporate Governance: A Functional and International Analysis* (Cambridge: Cambridge University Press, 2013), pp. 156-207.

134 Xie Qingxi and Wang Ruiying, '中国上市公司内部人控制与非公平关联交易的实证分析 (Empirical Analysis on Insider Control and Unfair Affiliated Transactions in Chinese Listed Companies)', 4 (2004) *经济评论* (*Economic Review*), pp. 113-117.

135 Masahiko Aoki Hyung-Ki Kim (ed.), *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks* (Washington D C: World Bank Institute Development Study EDI Development Studies, 1995), p. xii.

136 Supra. 133.

137 Li, Shuangyan, Feng, Genfu. and Cao, Guangjun, 'Private Benefits of Managerial Control, Government Ownership, and Acquirer Returns: Evidence from the Chinese State-Controlled Listed Companies', 29 (2012) *CAN J ADM SCI*, pp. 165-176.

138 Chen Xiangyong, Zhang Jianwen, and Zhang Weiwen, '我国上市公司'内部人控制'研究 (Research on Insider Control of Chinese Listed Companies)', 4 (2000) *管理世界* (*Management World*), pp. 103-109.

139 Various corruption scandals of Chinese state-owned listed companies, such as Chen Tonghai from Sinopec, Zhang Chunjiang from China Mobile and Kang Rixin from Nuclear Industry Group, have been found (Chen

state-owned listed companies, the chairman of the board is commonly a former party secretary or retired government official.[140] That is to say, managers of state-owned listed companies often hold semi-political authority over and above that of private businessmen. Usually, the chairman is also the general manager. This overlap of managers and directors disempowers the internal supervision designed by the *Chinese Company Law*, which grants the board of directors the power to appoint and remove managers.[141] Moreover, due to the over-proportion of state-owned shares, the state is unable to monitor persistently all state-owned listed companies. In fact, the idea behind appointing political authorities as management is that, based on political trust, the state is able to delegate more decision-making power to managers and undertake less strict monitoring.[142] Consequently, the state controller constantly fails to monitor the board and managers, while minority shareholders are normally too weak to monitor management.[143] In this context, directors and managers, as “de facto” controllers of the company, have sufficient motivation to seek private benefits at the expense of the company and of its minority shareholders.[144] Thus, the issue of powerful management with semi-political powers exacerbates the insider control problem.

Xie and Wang noted that in most state-owned listed companies, the state controller is also not well-informed, and as a result, insiders can arbitrarily exploit the company and encroach on the interests of minority shareholders.[145] More specifically, scholars have identified eight typical insider control

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Tonghai, former chairman of the board of directors of the Sinopec, was sentenced to death with a two-year reprieve for the crime of corruption; Zhang Chunjiang, former vice CEO of China Mobile, was sentenced to death with a two-year reprieve for the crime of corruption; Kang Rixin, former chief manager of the Nuclear Industry Group, was sentenced to life imprisonment for the crime of corruption). See: Brødsgaard, Kjeld Erik, and Xin Li, ‘SOE Reform in China: Past, Present and Future’, 31 (2014) *The Copenhagen Journal of Asian Studies*, pp. 54-78.

[140] Liu, Qiao, ‘Corporate governance in China: current practices, economic effects and institutional determinants’, 52 (2006) *CESifo Economic Studies*, pp. 415-453.

[141] Deng Yungui, ‘论公司‘内部人’控制之法律治理 (Analysis on Legal Regulation on the Insider Control of the Company)’, 2 (2002) *当代法学* (*Contemporary Law Review*), pp. 128-130.

[142] Masahiko Aoki Hyung-Ki Kim (ed.), *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks* (Washington D C: World Bank Institute Development Study EDI Development Studies, 1995), p. xviii.

[143] Ding, Yuan, Hua Zhang, and Junxi Zhang. ‘Private vs State Ownership and Earnings Management: Evidence from Chinese Listed Companies’, 15 (2007) *Corporate Governance: An International Review*, pp. 223-238.

[144] Ibid.

[145] Xie Qingxi and Wang Ruiying, ‘中国上市公司内部人控制与非公平关联交易的实证分析(Empirical Analysis on Insider Control and Unfair Affiliated Transactions in Chinese Listed Companies)’, 4 (2004) *经济评论* (*Economic Review*), pp.113-117.

behaviours in China: (1) excessive company-paid consumption, such as sumptuous banquets financed by the company, business trips abroad or private tours funded by the company; (2) defective information disclosure, abusing management power to "modify" accounting procedures at will or provide no explanation for major company events; (3) short-term action without considering the long-term value and development of the company; (4) excessive investment and a waste of company assets; (5) unreasonable increases in the remuneration, bonuses and welfare of managers; (6) the transfer of state-owned capital;[146] (7) no dividend, or an insufficient dividend, and (8) overdue debts.[147]

The above discussed "absence of owner", and its resulting "insider control" phenomenon, force a redefinition of the "principal-agent" cost in China. In Chinese state-owned listed companies, if the state controlling shareholder fails to monitor management effectively, the abuse of managerial power constitutes the principal-agent cost between shareholders and management. Different from shareholders in a dispersed company, the state controlling shareholder is very powerful, and thus the principal-agent conflict in fact intensifies between management and minority shareholders. In this research, the "principal-agent" cost between minority shareholders and management should be distinguished from the traditional "principal-agent" cost between shareholders as a whole and management.

Different from the "principal-agent", the "principal-principal" conflict describes a situation whereby the controlling shareholder manipulates management to intrude upon the interests of minority shareholders. In the Chinese context, the principal-principal cost may be found in both state-owned and non-state-owned listed companies, since they are both characterised by a concentrated ownership structure. And yet, some differences exist.

In state-owned listed companies, if the state controlling shareholder dominates management and coerces managers into misappropriating company assets to pursue political goals, the company may be led astray by ineffective investments, and minority shareholders may suffer financial losses. This state "principal-principal" cost differentiates itself from the traditional

146 Deng Yungui, '论公司 '内部人'控制之法律治理 (Analysis on Legal Regulation on the Insider Control of the Company)', 2 (2002) *当代法学* (*Contemporary Law Review*), pp. 128-130.

147 Fei Fangyu, '控制内部人控制-国企改革中的治理机制研究 (Control Insider Control-Research on Governance of the Reform of the SOEs)', 6 (1996) *经济研究* (*Economic Research Journal*), pp. 31-39.

"principal-principal" cost. As a matter of fact, the state may be less effective in monitoring management than a private controlling shareholder. Moreover, the conflict between the state and minority shareholders normally takes place around political issues rather than economic issues. In other words, the conflict is often about the fact that the state is likely to pursue non-commercial interests, due to its political nature.[148] Different from private shareholders who prioritise profits, economic returns are usually not the only priority of government-related investors.[149] Such "inconsistency in goals" is particularly severe between the controlling and minority shareholders.[150]

A typical example in this regard is state-owned listed companies' high consideration of social costs, also known as political costs, such as maintaining a certain employment rate and social welfare, which are the reasons behind the inefficiency of many state-owned companies.[151] If truth be told, managers normally have to consult with the dominant shareholder, i.e. the state, before making crucial decisions.[152] When there is a conflict of interest between the state and minority shareholders, it is unrealistic to expect the board to safeguard the latters' interests by counteracting the former. The main reason for the lack of board independence is their semi-political identity; for example, an adverse decision might have repercussions on the future political career of managers or directors. As could be expected, those managers and directors who intend to pursue a political position will be more prone to applauding the state controller.[153] In a nutshell, the "state-owned" element turns the relationship between different parties in a firm into a bureaucratic straitjacket, and in such a context, minority shareholders find themselves at the very bottom of this hierarchy.

In non-state-owned listed companies, the private controller-minority conflict can instead be described according to the traditional "principal-principal" cost

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148 Yu, Guanghua, *Comparative Corporate Governance in China: Political Economy and Legal Infrastructure* (USA and Canada: Routledge, 2007), p. 78.

149 Ibid.

150 Li Jiatao and Qian Cuili, 'Principal-principal Conflicts under Weak Institutions: A Study of Corporate Takeovers in China', 34 (2013) *Strategic Management Journal*, pp. 498-508

151 Brødsgaard, Kjeld Erik, and Xin Li, 'SOE Reform in China: Past, Present and Future', 31 (2014) *The Copenhagen Journal of Asian Studies*, pp. 54-78.

152 Tomasic, Roman, and Neil Andrews, 'Minority shareholder protection in China's top 100 listed companies', 9 (2007) *Australian Journal of Asian Law*, p. 88-119.

153 Ibid.

examined in the opening sections of this chapter.[154] By abusing the dominant position, a private controller can easily acquire the private benefit of control at the expense of minority shareholders.[155] On the one hand, when compared with the state, a private controlling shareholder may keep a closer eye on management. On the other hand, a private controlling shareholder may have more incentive to exploit minority shareholders for personal economic interests.[156]

According to a number of empirical studies, private controlling shareholders are in fact more likely to pursue illegitimate activities, such as tunnelling[157] and earnings management than the state.[158] Such illegitimate activities can be credited to the insufficient protection of property rights,[159] weak enforcement of the law[160] and, crucially, discrimination against non-state-owned companies.[161] It has also been emphasised that since non-state-owned companies have less access to equity markets and bank loans than state-owned companies,[162] private controllers often intentionally turn to political connections for "alternative safeguards" they may not find in the law.[163] Unavoidably, such political shelter-seeking entails extra costs, and such expenses are normally split among minority investors. As a result, private controllers have the financial incentive to conduct minority expropriations.

Another factor that may worsen the conflict between minority shareholders and controlling shareholders is that most of the existing Chinese corporate legislation is based on the US model, which targets conflicts of interest between shareholders and management. One strand of academic opinion argues that by adopting "principal-agent" solutions tailored to the US reality,

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154 Weng, Charlie Xiaochuan. 'Chinese Shareholder Protection and the Influence of the US Law: The Idiosyncratic Economic Realities and Mismatched Agency Problem Solutions', 40 (2012) *Securities Regulation Law Journal,* pp. 401-436.

155 Reiner Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, Mariana Pargendler, Wolf-Georg Ringe and Edward Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford: Oxford University Press, 2017), p. 30.

156 Ibid.

157 Jiang, Guohua, Charles M.C.Lee and Heng Yue, 'Tunneling through intercorporate loans: the Chinese experience', 98 (2010) *Journal of Financial Economics*, pp. 1-20.

158 Ding, Yuan, Hua Zhang, and Junxi Zhang. 'Private vs state ownership and earnings management: evidence from Chinese listed companies', 15 (2007) *Corporate Governance: An International Review*, pp. 223-238.

159 ibid

160 Chen, Charles JP, et al. 'Rent-seeking incentives, corporate political connections, and the control structure of private firms: Chinese evidence', 17 (2011) *Journal of Corporate Finance*, pp. 229-243.

161 Ibid.

162 Ibid.

163 Ibid.

the existing Chinese corporate governance system cannot adequately address the roots of the problem of minority expropriations by controlling shareholders, particularly private controllers, in the Chinese context.[164]

As good deal of the literature remarks, the principal-principal conflict in the Chinese context has caused a pressing issue in practice, namely "tunnelling",[165] an expression that describes a situation whereby the company controller pursues his or her own private benefit of control by transferring company assets and resources.[166] The phenomenon has many damaging effects on minority shareholders: it worsens information asymmetry, it decreases market transparency,[167] it reduces the efficiency of the capital market[168] and, finally, it lowers the company's performance and its equity value.[169] Methods involved in tunnelling include: (1) acquiring listing qualifications by fraud; (2) embezzlement of listed companies' funds; (3) financing guarantees which expose listed companies to abnormal risks; (4) looting company assets or profits through related-party transactions; (5) low dividend rates or malicious dividend policies; (6) false capital contribution and fraud listings to deceive

[164] Weng, Charlie Xiaochuan. 'Chinese Shareholder Protection and the Influence of the US Law: The Idiosyncratic Economic Realities and Mismatched Agency Problem Solutions', 40 (2012) *Securities Regulation Law Journal,* pp. 401-436.

[165] Tang Qingquan, Luo Danglun and Wang Li, '大股东的隧道挖掘与制衡力量-来自中国市场的经验证据 (Tuneling of the Controlling Shareholder and its Counter Force- Empirical Evidence from the Chinese Market)', 1 (2005) *中国会计评论* (*China Accounting Review*), pp. 63-86.
Zheng Jianming, Fan Libo, and Zhu Mei, '关联担保,隧道效应与公司价值(Affiliated Guarantee, Tuneling and Company Value)', 5 (2007) *中国工业经济* (*China Industrial Economics*), pp. 1-7.
Liu Feng, Zhong Ruiqing and Jin Tian, '弱法律风险下的上市公司控制权转移与 '抢劫'-三利化工掏空通化金马案例分析 (Transfer of Control of Listed Companies Under Weak Legal Risk and 'Robbery'- Case Analysis on Tuneling of Tong Hua Jin Ma by San Li Hua Gong)', 12 (2007) *管理世界* (*Management World*), pp. 106-116.

[166] Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Tuneling', 90 (2000) *American Economic Review*, pp. 22-27.

[167] Marianne Bertrand, Paras Mehta and Sendhil Mullainathan, 'Ferreting Out Tuneling: An Application to Indian Buisness Groups', 117 (2002) *Journal of Economics*, pp. 121-148.

[168] Randall Morck, Bernard Yeung and Wayne Yu, 'The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?', 58 (2000) *Journal of Financial Economics*, pp. 215-260.
Jeffrey Wurgler, 'Financial Markets and the Allocation of Capital', 58 (2000) *Journal of Financial Economics*, pp. 187-214.

[169] Stijn Claessens, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang, 'Disentangling the Incentive and Entrenchment Effects of Large Shareholding', LVII (2002) *Journal of Finance*, pp. 2741-2771.
Michael L. Lemmon and Karl V. Lins, 'Ownership Structure, Corporate Governance, and Firm Value: Evidence from the East Asian Financial Crisis', 58 (2003) *Journal of Finance*, pp. 1445-1468.

minority shareholders and (7) the manipulation of share prices through false financial reporting intended to mislead minority shareholders.[170]

Liu et al. impute tunnelling activities to insufficient legal protection for minority shareholders and the absence of a market mechanism to control the controlling shareholder.[171] Within a highly concentrated structure, the company controller can exercise controlling power, without any restrictions. According to Tang and Jiang, due to China's specific context, minority expropriations by the controlling shareholder are more serious than in other developed markets.[172] Based on observations of the Hong Kong stock exchange, Cheung et al. showed that whenever an actual controller can be traced back to companies in mainland China, the company is more likely to have conducted the related-party transaction, which is a common method of tunnelling.[173]

The tunnelling phenomenon exists in both state-owned and non-state-owned listed companies. Furthermore, both state-owned and non-state-owned listed companies in China, more or less, suffer from different degrees of intervention by local governments, and state-owned listed companies, in particular, are considered as a "fund-raising platform" for the government.[174] As various scholars have demonstrated, over-investment by state-owned listed companies is more severe than non-state-owned listed companies.[175] Another

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170 证券市场中小投资者利益保护研究 (Research on Protection of Small-and-Medium Investors on the Securities Market), available at http://www.sipf.com.cn/tzzjy/tbyj/2010/01/2750.shtml. Last visited February 2019.

171 Liu Feng, He Jiangang and Wei Minghai, '控制权,业绩与利益输送-基于五粮液的案例研究 (Control Power, Performance and Tunneling-Based on the Case Study of Wu Liangye)', 8 (2004) *管理世界* (*Management World*), pp. 102-110, 118.

172 Tang Zongming and Jiang Wei, '中国上市公司大股东侵害度实证研究 (Empirical Research on the Infringement Degree of the Majority Shareholder)', 4 (2002) *经济研究* (*Economic Research Journal*), pp. 44-50.

Cheung, Yan-Leung, P. Raghqvendra Rau, and Aris Stouraitis, 'Tunneling, Propping, and Expropriation: Evidence from Connected Party Transactions in Hong Kong', 82 (2006) *Journal of Financial Economics*, pp. 343-386.

173 Cheung, Yan-Leung, P. Raghqvendra Rau, and Aris Stouraitis, 'Tunneling, Propping, and Expropriation: Evidence from Connected Party Transactions in Hong Kong', 82 (2006) *Journal of Financial Economics*, pp. 343-386.

174 Yin Zhongli, '上市公司强制分红的是与非 (The Advantages and Disadvantages of Mandatory Dividend for Listed Companies)', 6 (2012) *中国金融* (*China Finance*), available at http://www.doc88.com/p-1985428049232.html. Last visited February 2019.

175 Zhang Dong, Yang Shu'er and Yang Hong, '第一大股东股权,治理机制与企业过度投资(Shareholding of the Biggest Shareholder, Corporate Governance Mechanism and Over Investment)', 30 (2008) *当代经济科学* (*Modern Economic Science*), pp. 62-72.

study further reveals that non-commercial government interference could be the main reason behind the tunnelling.[176] Two cases further exemplify such government interference, with subsequent infringement upon minority shareholders' interests. In the Huang He Ke Ji (hereinafter HHKJ 黄河科技) case, the chairman of the board had been the party committee secretary since the establishment of HHKJ as a company. Senior management cared more about pursuing their political careers than protecting the interests of minority shareholders. For the fear of losing HHKJ as a local brand, the Shanxi provincial government directly intervened by terminating the restructuring plan between HHKJ and Ke Long and instead organising another transaction with a SOE.[177] A series of related-party transactions with other SOEs took a toll on HHKJ and caused serious losses for its minority shareholders.

Another example is the Wu Liang Ye (hereinafter WLY 五粮液) case. Initially, WLY was listed to serve the fundraising requirements of the Sichuan provincial government. The government dominated the board of directors and appointed the deputy mayor as the chairman. After its listing, the government directed WLY, a breweries company, to invest in scientific and car manufacturing projects, in order to support the development of those industries.[178] These over-investments damaged the economic returns of the company as well as the interests of minority shareholders.

Applying agency cost theories to the Chinese context, the last few sections have illustrated how Chinese listed companies may face two types of agency cost, namely the "principal-agent" cost between minority shareholders and management, and the "principal-principal" cost between minority

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Wang Ping and Sun Shixia, '自由现金流,股权结构与我国上市公司过度投资问题研究 (Research on Cash Flow, Shareholding Structure and Over Investment of Chinese Listed Companies)', 4 (2009) *当代财经* (*Contemporary Finance and Economics*), pp. 123-128.
Xu Xiaodong and Zhang Tianxi, '公司治理,自由现金流与非效率投资(Corporate Governance, Cash Flow and Inefficient Investment)', 35 (2009) *财经研究* (*Journal of Finance and Economics*), pp. 47-58.

[176] It has been claimed that the government may employ shareholding companies under its control, to invest in non-commercial issues in order to fulfil the government's social obligations. Yang Huajun and Hu Yiming, '制度环境与自由现金流的过度投资 (Institutional Environment and Over Investment of the Cash Flow)', 9 (2009) *管理世界* (*Management World*), pp. 99-104.

[177] 中国上市公司成败调研案例选(Research Case Files on the Success and Failure of Chinese Listed Companies), available at https://wenku.baidu.com/view/d79ad29e9ec3d5bbfd0a74f2.html. Last visited February 2019.

[178] Yin Zhongli, '上市公司强制分红的是与非 (The Advantages and Disadvantages of Mandatory Dividend for Listed Companies)', 6 (2012) *中国金融* (*China Finance*), available at http://www.doc88.com/p-1985428049232.html. Last visited February 2019.

shareholders and the controlling shareholder. Hereinafter, the expression "controlling-minority conflicts" will be referred to in this research, to cover both principal-principal and principal-agent costs.

Another possible lens through which to interpret the Chinese situation is the legal origin theory, according to which, China belongs to a civil law origin with a highly concentrated ownership structure. Insofar as minority shareholder protection remains a challenging issue in the country,[179] the Chinese reality fits the legal origin theory's correlation between a concentrated ownership structure and weak minority shareholder protection. Nevertheless, as previous sections have shown, China's concentrated ownership is more the product of a conscious political choice than a mere market response to a weak legal regime in terms of investor protection. After the establishment of the People's Republic of China in 1949, China's economy was guided by communist ideology and social public ownership, while firms existed primarily as state-owned enterprises.[180] As a matter of fact, the first *Chinese Company Law* was promulgated only in 1993, while the first *Chinese Securities Law* was promulgated in 1998. In other words, the interpretation offered by the legal origin theory would not make much sense here, as concentrated state ownership existed long before the law was introduced.

In addition to what could be described as a political choice, Lin emphasised the importance of the cultural element in shaping the power dynamic within Chinese listed companies.[181] More specifically, in assessing the Chinese context, one should take into consideration issues such as China's peculiar "family" ideology, which breeds two important values of "leadership" and "insiders vs. outsiders" and is deeply rooted in the nation's culture. Mirroring these values, a Chinese listed company may be regarded by its shareholders as a "family", and the controlling shareholder would therefore be seen as the "leader" thereof. As the most authentic figure within a family, he or she would hold the highest authority and power. Moreover, the aforementioned division between "insiders and outsiders" encourages the formation of closed interest groups that tend to be guided by the same goal. More specifically, in a Chinese

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[179] Qianhua Lei, Bingxuan Lin, and Minghai Wei, 'Types of Agency Cost, Corporate Governance and Liquidity', 32 (2013) *Journal of Accounting and Public Policy*, pp. 147-172.
More relevant research see Chapter 1, 1.1 and Chapter 3.

[180] For more discussion on the development of Chinese listed companies, see Chapter 1.

[181] Cyril Lin, 'Corporatisation and Corporate Governance in China's Economic Transition', 34 (2001) *Economics of Planning*, pp. 5-35.

listed company, the controlling shareholder and management may be viewed as “insiders”, while minority shareholders may be treated as “outsiders”. This insider-outsider conflict may in turn generate collusion between management and the controlling shareholder, and it may also worsen the information asymmetry of minority shareholders. As claimed by a Chinese proverb, “family shames should stay within the family”, so the “litigation-aversion” sentiment means that minority shareholders who bring any action against the “family” not to mention against their “leader” as the controlling shareholder, are despised.[182] All of the above elements not only appear to consolidate further state concentrated ownership structure in China, but they also further prove that the legal origin theory is inadequate in terms of interpreting the Chinese context.

It could be argued that the path dependence theory and the political determinant theory are a better fit in this regard, as they claim that the efficiency of a country’s ownership structure depends on its initial ownership and political context.

As seen above, the idiosyncratic vision theory argues that the controlling shareholder may achieve beyond-market interests for the company by fulfilling his or her long-term vision. This interpretation could also be an apt fit for China’s case. Following this theory’s logic, a concentrated ownership structure, and even state ownership per se, may not be a disadvantage. This interpretation is shared by scholars such as Stiglitz who has recently argued that a market-oriented state controller may be the best choice for countries with a weak institutional environment.[183] In other words, as some have contended, government interference may turn out to be an alternative to the market control system, which is currently lacking in China.[184] However, as things currently stand, widespread phenomena such as “insider control” and “tunnelling” in the Chinese context do indeed confirm a serious minority expropriation problem and the poor corporate governance of Chinese listed companies. On the one hand, the idiosyncratic vision theory shows the

[182] Cyril Lin, ‘Corporatisation and Corporate Governance in China’s Economic Transition’, 34 (2001) *Economics of Planning*, pp. 5-35.
[183] Joseph E. Stiglitz, ‘Whither Reform? Ten Years of the Transition’, Keynote Address, Annual Bank Conference on Development Economics, the World Bank, available at https://www.gsid.nagoya-u.ac.jp/sotsubo/stiglitz.pdf. Last visited February 2019.
[184] Zhong Haiyan, Ran Maosheng and Wen Shouxun, ‘政府干预，内部人控制与公司投资 (Government Interference, Insider Control and Company Investment)’, 7 (2010) *管理世界* (*Management World*), pp. 98-108.

potential of a concentrated state ownership structure. On the other hand, the minority expropriation theory reflects the current Chinese reality. Therefore, the future of minority shareholder protection in China largely depends on how to address the "imbalance" of powers and to establish "balanced" corporate governance in Chinese listed companies.

It should also be noted that Western theories may not be able to grasp fully the Chinese picture in its entirety, due to the particularity of state participation.[185] As a result, while this work will employ and deem useful some of the legal strategies individuated in Western literature,[186] it will also underline, from time to time, potential deviations from existing theories, in order to analyse Chinese minority shareholder protection.

2.5 Conclusion

The existing literature has examined and shed light on issues of corporate governance and minority shareholder protection. Originally, the agency theory focused on the "separation of ownership and control", which in turn leads to a principal-agent cost between shareholders and management. Further, the theory has been applied to interpret conflicts of interest in a concentrated ownership structure where a principal-principal cost between the controlling and minority shareholders has been identified. On the basis of the agency theory, academic research has moved forward to explore how a country's ownership structure may affect its shareholder protection.

Additionally, the existing literature provides various legal strategies for minority shareholder protection. Academic debates seem to be divided into two main positions. One argues that minority shareholders can be protected through large shareholders. Specifically, coalitions of relatively big minority shareholders may form a counter-force against the controlling shareholder and simultaneously shield minority interests. The other one posits instead that minority shareholders can be protected by the board of directors. This view depicts directors appointed by the minority shareholders as trustees, and it asserts that these trustees will represent minority interests in running the company.

[185] Cheong Cheok Kee, Li Ran, Tan Chye Eu, Zhang Milao, 'China's state Enterprises, Economic Growth and Distribution: A Revisionist View', 12 (2014) *China: An International Journal*, pp. 132-152.
[186] See 2.4 of this chapter.

Applying the above theories to the Chinese context, this research proposes to define the Chinese principal-agent relationship as the cost between minority shareholders and management, and to distinguish the principal-principal cost in state-owned and non-state-owned listed companies. Within the Chinese corporate structure, minority shareholders may be exposed to both principal-principal and principal-agent costs. The resulting insider control and tunnelling phenomenon seems to confirm the minority expropriation theory, which asserts that the controlling shareholder tends to exploit minority shareholders in exchange for private benefits of control. This research also found that the path dependence and the political determinant theories may explain the concentrated ownership structure of Chinese listed companies. The former claims that a country's initial ownership structure determines its subsequent ownership structure, while the latter posits that concentrated ownership is the best alternative facing social-oriented policies. Besides, idiosyncratic vision theories may stand if the controlling shareholder can provide better monitoring and consistently pursue a long-term vision that benefits the company and minority shareholders.

The consideration of these theories in the light of the Chinese case further revealed how shareholder protection is not an issue exclusively determined by existing legal rules. In fact, cooperation between legal rules and the legal environment is a key determinant of the levels of protection of minority shareholders' rights. In other words, the consideration of the Chinese case progressively revealed how elements such as a country's legal tradition, legal institutions, ownership structure and agency conflicts are key to determining what kind of approach will be adopted by legislation, and whether these rules can be effectively implemented in practice.

Having uncovered the problem in theory, the next chapters will attempt to establish a few solutions by way of a comparative perspective between the Chinese context and two other countries, namely the US and the Netherlands. Such a comparative perspective will be crucial in enabling the research to reflect upon the Chinese context and propose innovative suggestions for minority shareholder protection in Chinese listed companies.

Chapter 3 Minority Shareholder Protection in China

3.1 Introduction

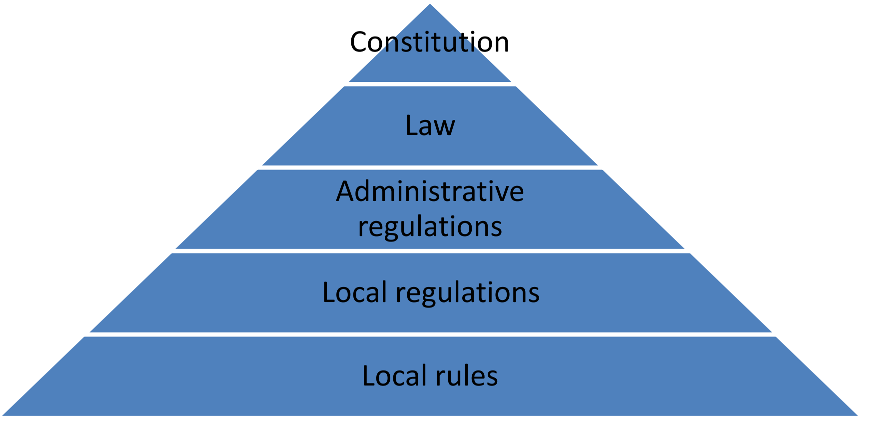
The historical heritage of the transformation from a planned economy to a socialist market economy has left Chinese listed companies with a special ownership structure. Highly concentrated ownership and state ownership have caused a series of governance problems, such as insider control, tunnelling and an inactive securities market. These complications in turn impose both principal-principal and principal-agent costs on minority shareholders, and as a result, minority shareholder protection has become a pressing issue in China.

A series of newly promulgated or amended legislations, such as the *Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China* (*IV*), *Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China* (*V*), the latest revision of the *Chinese Corporate Governance Code*, and the newly revised 2020 *Chinese Securities Law* has responded to the corporate governance challenge by especially focusing on the protection of minority interests. In order to form a better understanding of the issue, this chapter intends to analyse minority shareholder protection in Chinese listed companies from the corporate governance perspective. Specifically, the discussion includes three main parts. First, it reviews shareholder rights in Chinese legislation. Second, it examines the monitoring mechanisms of disclosure and internal supervision, and third, it underlines minority shareholder protection in mergers and acquisitions. Lastly, the chapter ends with a conclusion.

3.2 Minority shareholder protection through shareholder rights in China

According to the *Law on Legislation of the People's Republic of China* (hereinafter *Legislation Law*), Chinese legislation consists of laws enacted by the National People's Congress or its Standing Committee, administrative regulations enacted by the State Council, local regulations, autonomous regulations and separate regulations enacted by a provincial-level government's People's Congress or its Standing Committee and administrative rules enacted by the State Council's departments, committees, other regulatory institutions or local rules enacted by local governments. The hierarchy of the legislation is as follows: the constitution has the highest legal effect; laws have higher legal effect than administrative regulations, local regulations and rules; administrative regulations have higher legal effect than local regulations and rules**,** and local regulations have higher legal effect than the same-level and lower-level local rules.[187]

Table 3.1 Legislation Hierarchy



Shareholder rights are mainly prescribed by the *Chinese Company Law*, the *Chinese Corporate Governance Code* and the *Provision on Strengthening the Protection of the Rights and Interests of Public Shareholders*. Explicitly, the *Chinese Company Law* is on the level of law, and the other two legislations fall into the category of departmental regulatory documents, whose legal effects

[187] Articles 87, 88 and 89, *Legislation Law*.

are not specified in the *Legislation Law*. Academics hold the opinion that departmental regulatory documents have a lower legal effect than administrative rules.[188]

3.2.1 Shareholder rights in legislation

Within a highly concentrated ownership structure, the general meeting of a Chinese listed company is often dominated by the controlling shareholder. Considering the potential conflicts of interest between the company controller and minority shareholders, the rights of the general meeting do not equate to minority shareholder protection. According to how a shareholder right is exercised, i.e. by the general meeting, by passing a threshold or by any shareholder, the elaboration below will describe shareholder rights from a minority shareholder perspective. The first step will outline the general meeting's powers, while the second step will discuss what rights minority shareholders can exercise if they pass a certain threshold. The last step will enquire into the rights and rules that have been designed especially for minority shareholders.

Powers of the general meeting

The *Chinese Company Law* (hereinafter *CCL*)[189] explicitly declares in its Article 98 that the general meeting is the governing body of a company limited by shares.[190] In other words, the general meeting is entitled to all of the essential

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[188] Some academics believe that regulatory documents are legally binding but the legal effect is lower than administrative regulations. In other words, if there is any conflict between administrative regulations and regulatory documents, the former prevails. See: Ye Bifeng, '论规范性文件的效力(Legal Effect of Regulatory Documents)', 4 (1994) *行政法学研究* (*Administrative Law Review*), pp. 50-55.
Huang Jinrong, '"规范性文件"的法律界定及其效力 (Defining the Legal Effect of "Regulatory Documents")', 7 (2014) *法学* (*Law Science*), pp. 10-20.
Some academics claim that regulatory documents are one type of soft law in China. See: Luo Haocai and Song Gongde, '认真对待软法-公域软法的一般理论及其中国实践 (Take Soft Law Seriously – General Theories of Soft Law in Public Law and its Practice in China)', 2 (2006) *中国法学* (*China Legal Science*), pp.3-24.
[189] *中华人民共和国公司法* (The *Chinese Company Law*)was originally promulgated by the Standing Committee of the National People's Congress on 29th December 1993, amended on 25th December 1999, amended on 28th February 2004, amended on 27th October 2005, amended on 28th December 2013 and amended on 26th October 2018. The latest version came into effect on 26th October 2018.
[190] In order to become a Chinese listed company, the establishment of a company limited by shares is the preliminary step. In other words, Chinese listed companies can be considered a sub-group of companies limited by shares. Accordingly, provisions on the rights of shareholders in companies limited by shares also apply to shareholders in Chinese listed companies, if there is no special provision prescribed otherwise. For this reason, provisions on limited liability companies will not be discussed here.

decision-making powers within a company. Specifically, Article 99 clarifies the powers of the general meeting as follows:

- to decide on operating guidelines and investment plans;

- to appoint and remove directors and supervisors who are not employee representatives, and also to determine their remuneration;

- to approve reports provided by the board of directors and the supervisory board, annual financial budget plans, final accounts, profit distribution plans and loss recovery plans;

- to make resolutions on increasing or decreasing registered capital, the issuance of corporate bonds, mergers, divisions, dissolution, liquidation or conversion of the corporate form;

- to modify the articles of association;

- and other powers, if prescribed in the articles of association.

Rights with a threshold

Rights with a threshold refer to a right that can be exercised once a certain threshold is reached by a shareholder(s). According to the *CCL*, if minority shareholders pass the minimum requirements, they may exercise rights with a threshold, which affects the company in four ways. To start with participation in the general meeting, minority shareholders who pass the 10% shareholding and 90 consecutive-day requirements have the right to convene and preside over the general meeting,[191] who pass the 10% shareholding have the right to request for an extraordinary general meeting,[192] and who pass the 3% shareholding are entitled to the right to initiate an interim proposal.[193] Second, minority shareholders who fulfill the 10% shareholding demand may propose

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[191] Article 101 of the *CCL* prescribes that if the board of directors and the board of supervisors do not convene and preside the general meeting, shareholders who either independently or collectively have held 10% or more than 10% of the company shares for at least 90 consecutive days have the discretion to convene and preside over the general meeting.

[192] Article 100 of the *CCL* stipulates that the general meeting of shareholders shall be held once a year. However, if requested by shareholders who either independently or collectively owns 10% or more than 10% of company shares, an extraordinary meeting shall be held within two months.

[193] Article 102 of the *CCL* prescribes that shareholders shall be informed in advance concerning the time, location and issues to be discussed of the general meeting. And shareholders who independently or collectively hold 3% or more than 3% of the company shares, are entitled to the right to submit an interim proposal to the board of directors ten days before the meeting, and the content of the interim proposal shall be within the power of the general meeting. Besides, issues that have not been delivered to the shareholders in advance shall not be decided at the general meeting.

to convene an interim meeting of the board of directors.[194] Third, in the most extreme situation,[195] minority shareholders who pass the 10% shareholding threshold can request a court to dissolve the company. Lastly, minority shareholders who have held 1% or more of company shares for at least 180 consecutive days are entitled to bring a derivative action.[196] This derivative action can be used to redress any breach of fiduciary duty by the directors or the controlling shareholders.[197]

Rights of minority shareholders

To safeguard the interests of minority shareholders better, Chinese legislation prescribes rights that a shareholder may exercise on his or her own. Specifically, the protection is granted mainly through the equal treatment principle, the economic right, the participation right and the exit right.

First, equal treatment is confirmed in Article 126 of the *CCL*, which maintains that "each share of the same class shall be entitled to the same rights". And Article 103 of the *CCL* declares the "one share, one vote" by specifying that each share held by a shareholder should entitle the holder to one voting right at the general meeting, except for the shares held by the company itself. Furthermore, Article 8 of the *Chinese Corporate Governance Code* (*hereinafter CCGC*)[198] stresses that a listed company's corporate governance should protect shareholders' rights, especially those of small and medium shareholders. In addition to common shares, Article 131 of the *CCL* grants the State Council the power to regulate other categories of shares, such as preferred shares, in separate provisions.

Second, the *CCL* prescribes that a shareholder is entitled to the right to a dividend,[199] and the general meeting has the power to declare and distribute

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[194] Based on Article 101 of the *CCL*, shareholders who represent 10% or more than 10% of the voting rights may propose to convene the interim meeting of the board of directors.
[195] Article 182 of the *CCL* prescribes the most extreme situation whereby the company is facing great difficulty in its operation and management, and the continued existence of the company will expose shareholders to great losses and there is no other way to solve the problem.
[196] For Article 151 of the *CCL*, more discussion on the derivative action can be found in section 3.4.2 of this chapter.
[197] The fiduciary duties of directors and controlling shareholders will be elaborated in 3.4.2 of this chapter.
[198] *上市公司治理准则* (*Code of Corporate Governance of Listed Companies*), China Securities Regulatory Commission and the State Economic and Trade Commission, date of issue January 7th 2002. The latest amendment came into effect on 30th September, 2018. The citations in this research refer to the 2018 version. The legal effect of the *CCGC* is at the level of "normative documents", which has a binding effect.
[199] Article 4, *CCL*.

dividends.[200] The general rule is that the distribution of the remaining after-tax profits[201] should be in proportion to the shares held by the shareholder, albeit the articles of association can deviate from such a rule.[202] Besides the *CCL*, the *Provision on Strengthening the Protection of the Rights and Interests of Public Shareholders* (hereinafter *Public Shareholder Provision*)[203] holds the distribution of cash dividends as one of the preconditions for a listed company seeking to issue new shares.[204] In 2006, this precondition was specified in the *Administrative Measures for the Issuance of Securities by Listed Companies* as a dividend distribution of no less than 20% of the average annual distributable profits in the previous three years.[205] This dividend requirement was raised from 20% to 30% in 2008 by the *Decisions on Amending Some Provisions on Cash Dividends by Listed Companies*.[206] In 2012, the *Notice on Further Implement Related Issues of Cash Dividend of Listed Companies* emphasised that the decision to distribute cash dividends should be made in consultation with minority shareholders and independent directors.[207] The latest 2018 revision of the *CCGC* added a provision to deal specifically with the cash dividend problem. Article 10 states that a listed company's articles of association should explicitly stipulate the measures available for dividend distribution, especially cash dividend policies.[208] For a listed company that has the ability but chooses not to distribute cash dividends,

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[200] Article 99, *CCL*.

[201] Article 166 of the *CCL* regulates that 10% of after-tax profit shall be allocated to the company's statutory common reserve fund. Thereafter, the general meeting may also accrue a discretionary common reserve fund from the after-tax profit. And only after covering losses and making allocation to the common reserve fund can the remaining after-tax profit be distributed to shareholders.

[202] According to Article 166 of the *CCL*, the distribution of the remaining after-tax profit can deviate from the proportion of shares held by each shareholder, if the articles of association provide so.

[203] *关于加强社会公众股股东权益保护的若干规定* (*Provision on Strengthening the Protection of the Rights and Interests of Public Shareholders*), issued by China Securities Regulatory Commission, date of issue December 7th 2004.

[204] "No listed company may issue additional shares or convertible bonds to the general public or allot shares to its existing shareholders, if it did not make any profit distribution in cash in the last three years". Section 3, Article 4, *Public Shareholder Provision.*

[205] "The profits which it has accumulatively distributed in cash or in stocks are not less than 20% of the average annual distributable profits realized in the recent 3 years". Section 5, Article 8, *《上市公司证券发行管理办法》* (*Administrative Measures for the Issuance of Securities by Listed Companies*), China Securities Regulatory Commission, date of issue May 6, 2006, amended.

[206] *《关于修改上市公司现金分红若干规定的决定》* (*Decisions on Amending Some Provisions on Cash Dividends by Listed Companies*), China Securities Regulatory Commission, date of issue October 9th 2008.

[207] *《关于进一步落实上市公司现金分红有关事项的通知》* (*Notice on Further Implement Related Issues of Cash Dividend of Listed Companies*), China Securities Regulatory Commission, date of issue May 4th 2012.

[208] The revised 2020 *Chinese Securities Law* added Article 91, which similarly prescribes that the articles of association should specify the procedure and measures for distributing cash dividends, and a company should follow these provisions to distribute cash dividends if after-tax profits are available.

it should fully disclose its reasons for not doing so. The *Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China* (*IV*) (hereinafter *CCL Provisions IV*)[209] states that shareholders may file an action in a court based on the specific dividend distribution resolution of the general meeting.[210] Without this resolution, the court will reject the shareholder's request, unless the no-dividend resolution was the result of an abuse of shareholder rights, normally by the controlling shareholder and causing losses for other shareholders.[211]

Third, to encourage the participation of minority shareholders in corporate governance, Chinese legislation has made four key improvements, by strengthening the right to know, by stipulating friendly voting rules, by granting the right to request a court to cancel a flawed resolution and by the right to bring a direct action.

Right to know

Minority shareholders' right to know is represented by the right to inspect and the right to inquire. Article 97 of the *CCL* prescribes that a shareholder has the right to inspect corporate documents, which include "articles of association, shareholder registers, counterfoils of corporate bonds, minutes of the general meetings or of meetings of the board of directors or of meetings of the supervisory board and financial and accounting reports".[212] The *CCL Provisions IV* further clarifies that the right to inspect should not be substantially restricted by the articles of association or shareholder agreements.[213] Shareholders are entitled to bring an action if the right to inspect has been violated.[214] And if directors or senior managers fail in their duties, so that the company does not prepare or reserve documents prescribed in Article 97 *CCL*, shareholders are eligible to request compensation from responsible directors

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[209] *最高人民法院关于适用《中华人民共和国公司法》若干问题的规定（四）* (*Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China* (*IV*)), issued by the Supreme People's Court, date of issue 25th August 2017, date of effect 1st September 2017.

[210] Article 14, *CCL Provisions IV*.

[211] Article 15, *CCL Provisions IV.*

[212] Concerning the financial and accounting report, Article 165 of the *CCL* requires a company limited by shares to make them available 20 days in advance of the annual general meeting for its shareholders to inspect.

[213] Article 9, *CCL Provisions IV.*

[214] Article 7, *CCL Provisions IV.*

or senior managers.[215] For the right to inquire, Article 150 of the *CCL* clarifies that it is the general meeting that has the power to demand directors, supervisors and senior management personnel, as non-voting participants, be present at the general meeting, so that shareholders may question the above personnel.

Moreover, Chinese legislation provides various minority-friendly voting rules which cover the cumulative voting, proxy voting, online voting, supermajority and separate vote counting rules.

Cumulative voting

As an instrument designed to enhance the appointment rights of minority shareholders, and to increase their representation on boards, cumulative voting is prescribed in Article 105 of the *CCL*.[216] Precisely, when it comes to the election of directors and supervisors, the general meeting may adopt cumulative voting. However, it has to be clarified that cumulative voting is not a default rule pursuant to Article 105; instead, its application depends on the articles of association or the resolution of the general meeting.

In comparison with the *CCL*, the *CCGC* takes a stronger stance on minority representation on boards. For example, Article 17 of the *CCGC* starts with an explicit statement that the selection of directors or supervisors should fully represent the opinions of small- and medium-sized shareholders. If a single shareholder, or persons acting in concert, holds more than 30% of shares, the listed company should adopt cumulative voting. Furthermore, the listed company that employs cumulative voting should formulate detailed implementing rules in the articles of association.[217]

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[215] Article 12, *CCL Provisions IV.*

[216] According to section 2 of Article 105, cumulative voting applies when the general meeting appoints directors or supervisors, the number of voting rights under each share is equivalent to the number of directors or supervisors to be elected, and shareholders may cast all of their votes for a single candidate.

[217] Academics hold the opinion that there is a legislative conflict between Article 31 of the *CCGC* (Article 17 of the revised 2018 *CCGC*) and Article 105 of the *CCL*. Since the legal effect of the *CCL* is greater than the *CCGC*, it remains a question as to whether minority shareholders may rely on the judicial remedy to enforce cumulative voting, if the controlling shareholder (a single shareholder and persons acting in concert in the revised 2018 *CCGC*) owns more than 30% shares, while the articles of association do not recognise cumulative voting. See: Xiao Wei, Lu Xiongying and Xu Yang et.al 上市公司治理准则与国内经济法律制度匹配性研究 (Research on the Compatibility between Code of Corporate Governance of Listed Companies and the Chinese Economic Legal System), available at http://max.book118.com/html/2014/0525/8459675.shtm. Last visited February 2019.
In addition to cumulative voting, Article 79 of the C*CGC* highlights that institutional investors shall play a role in the appointment of directors.

Proxy voting

Article 106 of the *CCL* endows a shareholder with the right to authorise a proxy to attend the general meeting and also to exercise voting rights within the scope of authorisation. The corresponding procedure requirement is that the proxy should submit the power of attorney issued by the shareholder to the company. Besides the *CCL*, the *CCGC* affirms that proxy voting has the same legal effect as voting in person,[218] and the solicitation of votes should be conducted in a gratuitous way; moreover, there should be no minimum shareholding threshold to exercise the right to solicitation.[219] Recently, the revised 2020 *Chinese Securities Law* (hereinafter 2020 *CSL*)[220] added two articles to regulate proxy solicitation. Article 90 stipulates that a listed company's board of directors, independent directors, shareholders who hold 1% or more shares and the Investor Service Center are entitled to independently or to designate securities companies or securities service institutions to solicit shareholder votes.[221] Illegal solicitation which damages a listed company or its shareholders' interests comes with compensation liabilities. Article 199 specifies that any breach of Article 90 will face correction, warning or a fine under 500 thousand RMB.

Online voting

Online voting is a modern voting method which allows minority shareholders to express their own will without being physically present at the general meeting. This new method may largely reduce the voting cost, and thus it is highly recommended by Chinese legislation. The *Public Shareholder Provision* places a strong emphasis on online voting as a method to encourage the participation of minority shareholders in listed companies. On December 28th 2004, both the SSE and the SZSE issued their own *Implementing Rules for Online Voting at General Meetings of Listed Companies*.[222] In addition, the

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218 Article 15, revised 2018 *CCGC*.
219 Article 16, revised 2018 *CCGC*.
220 The *Chinese Securities Law* was originally promulgated by the Standing Committee of the National People's Congress on 29th December 1998, amended on 28th August 2004, on 27th October 2005, on 29th June 2013 and 31st August 2014. The latest amendment was on 28th December 2019 and will come into effect on 1st March 2020.
221 The solicitation should not be conducted in a paid way, and solicitation documents should be disclosed. Article 90, revised 2020 *CSL*.
222 *上海证券交易所上市公司股东大会网络投票实施细则* (*Implementing Rules of SSE for the Online Voting at General Meetings of Listed Companies*), Shanghai Stock Exchange, date of issue December 28th 2004. Amended on September 8th 2006; February 22nd 2011; and the latest amendment issued on January 15th 2015.

Guidance on Listed Companies' Articles of Association (*hereinafter Guidance on AoA*)[223] also calls for listed companies to adopt modern techniques, such as online voting. The 2018 revision of the *CCGC* also stipulates that the general meeting should be held in a combination of on-site meetings and online voting.[224]

Supermajority rule

Under the simple majority rule, the controlling shareholder often dominates the voting process. Consequently, Article 103 of the *CCL* clarifies that major events, such as a "modification of the articles of association, increase or reduction of the registered capital, merger, division or dissolution, or the conversion of the company", require a two-thirds supermajority. Additionally, Article 121 of the *CCL* commands a supermajority when "the value of the purchase or sale of any substantial assets or the provision of guarantee exceeds 30% of the total asset value of the listed company within a given year".

Separate vote-counting rule

Also known as the "majority of minority" rule, separate vote counting applies in order to guide major issues that may influence minority shareholders' interests.[225] According to the *Public Shareholder Provision*, major decisions of a listed company not only require the resolution of the general meeting, but also a simple majority agreement of public shareholders.[226] Furthermore, these major decisions include the issuance of additional shares, convertible bonds and the allotment of shares to the company's existing shareholders; "major asset reorganisation, in the case where the total price of the assets purchased exceeds the audited net book value of those assets by 20% or more"; a shareholder who repays the debts owed to a listed company with the shares of this company that he or she holds; oversea listing of any subsidiaries

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深圳证券交易所上市公司股东大会网络投票实施细则 (*Implementing Rules of SZSE for the Online Voting at General Meetings of Listed Companies*), Shenzhen Stock Exchange, date of issue December 28th 2004. Amended on April 20th 2006; February 1st 2010; February 14th 2014; and the latest amendment on September 5th 2014.

223 *上市公司章程指引* (*Guidance on Listed Companies' Articles of Association*), issued by China Securities Regulatory Commission, date of issue 20th October 2014.

224 Article 15, the revised 2018 *CCGC*.

225 *关于加强社会公众股股东权益保护的若干规定* (*Provision on Strengthening the Protection of the Rights and Interests of Public Shareholders*), issued by China Securities Regulatory Commission, date of issue December 7th 2004.

226 Article 1 of the *Public Shareholder Provisions* implements the "majority of minority" rule on a trial basis.

which has a great influence on a listed company and other issues that may have a significant impact on public shareholders' interests.[227]

Right to request a court to cancel, confirm the non-existence or invalidate a resolution

In addition to the preferential treatments in voting mentioned above, Article 22 of the *CCL* endows a shareholder with the right to request a court to cancel a flawed resolution or confirm a resolution that has never been formed or is invalid.[228] Specifically, a resolution of the general meeting or the board of directors is invalid by default if its content breaches laws or administrative regulations. In a lenient case, if the convening or voting procedures of the general meeting or the meeting of the board of directors violate laws, administrative regulations or articles of association, or if the content of the resolution violates the articles of association, then a shareholder may request a court to cancel the resolution within 60 days. However, Article 22 also imposes a restriction on this right, namely when a shareholder brings a cancellation lawsuit, in which case the company can request the court to demand a guarantee from the plaintiff shareholder.

Direct action

Additionally, minority shareholders have the right to bring a direct action. Different from the derivative action, the direct action does not have a threshold. Article 152 of the *CCL* prescribes that directors, senior management personnel who breach laws, administrative regulations or articles of association, infringe on shareholders' interests, the shareholder(s) is/are entitled to bring an action in a court. Simply judging from this Article, the direct action seems to have a narrower scope than the derivative action. Namely, it does not specify whether supervisors or "any other person" can be charged as the respondent.

However, for securities compensation litigation based on for example false statements, if claims fall into the same type and one party involves numerous person, then a representative can be selected to proceed the action. The court

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[227] Article 1, *Public Shareholder Provisions*.

[228] The right to request the court to confirm a resolution that has never been formed was newly added by the *CCL Provisions IV*.

Article 2 of the *CCL Provisions IV* also clarified that the plaintiff should remain as a shareholder of the company at the time of bringing an action to cancel the disputed resolution.

should make an announcement of the case so that investors may register with the court within a certain period. The verdict or ruling of the court will be valid for all registered investors. The China Securities Investor Service Center may act as the litigation representative if it received authorizations from 50 or more shareholders. The China Securities Investor Service Center will register with the court on behalf of investors who have been confirmed by the securities registrar, except those who have clearly expressed their unwillingness to participate in the litigation. This Chinese "representative action" were recently added as Article 95 in the revised 2020 *CSL*.

Fourth, Chinese legislation offers minority shareholders the freedom to leave the company. Article 137 of the *CCL* affirms a shareholder's right to transfer his or her shares, albeit with certain exceptions.[229] In acquisitions, shareholders are entitled to mandatory bid rule and sell-out right protection. Similarly, minority interests are guarded by the appraisal right in mergers. Protection in takeover transactions will be further elaborated in paragraph 3.4.1 of this chapter.

3.2.2 Protection by quasi-state institutions

Different from many jurisdictions, corporate governance in China consists of a general meeting of shareholders, boards and the party organisation. Participation of the party organisation in corporate governance has gone through four main stages in China.[230] In the plan economy stage, the party was in charge of SOEs' operations. At the beginning of the opening and reform stage, the party intended to step down and shown more respect to the autonomy of the company. After the establishment of the socialist market economy, the party organisation primarily focused on its political role rather than business-oriented issues. Nevertheless, the classification reform stage brought back a strengthened party organisation in corporate governance.[231]

This party influence has been reinforced by recent policies. For instance, in the 2016 document *Promote Party Building While Comprehensively Deepening SOE*

[229] Article 141, *CCL*.
[230] Liu Dahong and Xu Danlin, '党组织参与国企公司治理的路径与法律研究-以国企分类改革为视角 (The Approaches and Implementation Mechanism of the Party's Participation in Administering the State-owned Enterprises Under the Circumstances of Classification Reform)', 23 (2017) *中南大学学报* (*Journal of Central South University*), pp. 31-38.
[231] Ibid.

Reform,[232] the State-owned Assets Supervision and Administration Commission (hereinafter SASAC) confirmed an "ex-ante procedure", in that major decisions should be discussed and approved by the party organisation before being submitted to the board of directors.[233] Similarly, two *Circulars*[234] were issued by the State Council in 2017 to strengthen the party organisation's leadership in SOEs, especially the supervision of cadres. Specifically, the party organisation is in charge of three main tasks: making "three important, one large decisions", i.e. decide on important decisions, important cadres, important projects and the usage of large funds; "double entry, cross offices", i.e. members of the party organisation can also serve as directors, supervisors and managers and vice versa; "party supervising both cadres and talents", whereby the party cooperates with the board of directors to appoint senior executives and human resource management, and the party seeks to build up professional talents.[235] Furthermore, the revised 2018 *CCGC* added Article 5 to require explicitly all listed companies to establish party organisations and state-controlled listed companies to incorporate party organisation policies into their articles of association. The party organisation plays both a leadership role and a political core role,[236] and the party organisation even comes before the board of directors in the decision-making process.[237]

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232 《在全面深化国企改革中加强党的建设工作》, available at http://www.qstheory.cn/dukan/qs/2016-05/31/c_1118938354.htm. Last visited February 2019.

233 Jamie Allen, Li Rui, Guo Peiyuan, Li Zhaowen, Zhang Zhengjun and Zhou Chun, *Awakening governance: The Evolution of Corporate Governance in China*, Asian Corporate Governance Association China Corporate Governance Report 2018, available at https://www.acga-asia.org/specialist-research.php. Last visited February 2019.

234 *Guiding Opinions on Further Improving the Legal Person Governance Structure of State-owned Enterprises 《关于进一步完善国有企业法人治理结构的指导意见》* and *Notice on Forwarding the Plan of SASAC on Focusing on Capital Management and Advancing the Functional Transformation《国务院办公厅关于转发国务院国资委以管资本为主推进职能转变方案的通知》*, issued by the General Office of the State Council, available at http://www.gov.cn/zhengce/content/2017-05/03/content_5190599.htm and http://www.gov.cn/zhengce/content/2017-05/10/content_5192390.htm. Last visited February 2019.

235 Supra. 233.

236 The party organisation decides SOEs' directions, macro development and the implementation of party policies, law and legislations and major decisions of the central party. See: Ma Lianfu and Wang Jianing, '党组织嵌入国有企业治理结构的三重考量 (Considerations of Party Organizations Embedded in the Governance Structure of State-owned Enterprises)', 3 (2017) *改革* (*Reform*), pp. 5-13.

237 The party organisation has the right to participate in decision-making when it comes to major company issues. With the implementation of the "double entry, cross-offices" policy, the party organisation has a greater influence on the board of directors. Normally, the party organisation and members of the board of directors have a meeting before any decision-making. Later, these board members will report the opinion of the party organisation to the board of directors. See: Ma Lianfu, Wang Yuanfang and Shen Xiaoxiu, '中国国有企业党组织治理效应研究 (Research on Governance Effects of China's State-owned Companies' Party

In order to improve further the corporate governance of SOEs, the Central Committee of the Chinese Communist Party established four pillars of SOE reform.[238] Especially, the main task of the SASAC should be limited to capital management, and it should improve SOEs and prevent the losses of state assets. In other words, government intervention is not boundless, and more decision-making should be delegated to the company. Moreover, SOEs should establish a modern corporate governance system in which checks and balances are guarded by the independent operation of both boards.[239] Besides, the SOE reform encourages the development of mixed ownership, namely state-owned capital and non-state-owned capital jointly support and supervise the development of a SOE.[240]

Under this peculiar "political company law"[241] structure, recent developments seem to show that China intends to solve its minority shareholder expropriation problem also through the visible hand of the government. Investor protection in China has been summarised as the "one body, two wings (一体两翼)" system.[242] The "one body" refers to the Investor Protection Bureau of the China Securities Regulatory Commission (hereinafter CSRC), and the "two wings" element refers to the Securities Investor Protection Fund and the China Securities Investor Services Centre.

The Investor Protection Bureau steers Chinese investor protection on the macro level and provides guidance on all relevant investor protection issues, such as improving legislation and policies to protect investors, supervising and educating related institutions, stock exchanges, associations and other market

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Organization-A Perspective Based on 'Insider Control')', 8 (2012) *中国工业经济* (*China Industrial Economics*), pp. 82-95.

238 These four pillars are capital management, the categorisation of SOEs, corporate governance and mixed ownership. See: supra. 233.

239 It was also stipulated that the party would supervise and guide the company through the "cross-office" process, i.e. where party members simultaneously hold board positions or vice versa. However, it is still unclear how this requirement could be fulfilled without damaging the independence of directors or supervisors. See: ibid.

240 Ibid.

241 The "political company law" emphasises the party organisation's participation in corporate governance. It intends to establish such a system whereby the party organisation supervises the company internally and the market supervises the company externally. See: Jiang Dazing, '走向"政治性公司法"-党组织如何参与公司治理 (Political Company Law: How Party Organisation Participates in Corporate Governance)', 23 (2017) *中南大学学报* (*Journal of Central South University*), pp. 27-33.

242 See: *New Channel of Investor Protection*, interpretation of policies, available at http://www.gov.cn/zhengce/2018-05/25/content_5293507.htm. Last visited February 2019.

participators, encouraging investors to seek legal remedies and organising domestic and international cooperation.[243]

Article 126 of the *Chinese Securities Law* establishes the Securities Investor Protection Fund (hereinafter SIPF), which is maintained by the state and composed of funds contributed by securities companies and other funds raised according to law. The State Council has the discretion to stipulate detailed rules to regulate the size,[244] raising, control and use of funds. The task of the SIPF is to compensate creditors and investors when securities companies are annulled, closed, bankrupted or under mandatory regulatory measures, such as in the case of an administrative takeover or a trusteeship.[245]

In December 2014, the China Securities Investor Services Centre (hereinafter ISC), i.e. a non-profit securities and financial institution under the direct control of the CSRC, was established to provide educational, legal, informational, technical and other services to minority shareholders.[246] In February 2016, the CSRC started a pilot project which approved the ISC holding shares of listed companies in Shanghai, Guangdong (excluded Shenzhen) and Hunan provinces. During the pilot project, the ISC issued letters to 181 listed companies and provided 388 suggestions on the articles of association. All 181 listed companies made their official responses, and more than 100 listed companies amended their articles of association. In April 2017, the CSRC announced that the pilot project had achieved significant success and the project would extend across the entire Chinese mainland. Up to May 2017, the ISC had become a shareholder in 3003 listed companies (with 100 A shares in each company) on the SSE and the SZSE. Shares held by the ISC are not for sale.[247] This minority guardian role of the ISC was confirmed in the 2018 revision of the *CCGC*, which added Article 82 to call for the active participation of the ISC in the interests of minority shareholders, as well as in the newly revised 2020 *CSL* that the ISC should assist minority shareholders with vote solicitation,[248] advanced compensation, mediation, and litigation.[249]

[243] See: http://www.csrc.gov.cn/pub/newsite/tzzbhj/. Last visited February 2091.
[244] This element was recently added into the 2020 *Chinese Securities Law*.
[245] See: http://www.sipf.com.cn/index.shtml. Last visited February 2019.
[246] See: http://www.isc.com.cn/about_us/. Last visited February 2019.
[247] See: http://www.isc.com.cn/exercise/201705/t20170517_171506.shtml. Last visited February 2019.
[248] See: 3.2.1 proxy voting.
[249] Articles 90, 93, 94 and 95, revised 2020 *CSL*.

If an issuer's fraudulent issuance, false statement or other illegal behavious damage shareholders' interests, the issuer's controlling shareholder, actual controller or related securities companies can designate the ISC to reach an advanced compensation agreement with the shareholders.[250] Regarding disputes between shareholders and issuers or securities companies, either party can request the ISC for a mediation.[251] Based on its shareholder identity, the ISC represents minority shareholders in exercising all kinds of rights, such as the inspection right and the voting right. For rights with a threshold, such as the right to initiate an interim proposal and the right to bring a derivative action, the ISC represents minority shareholders exercising these rights through the public solicitation of votes.[252] After the latest amendment of the 2020 *CSL*, derivative actions filed by the ISC based on its shareholder identity are exempted from the 180 consecutive days and the 1% shareholding requirements.[253] With authorizations of 50 or more shareholders, the ISC can act as the litigation representative in securities compensation suits.[254] To support further minority shareholders' right to suit, the ISC collaborates with the All-China Lawyers Association, and it is in charge of the preparation of litigation materials as well as the appointment of litigation attorneys. In other words, minority shareholders do not need to pay lawyers' fees but only the litigation fee, which is refunded if minority shareholders eventually win the case.[255] The ISC, through its website and other media platforms, discloses relevant information in a timely manner regarding the exercise of shareholder rights. The ISC also supervises listed companies and reports any illegal actions to the CSRC.[256]

In addition to the SIPF and the ISC, an investor hotline 12386 and an investor website[257] were established to provide small and medium investors with information, consultation services, mediation and other assistance. Securities companies are held liable to shareholders for compensations unless a company fully informs itself of relevant shareholder information, discloses its securities' or services' important information and risks, and sells securities or provides

[250] Article 93, revised 2020 *CS L*.
[251] Article 94, revised 2020 *CSL*.
[252] See: http://www.isc.com.cn/exercise/201705/t20170517_171505.shtml. Last visited February 2019.
[253] Article 94, revised 2020 *CSL*.
[254] Article 95, revised 2020 *CSL*.
[255] See: http://www.isc.com.cn/rights/201705/t20170517_171527.shtml. Last visited February 2019.
[256] See: http://www.isc.com.cn/exercise/201705/t20170517_171505.shtml. Last visited February 2019.
[257] See: https://www.investor.gov.cn/. Last visited February 2019.

services that are suitable to its investors.[258] In terms of disputes between individual investors and securities companies, the burden of proof falls on the securities companies.[259]

3.2.3 Analysis

Corporate governance in China has its own characteristics, one of which is the participation of party organisations. Under this "political company law", the goals of minority shareholder protection are pursued by both the legal approach and the political approach. The legal approach refers to shareholder rights prescribed in Chinese legislation, while the political approach refers to protection provided by quasi-state institutions, particularly the ISC.

Chinese legislation presents a strong general meeting which is in charge of the significant decision-making in a listed company.[260] Considering the highly concentrated ownership structure, a controlling shareholder can easily dominate the general meeting and usurp its strong power granted by law. Consequently, and as discussed in Chapter 2, a strong controlling shareholder may turn out to be a double-edged sword for minority shareholders.

Also, Chinese legislation provides shareholders with rights with a threshold, which normally consists of a shareholding or timing requirement, or a combination thereof. According to SZSE statistics, individual minority shareholders hold their shares for 39.1 consecutive days on average, and institutional investors hold their shares for 190.3 consecutive days on average.[261] Up to February 2016, 27.83% individual minority shareholders held less than 10,000 RMB share capital, and 48.9% individual minority shareholders held a share capital between 10,000 and 100,000 RMB. In contrast, 52.72% institutional investors held more than 1 million RMB share

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[258] Article 88, revised 2020 *CSL*.
[259] Article 89, revised 2020 *CSL*.
[260] Nicholas C. Howson, 'Protecting the State from Itself? Regulatory Interventions in Corporate Governance and the Financing of China's State Capitalism', in Benjamin L. Liebman and Curtis J. Milhaupt (eds.), *Regulating the Visible Hand?: The Institutional Implications of Chinese State Capitalism* (New York: Oxford University Press, 2016), pp. 49-68.
[261] The most recent available statistics this research could find were collected from 2009-2012. See: 从近年数据看深市投资者结构和行为变化特征 (Characteristics of trading and structure of investors of the SZSE Based on Recent Statistics), available at http://www.csrc.gov.cn/zhejiang/gzdt/201305/t20130530_228814.htm. Last visited February 2019.

capital.[262] Compared with individual minority shareholders, institutional investors hold more shares and for a longer period. Besides institutional investors, the newly developed ISC is a long-term shareholder with 100 shares in a listed company. Though the ISC does not own a large amount of shares, its semi-governmental status may help it to solicit votes easily from individual minority shareholders and overcome the shareholding threshold. After 1st March 2020, the ISC is no longer restricted by the threshold when bringing derivative actions thanks to recent legislative developments. Consequently, qualified minority shareholders, such as institutional investors and the ISC, have a greater chance than individual minority shareholders of overcoming the threshold and exercising these shareholder rights, either on their own or through a coalition.[263] Under a highly concentrated ownership structure, the participation of qualified minority shareholders may strengthen the supervision of both management and the company controller, and thus individual minority shareholders are also protected. Nevertheless, if the interests of qualified minority shareholders are in conflict with those of individual minorities, then the former could turn out as expropriators instead of guardians of the latter.[264]

However, minority shareholder rights prescribed in Chinese legislation are still subject to various limitations. First, the implementation of many minority rights depends on the general meeting. For example, minority shareholders are entitled to the right to a dividend, but the power to declare and distribute dividends remains with the general meeting. Minority shareholders also have the right to question directors, supervisors or senior managers, but they have to count on the general meeting to demand that the above personnel are present at the meeting. This reliance on the general meeting may cause an obstacle if there is a controller-minority conflict.

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262 中国股市投资者全景图：个人账户高达 99.71% (An Overview of the Investors on the Chinese Stock Exchange: the Number of Individual Shareholders Accounts for 99.71%), available at http://finance.sina.com.cn/money/smjj/smdt/2016-04-01/doc-ifxqxcnr5189753.shtml. Last visited February 2019.

263 Jin Qiong, '对机构投资者、独立董事制度与公司治理的思考(A Thought on the Relations of Institutional Investor, Independent Director System and Corporation Governance)', 4 (2013) *铜陵学院学报* (*Journal of Tongling University*), pp. 45-48.

264 Zhai Feng, '公司治理视角中的中小股东权益保护 (Minority Shareholder Protection Under the Perspective of Corporate Governance)', 1 (2013) *上海企业* (*Shanghai Enterprise*), pp. 67-69.

Second, scholars express some concerns about the right to request a court to cancel a flawed resolution.[265] Especially, the 60-day limit to bring an action is calculated from the day that the resolution was made. A strict application of this time limit may ignore the interests of uninformed minority shareholders who may have been unaware of the meeting in the first place.[266] Besides, scholars emphasise that the guarantee requirement may cause a huge obstacle for minority shareholders seeking to bring litigation in practice, and the law should clarify preconditions pertinent to requesting a guarantee, such as the respondent's obligation to prove the "bad will" of the applicant.[267] Vanke (万科) is a controversial case in terms of this "guarantee" requirement. Responding to a litigation, which requested the court to cancel flawed resolutions made by the board of directors, the company demanded minority shareholder applicants a guarantee of 1.2 billion RMB.[268]

Third, some minority preferential rules, such as the online voting and the separate vote counting rules, are mainly stipulated by regulatory documents, which may have less authority, since the main legal sources for a judicial ruling are laws and administrative regulations.[269]

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[265] Ye Haiyan and Mo Min, '论股东会决议瑕疵救济制度-以中小股东利益保护为视角 (Discussion on the Legal Remedies of Flawed Resolutions of the General Meeting-From the Perspective of Small-and-Medium Shareholder Protection)', 19 (2013) *会计之友* (*Friends of Accounting*), pp. 107-110.

[266] Ibid.

[267] Ding Yong, '公司决议瑕疵诉讼担保制度检讨及立法完善 (Examination and Improvement of the Guarantee System for Flawed Resolution Litigations)', 5 (2014) *法学* (*Law Science*), pp. 90-101.
Li Jianwei, '公司决议效力瑕疵类型及其救济体系再构建-以股东大会决议可撤消为中心 (Categories of Flawed Resolution and the Reestablishment of Its Legal Remedy-Focus on Revocable Resolutions of the General Meeting)', 15 (2008) *商事法论集* (*Commercial Law Review*), pp. 53-94.

[268] In the midst of the takeover battle between Vanke and Baoneng, Vanke turned to Shenzhen Metro as a white knight by passing 12 resolutions to issue new shares and to purchase Shenzhen Metro assets. An independent director, Zhang Liping, who was supposed to safeguard minority shareholders' interests, circumvented voting on the above resolutions, based on a conflict of interest. Two individual shareholders, Ms. Yuan and Mr. Zhang, brought an action in court for the cancellation of the above 12 resolutions. They claimed that Vanke did not review the claim of the independent director Zhang, did not disclose relevant information and did not postpone the voting but let independent director Zhang circumvent it, which led to the passing of the 12 resolutions. See: 小股东诉万科要求撤销董事会决议 被索 12 亿担保金 (Minority Shareholders Who Suit Vanke For Cancellation of Resolutions of the Board of Directors Were Requested For A Guarantee of 1.2 Billion), available at http://finance.sina.com.cn/roll/2016-09-27/doc-ifxwermp3973567.shtml. Last visited February 2019.
More details of the Vanke case can be found in 3.4.3 of this chapter.

[269] Deng Rui and Guan Yanfang, '控股股东的诚信义务与中小股东利益的保护 (Controlling Shareholders' Fiduciary Duty and Minority Shareholder Protection', 2 (2011) *特区经济* (*Special Zone Economy*), pp. 145-146.

3.3 Minority shareholder protection through monitoring mechanisms in China

Listed companies' disclosures are directly linked to minority shareholders' right to know, information asymmetry and the external supervision of the securities market and the CSRC. Likewise, the internal supervision system of a listed company is closely related to minority interests, since it oversees both management and the controlling shareholder. Accordingly, this part intends to explore how minority shareholders are protected by disclosure and the internal supervision system of a Chinese listed company.

3.3.1 Disclosure

Elaboration on disclosure follows three steps: a brief introduction to Chinese legislation, mainstream academic views on the disclosure of Chinese listed companies based on existing research and a discussion on the obstacles and elements that are detrimental to the transparency, as well as suggestions for potential improvements.

3.3.1.1 Disclosure in legislation

The main disclosure legislation in China covers the *Chinese Company Law*, the *Chinese Securities Law*, the *Chinese Corporate Governance Code* and the *Regulation on Listed Companies' Information Disclosure*.

Generally speaking, Chinese legislation regulates the disclosure of a listed company in relation to four elements, namely disclosure obligations, obligators, supervision and liabilities. First, disclosure obligations cover both positive and negative disclosures. A positive disclosure demands a listed company continuously and in a timely manner[270] discloses truthful, accurate, complete,[271] understandable[272] and substantial information, and it should also ensure all shareholders have equal access to this information. Besides

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[270] Article 88, *CCGC*.

[271] Article 78, disclosure standards of "simplify, clear and easy to understand" were newly added into the revised 2020 *CSL*.

[272] Article 92, *CCGC*.

mandatory disclosure, listed companies are encouraged to disclose voluntarily other useful information, but this disclosure should not serve any illegal purpose.[273] A negative disclosure states the clear prohibition of “false entries, misleading statements or major omissions”.[274] Second, the obligators of information disclosure concern issuers and their directors, supervisors, senior management personnel,[275] the sponsor, the underwriter, the controlling shareholder or the actual controller.[276] Third, Article 87 of the revised 2020 *CSL* delegates “the securities regulatory authority under the State Council” and the “stock exchanges” to oversee disclosur**e**. Furthermore, Article 9 of the *Regulation on Listed Companies’ Information Disclosure* (hereinafter *Information Disclosure Regulation*)[277] specifies that the CSRC and the stock exchange are two supervision bodies for information disclosure.[278] Fourth, Article 197[279] of the revised 2020 *CSL* states that a breach of the disclosure duty will lead to a correction, a warning and a fine of no less than 500,000 RMB but no more than 5 million RMB. For the directly-in-charge person and other directly responsible persons, a warning and a fine of no less than 200,000RMB but no more than 2 million RMB will be imposed. If the controlling shareholder or the actual controller organizes or instigates the illegal conduct, the sanctions mentioned above also apply. For “false entries, misleading statements or major ommissions”, the fine was raised to no less than 1 million RMB but no more than 10 million RMB; and its direct responsible persons’ fine was raised to no less than 500,000 and no more than 5 million RMB.

Chinese legislation enumerates the scope of disclosure of listed companies in eight ways:

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[273] Article 91, *CCGC*.
[274] Article 78, revised 2020 *CSL*.
[275] Article 82, revised 2020 *CSL*.
[276] Article 85, revised 2020 *CSL*.
[277] *上市公司信息披露管理办法* (*Regulation on Listed Companies’ Information Disclosure*), issued by China Securities Regulatory Commission, date of issue January 30th 2007.
[278] Specifically, Article 9 stipulates that the CSRC is in charge of supervising disclosed documents and related announcements, and managing information disclosure, and also the behaviours of the controlling shareholder, actual controller and other responsible persons for information disclosure. The stock exchange shall monitor disclosures of listed companies and other responsible persons, to urge them to disclose accurately and in a timely manner the required information, and to monitor the trading of securities and other derivative products. However, listing rules and other rules of information disclosure employed by the stock exchange shall be approved by the CSRC.
[279] In comparison with Article 193 of the 2014 *CSL*, the amendment imposed a harsher punishment by raising the fine range from 300,000 to 500,000 RMB, from 600,000 to 5 million RMB, from 30,000 to 200,000 RMB, from 300,000 to 2 milllion RMB, from 300,000 to 1 million RMB, from 600,000 to 10 million RMB, from 30,000 to 500,000 RMB, and from 300,000 to 5 million RMB.

- Listing documents: Article 64 of the 2014 *CSL* specifies that the public issuance of shares or corporate bonds, the prospectus or methods used for fundraising should be made public. For the issuance of new shares or bonds, financial and accounting reports should also be released**.** However, the revised 2020 *CSL* deleted this Article.
- Basic company reports: these refer to the mandatory disclosure of a listed company's interim report,[280] annual report[281] and provisional report.[282]
- 5% shareholding disclosure: the obligation to disclose when an acquirer owns more than 5% of a company's shares through the stock exchange, which will be further discussed in paragraph 3.4.1 of this chapter.
- Remunerations: article 116 of the *CCL* imposes a general obligation on the company to disclose regularly the remunerations of directors, supervisors and senior management personnel.

[280] According to Article 65 of the 2014 *CSL*, the interim report shall cover financial and accounting reports, the state of the business; major litigations; changes to issued shares or corporate bonds; important issues considered by the general meeting and other issues prescribed by the securities regulatory authority under the State Council. However, Article 79 of the revised 2020 *CSL* deleted the above specific requirements and only generally required the release of the interim report.

[281] Pursuant to Article 66, the annual report shall disclose the general situation; financial and accounting reports, the state of the business; a brief introduction to directors, supervisors and senior management personnel as well as their respective shareholdings; the situation regarding issued shares and corporate bonds, a list of the top 10 shareholders and their respective shareholdings; the actual controller and other issues prescribed by the securities regulatory authority under the State Council. However, Article 79 of the revised 2020 *CSL* deleted the above specific requirements and only generally required the release of the annual report.

[282] When a major event which may considerably affect the market price of shares has happened, and such an event has not been made known to the shareholders, Article 67 of the 2014 *CSL* requires the immediate submission of a provisional report to the securities regulatory authority under the State Council and the stock exchange. In addition, the report must be publicised. Based on Article 67, a "major event" refers to a fundamental change in business policy or the scope of business; major decisions on investments or the purchase of assets (Article 80 of the revised 2020 *CSL* added a standard of 30% of the company assets); the conclusion of an important contract which may have a considerable impact on assets, liabilities, rights and interests or business results (added important garantees or related-party transactions)**;** the incurring of significant debts or default on significant debts at maturity; a major deficit or loss; a major change to external business conditions; the replacement of directors, or one-third or more of supervisors or managers (added that " and the chairman or manager cannot perfom his or her duties"); a big change to the actual controller or shareholder with a 5% or more than 5% shareholding (added that "a big change to the actual controller and his or her other enterprises that run similar or the same business"); a decision on capital reduction, mergers, division, dissolution or bankruptcy (added that "important changes to dividend distribution, shareholding structure as well as legally enter bankrupt procedure or closed down"); a major litigation (added "abitration") or the nullification or rescission of a resolution of the general meeting or the board of directors; a criminal investigation into the company or (added the controlling shareholder , actual controller) a director, supervisor, or senior management personnel who has been held as a criminal suspect and under compulsory measure of the judiciary and other issues prescribed by the securities regulatory authority under the State Council. Article 80 of the revised 2020 *CSL* also added the controlling shareholder or actual controller's inform and disclose obligations regarding major events.

- Financial and accounting reports: apart from the basic company reports, Article 165 of the *CCL* stipulates a general rule that listed companies should publicise their financial and accounting reports.
- Information on the environment, social and governance (ESG): to improve the ESG scores of Chinese listed companies, the 2018 revision of the *CCGC* incorporated ESG reporting by adding Articles 95 and 96. Namely, a listed company should disclose relevant environmental information and provide information on its social responsibilities.[283] Besides, a listed company should disclose relevant corporate governance information and regularly analyse the status quo, devise plans to improve corporate governance and then implement these plans.[284]
- Shareholder information: persons such as shareholders who reach a disclosure threshold, actual controller, acquirer and its transaction party etc., should disclose information required by relevant regulations, cooperate with the disclosure of the listed company and inform the listed company about major events in a timely manner, such as changes of control, changes of ownership and affiliated relationships.[285]
- Related-party transactions: directors, supervisors, senior management personnel, shareholders who hold 5% or more shares and those who act in concert, and the actual controller of a listed company, should report in a timely manner the names and relationships of the related parties to the board of directors.[286]

3.3.1.2 Disclosure in practice

Based on available academic research, three observations on disclosure can be noted. First, the transparency of the Chinese securities market needs to be further improved. For example, it has been demonstrated that the average

[283] Article 95, *CCGC*.
[284] Article 96, *CCGC*.
[285] Article 90, *CCGC*.
[286] Article 48, *Information Disclosure Regulation*. Moreover, the listed company shall follow the deliberation procedure of related-party transactions and strictly exclude interested parties from voting on the related issues.

information cost[287] in mainland China is twice as great as the information cost of the Hong Kong market.[288]

Second, Chinese listed companies still face big challenges in terms of information asymmetries and unsatisfactory information disclosures.[289] Research has shown that during the period 2002-2010, the quality of information disclosed by A share listed companies on the SZSE was rather unstable, and most of the disclosures could hardly be regarded as satisfactory.[290] Furthermore, statistics from 2008 to 2012 show that there were 757 breaches of disclosure duty cases among Chinese listed companies. Specifically, there were 275 delays (36.3%), 252 major omissions (33.3%), 189 false statements (25%) and 41 fraudulent profits and assets (5.4%).[291] Moreover, research highlights that information disclosed by Chinese listed companies is "abundant but empty", and there is very little valuable material that can be used by shareholders.[292] Taking the disclosure of major events as an example, empirical research observes an abundance of low-quality information.[293]

Third, it has been claimed that the disclosure of fraudulent accounting information is the "Chinese chronic disease".[294] Publicly known influential cases illustrate the seriousness of this problem. In 2010, for instance, Huang Guanyu, the founder of GOME Electrical Appliances (国美电器), was

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287 According to Farlex Financial Dictionary, information costs include everything an individual or company spends when investigating whether a particular investment or activity is prudent and/or likely to be profitable, available at http://financial-dictionary.thefreedictionary.com/Information+costs. Last visited February 2019.

288 Wang Yihui, Liao Li and Deng Xiao Tie, '不对称信息，交易成本与投资者保护：内地（中国大陆）和香港的比较研究 (Asymmetry of Information, Transaction Costs and Investor Protection: Comparative Research between Mainland China and Hong Kong)', 10 (2003) *金融研究* (*Journal of Financial Research*), pp. 27-36.

289 证券市场中小投资者利益保护问题系统研究(Systematic Research on Protection of Small-and-Medium Investors in the Securities Market), available at http://www.sipf.com.cn/tzzjy/tbyj/2010/01/2750_2.shtml. Last visited February 2019.

290 Luo Jinhui, '上市公司的信息披露质量为何摇摆不定? (Why Quality of the Information Disclosed by Listed Companies Are Unstable?)', 1 (2014) *投资研究* (*Review of Investment Studies*), pp. 134-152.

291 Mi Zhiqiang and Xie Ruifeng, '上市公司信息披露违规研究 (Research on Illegal Information Disclosure of Listed Companies)', 1 (2015) *价值工程* (*Value Engineering*), pp. 160-162.

292 Chen Junlan and Xie Chi, '上市公司信息披露质量测度与评价 (Measurement and Evaluation of the Quality of the Disclosed Information of Listed Companies)', 23 (2013) *证券市场导报* (*Securities Market Herald*), pp. 25-33.

293 Zhang Zongxin and Zhu Weiye, '我国上市公司信息披露质量的实证研究 (Empirical Research on the Quality of the Disclosed Information of Chinese Listed Companies)', 1 (2007) *南开经济研究* (*Nankai Economic Studies*), pp. 45-59.

294 Liu Liguo and Du Ying, '公司治理与会计信息质量关系的实证研究 (An Empirical Research on the Relationship between Corporate Governance and the Quality of Accounting Information)', 2 (2003) *会计研究* (*Accounting Research*), pp. 28-36.

sentenced to 14 years' imprisonment for bribery, insider trading and illegal transactions. Furthermore, the disclosure of fraudulent financial information was the instrument through which Huang conducted financial fraud. In 2011, it was reported that "Xin Da Di (新大地)" had forged profits of 20.4236 million RMB. Additionally, it was condemned for major omissions in its 2012 pre-disclosed prospectus. In 2013, based on the announcement of administrative penalty decisions, 10 listed companies were punished by the CSRC or local securities regulatory bureaus for financial fraud. Furthermore, another nine listed companies were still under financial fraud investigation by the CSRC.[295] The insufficient punishment lowers disclosure rules' deterrent effect and accounts for continuing illegal disclosure in the Chinese securities market.[296]

3.3.1.3 Analysis

Disclosure has been demonstrated through empirical evidence to be closely related to minority shareholder protection in China.[297] For instance, research has shown that low-quality disclosure leads to severer tunnelling,[298] insider trading[299] and unstable business in Chinese listed companies.[300] On the contrary, a higher quality of disclosure can encourage Chinese listed companies to distribute dividends to their shareholders, and those with better transparency also tend to distribute more cash dividends.[301]

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295 More information regarding the above cases, see: Zhang Yong, '我国上市公司财务造假现状，成因及对策分析(Analysis on the Status quo, Causation and Solution of Financial Fraud of Chinese Listed Companies)', 11 (2014) *市场研究* (*Marketing Research*), pp. 61-62.
296 Li Jianwei and Li Jia qi, '中美股票市场比较分析与启示(The Comparative Analysis and its Enlightenment of China-US Stock Market)', 33 (2019) *湖南大学学报 (Journal of Hunan University),* pp.37-51.
297 Lan Wenyong and Wei Mingsheng, '我国上市公司信息披露机制实证检验-基于投资者保护的视角(Empirical Examination on the Information Disclosure System of Chinese Listed Companies—From the Perspective of Investor Protection)', 8 (2009) *广西社会科学* (*Guangxi Social Science*), pp. 46-51.
298 Wang Kemin, Ji Meiguang and Li Wei, '公司信息透明度与大股东资金占用研究 (Corporate Transparency and Tuneling)', 4 (2009) *南开管理评论* (*Nankai Business Review*), pp. 83-91.
299 Qu Wenzhou and Cai Zhiyue, '我国上市公司信息披露违规的动因实证研究 (An Empirical Study on the Motive of Illegal Disclosure of Listed Companies in China)', 4 (2007) *中国工业经济* (*China Industrial Economy*), pp. 96-103.
300 Quan Xiaofeng and Wu Shinong, 'CEO 权力强度、信息披露质量与公司业绩的波动性——基于深交所上市公司的实证研究 (CEO Power, Quality of Information Disclosure and Volatility of Business—An Empirical Research Based on Listed Companies of the Shenzhen Stock Exchange)', 4 (2010) *南开管理评论* (*Nankai Business Review*), pp. 142-153.
301 The research was based on the empirical evidence of A share listed companies on the SZSE during 2003-2010. See: Xu Shoufu, '信息披露、公司治理与现金股利政策：来自深市 A 股上市公司的经验证据

As presented in 3.3.1.1, existing Chinese legislation has imposed comprehensive disclosure obligations on listed companies. To increase the transparency of the Chinese market, it is important to address incentives, the institutional environment and other related elements. First, the highly concentrated ownership structure has an impact on both the incentive to disclose and the incentive to monitor. In a listed company, there is significant information asymmetry between minority shareholders and management. Different from minority shareholders, the controlling shareholder who has control over the company, and probably also dominates the board, has many informal channels through which to obtain information from within a company.[302] In other words, this information gap also exists between minority shareholders and the controlling shareholder. Both management and the controlling shareholder may have incentives to withhold information, in order to pursue their own interests at the expense of minority shareholders.

When it comes to the incentive to monitor, the concentrated ownership structure exhibits both sides of the same coin. The bright side is that the controlling shareholder may have a strong incentive to monitor management disclosure, which also serves the interests of minority shareholders. However, if the company controller is the one abusing the information asymmetry, then minority shareholders may be exploited. In this event, the safety of minority interests can only depend on the supervision of the CSRC, the securities market or minority shareholders themselves. Nevertheless, none of these "solutions" would be easy in China; for instance, the CSRC may face an accusation of self-supervision when the controlling shareholder is the state, and the quality of the supervision of the securities market has been challenged by empirical research.[303] For the last option, the "rational apathy"[304] and "free-rider"[305]

(Information Disclosure, Corporate Governance and Cash Dividend Policy: Empirical Evidence from A share Listed Companies on the Shenzhen Stock Exchange)', 1 (2013) *证券市场导报* (*Securities Market Herald*), pp. 1-11.

302 Chun Yip Yuen, Ming Liu, Xu Zhang and Chan Lu, 'A Case Study of Voluntary Disclosure by Chinese Enterprises', 1 (2009) *Asian Journal of Finance & Accounting*, pp. 118-145.

303 The empirical research, based on a sample of A share Chinese listed companies on the SZSE during 2002-2010, found that the "ups and downs" of the qualities of the disclosed information do not necessarily affect the share price or market values of the company. See: Luo Jinhui, '上市公司的信息披露质量为何摇摆不定? (Why is the Quality of the Information Disclosed by Listed Companies Unstable?)', 1 (2014) *投资研究* (*Review of Investment Studies*), pp. 134-152.

304 "Rational apathy" claims that it is a shareholder's rational choice not to be involved in a company operation after the cost-benefit analysis regarding enforcement of his or her rights.
See: Robert Charles Clark*, Corporate Law* (Boston and Toronto: Little Brown, 1986), pp. 390-392.
See also: Bernard S. Black, 'Shareholder Passivity Reexamined', 89 (1990) *Michigan Law Review*, pp. 520-608.

concerns have been known as obstacles to shareholder governance. Facing a powerful controller, these obstacles may become even more difficult for minority shareholders to overcome, and thus they may have fewer incentives to monitor the disclosure of the company.

Second, the institutional environment plays an important role in achieving a more transparent securities market. To begin with, accounting rules and the independence of auditors are crucial for disclosure. Some researchers claim that immature accounting rules and the unwillingness to follow full disclosure are two of the reasons why the accounting and reporting practices of Chinese listed companies still lag behind international accounting standards.[306] In addition, some auditors assert that there is a "race to the bottom" competition among auditing firms in China. Qin Xiaodong (George Qin), the partner and China affairs responsible person for the US auditing firm *Malone Bailey*, revealed that his Chinese clients once took him to task: "Why are you being so serious? You have to adapt to the unspoken Chinese rules if you want to do business here. Even some local governments are helping corporations with fraudulent financial disclosures". Furthermore, these complaints came from not only clients, but also other auditors.[307] Another research claims that the listed company is actually a relatively new concept in China. Many Chinese listed companies were transformed from the state-owned enterprises and unavoidably inherited the "old" governance problems. The pressure to survive on the securities market may tempt some companies to breach financial disclosure obligations and to forge good financial record.[308] Besides the above

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[305] The "free-rider" concern can be illustrated from two perspectives: on the one hand, due to the "opportunistic" consideration, it is easy for shareholders to sit still and do nothing but wish they could share information interests relying on other shareholders' monitoring behaviours; on the other hand, even if we assume shareholders are all highly moral people and there is no free-rider, Easterbrook argued that it will still cause waste if everybody repeats the same work, and it will also interrupt the division of labour. See: Frank H. Easterbrook, 'Mandatory Disclosure and the Protection of Investors', 70 (1984) *Virginia Law Review*, pp. 669-715.

[306] Lin Z. Jun and Wang Liyan, 'Financial Disclosure and Accounting Harmonization: Cases of Three Listed Companies in China', 16 (2001) *Managerial Auditing Journal*, pp. 263-273.

[307] Qin told the journalist that one peer approached him and warned him during a conference in Beijing that "if you continue to be so strict with the Chinese listed companies, then no one will dare to invest in the Chinese stock market, and we will all have no business in the future". Qin also expressed his concern that his auditing firm had lost a good deal of business with Chinese clients, due to its reputation for strict auditing. See: Wang Zhen, 近 3 月中国 19 家在美上市公司遭停牌或摘牌 (New York Exchange sanctioned 19 Chinese Companies for Stock Suspension or Delisting in the Past 3 Months), available at http://finance.sina.com.cn/stock/usstock/c/20110608/12369958941.shtml. Last visited February 2019.

[308] Yang Shizhong, Liu Saiding, '我国上市公司会计信息披露暨审计质量分析 (An Analysis of Audit Quality and Accounting Information Disclosure of China Listed Companies)', 2 (2013) *审计与经济研究* (*Journal of Audit & Economics*), pp. 42-48.

academic evidence, on December 3rd 2012, for the purpose of protecting US investors from accounting fraud perpetrated by Chinese companies listed on the US securities market, the SEC brought a charge against Chinese affiliates of four big accounting firms. This news cast serious doubt on the credibility of accounting firms in China.[309]

Furthermore, research points out that unsatisfactory law enforcement negatively affects the disclosure of Chinese listed companies,[310] so the supervision of the CSRC should be further improved. For example, it has been found that the CSRC, in many cases, has failed to discover forgery company prospectuses.[311] Regarding the breach of disclosure obligations, the CSRC mainly relies on soft measures, such as corrections and warnings, instead of harsher administrative sanctions. Based on 563 published disclosure-related cases dating from 2000 to 2012, there were 204 cases on which the CSRC imposed administrative sanctions, and there were 352 (62.52%) cases were merely subjected to self-discipline.[312] Empirical studies for the period of 2006 to 2014 revealed that the CSRC imposed very low sanctions on directors, independent directors, supervisors and senior managers.[313] Scholarly opinion asserts that the punishment for fraudulent financial disclosure is too low to deter offenders in China.[314] For example, Nanfang Gufen (南纺股份) continuously forged 344 million RMB profits over a five-year period; however, the company only faced a fine of 500,000 RMB, without any other penalty such as delisting or criminal prosecution. Another company, Lv Dadi (绿大地), even though it acquired its listing qualification by fraudulent pratices, was not subjected to delisting, and it even received a government subsidy of 13.072 million RMB. Similarly, ST Yaxin (ST 亚星), despite being sanctioned by the

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309 SEC Charges China Affiliates of Big Four Accounting Firms with Violating US Securities Laws in Refusing to Produce Documents, available at https://www.sec.gov/news/press-release/2012-2012-249htm. Last visited February 2019.

310 Lin Z. Jun and Wang Liyan, 'Financial Disclosure and Accounting Harmonization: Cases of Three Listed Companies in China', 16 (2001) *Managerial Auditing Journal*, pp. 263-273.

311 Li Boqiao and Wang Pei, '中国证监会信息监管的法律反思 (Introspection of the CSRC's Supervision on Information Disclosure)', 22 (2004) *河北法学* (*Hebei Law Science*), pp. 103-105.

312 Li Wenhua, '我国上市公司信息披露违法违规监管执法问题研究 (Research on the Law Enforcement of Breaches of Disclosure Obligations of Chinese Listed Companies)', 1 (2015) *西南金融* (*Southwest Finance*), pp. 56-60.

313 Zhang Fang and Li Xiang, '对证监会执法强度的实证分析(Quantitative Analysis of CSRC Enforcement Intensity)', 38 (2016) *现代法学 (Modern Law Science)*, pp. 173-183.

314 Zhang Yong, '我国上市公司财务造假现状，成因及对策分析 (Analysis on the Status quo, Causation and Solution of Financial Fraud of Chinese Listed Companies)', 11 (2014) *市场研究* (*Marketing Research*), pp. 61-62.

CSRC twice in 2013, also received a government subsidy of 150 million RMB in the same year.[315] And even when a huge fine of 449 million RMB was imposed on Yi'an Keji (亿安科技), it was never implemented in practice.[316]

In search of the reasons behind this phenomenon, research indicates that in the early days of the Chinese securities market, the security regulatory authority faced a difficult dilemma.[317] On the one hand, it should safeguard the interests of investors, but on the other hand, it was burdened with the task of assisting in the financing of state-owned enterprises. It was this dilemma that led to the unique Chinese phenomenon "selective supervision". However, with the modernisation of Chinese listed companies, the goal of "investor protection" has gradually aligned with the goal of "facilitating the growth of state-owned listed companies". Thus, the CSRC is expected to oversee in equal measure the disclosure of all listed companies and to build up a more transparent securities market in the future.[318]

In addition to the CSRC, courts' enforcement of disclosure rules is rather weak. In 2001, the Supreme People's Court issued the *Notice on Temporarily Stop Accepting Civil Securities Compensation Cases.*[319] In 2002, the Supreme People's Court promulgated the *Notice on Related Issues of Civil Tort Cases caused by Securities False Statement* (*hereinafter 2002 Notice*).[320] Thus, instead of an absolute rejection, courts can accept private securities cases caused by false statements. Besides, Article 2 of the *2002 Notice* imposes another filter, namely that only false statement cases which previously have been sanctioned by the CSRC or its agencies can be brought to courts. Subsequently in 2003, the Supreme People's Court enacted *Provisions on Adjudicating Civil Compensation Cases caused by Securities False Statement*

315 Ibid.
316 Cases on the breach of disclosure obligations are rarely brought to court for civil and criminal liabilities in China. See: Li Boqiao and Wang Pei, '中国证监会信息监管的法律反思 (Introspection of the CSRC's Supervision on Information Disclosure)', 22 (2004) *河北法学* (*Hebei Law Science*), pp. 103-105.
317 Zhao Juan, '国有上市公司信息披露监管分析 (Analysis on Information Release Regulation of State-owned Listed Enterprises)', 3 (2011) *技术经济与管理研究* (*Technoeconomics & Management Research*), pp. 96-101.
318 Ibid.
319 *最高人民法院关于涉及证券民事赔偿案件暂不予受理的通知* (*Notice on Temporarily Stop Accepting Civil Securities Compensation Cases*), Supreme People's Court, date of issue 21st September 2001, invalid.
320 *最高人民法院关于受理证券市场因虚假陈述引发的民事侵权纠纷案件有关问题的通知* (*Notice on Related Issues of Civil Tort Cases caused by Securities False Statement*), Supreme People's Court, date of issue 15th January 2002.

(*hereinafter 2003 Provisions*).[321] The *2003 Provisions* further clarify conditions to file a private securities' false statement litigation. For example, Articles 5 and 6 expand the scope of the filter prescribed in Article 2 of the *2002 Notice*. Besides cases sanctioned by the CSRC and its agencies, the *2003 Provisions* allows securities' false statement cases which were under administrative penalties imposed by the Ministry of Finance or other administrative authorities, or had been found criminally guilty, to enter into judicial proceedings. This situation lasted until the promulgation of the *Opinion on Promoting the Reform of the Registration System for Case Docket* in 2015.[322] This reform replaced the previous substantial review with the registration system. In other words, administrative sanctions are no longer a precondition for bringing securities' false statement litigation in courts.[323] Very recently, the revised 2020 *CSL* established a Chinese style of "class action" for securities civil compensation suits, and affirmed that the ISC may act as the litigation "representative" with 50 or more shareholders' authorizations. With the removal of the legislative obstacle, courts should gradually accept more breach of disclosure cases, in order to facilitate the enforcement of disclosure rules. Furthermore, with the recent development of the ISC project, the ISC should actively represent minority shareholders to bring direct action and seek compensation for any breach of disclosure duties based on tort.

Third, other elements influence the effect of disclosure. Research has found that elements such as the size and ownership structure of the firm, its composition, structure and the functioning of the board and director remuneration are related to the voluntary disclosure of a firm.[324] Another study, based on a sample of 472 listed companies on the SZSE in 2006, found that listed companies with an audit committee have higher information

321 *最高人民法院关于审理证券市场因虚假陈述引发的民事赔偿案件的若干规定* (*Provisions on Adjudicating of Civil Compensation Cases based on Securities False Statement*), Supreme People's Court, date of issue 9th January 2003.

322 *最高人民法院关于印发《关于人民法院推行立案登记制改革的意见》的通知 (Notice of the Supreme People's Court on Issuing the Opinions on Promoting the Reform of the Registration System for Case Docket by the People's Courts*), Supreme People's Courts, date of issue 14 April 2015.

323 Xiao Danfeng, '虚假陈述案件部分法律适用问题 (Legal Application Problems of False Statement Cases)', 1 (2020) *合作经济与科技 (Co-operative Economy & Science)*, pp.179-183.

324 Chun Yip Yuen, Ming Liu, Xu Zhang and Chan Lyu, 'A Case Study of Voluntary Disclosure by Chinese Enterprises', 1 (2009) *Asian Journal of Finance & Accounting*, pp. 118-145.

disclosure quality in comparison to those without an audit committee.[325] Apart from the audit committee, Chinese legislation accords "the secretary of board of directors" to be in charge of the information disclosure of listed companies.[326] It has been argued that qualified minority shareholders, such as institutional investors, are more capable and more motivated to monitor disclosure, in comparison with individual minority shareholders.[327] Based on statistics for Chinese listed companies from 2007-2010, research has found that the existence of long-term institutional investors is positively related to the voluntary disclosure of a company. Furthermore, this positive relationship becomes stronger when the institutional investors hold a larger shareholding in a concentrated company.[328]

In sum, the reason behind a listed company's breach of disclosure duty is that the benefit outweighs the cost of violation. To enhance the transparency of listed companies, it requires stronger supervision to impose a higher violation cost. This supervision is both internal and external. "Outward" supervision consists of the securities market and the CSRC. Specifically, the establishment of efficient market supervision demands an improvement in the credibility of intermediate agencies, such as accounting firms and law firms, as well as a more sensitive market which can quickly discipline any breach of disclosure duty with a lower share price. The CSRC should strengthen its supervision of

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[325] Cai Weixing and Gao Minghua, '审计委员会与信息披露质量：来自中国上市公司的经验证据 (The Audit Committee and Information Disclosure: Empirical Evidence of Chinese Listed Companies)', 4 (2009) *南开管理评论* (*Nankai Business Review*), pp. 120-127.
It is to clarify here that with the revision of *CCGC* in 2018, the audit committee has become mandatory for Chinese listed companies.

[326] First of all, Article 123 of the *CCL* prescribes that a secretary of the board of directors is in charge of preparing the general meeting and the meeting of the board of directors, preserving company files and shareholder data and disclosing information. On the basis of which, Articles 28 and 93 of the *CCGC* emphasise the information disclosure obligation of the secretary of the board of directors. It stipulates that the secretary organises and coordinates information disclosure issues, and he/she is in charge of publishing any disclosure. The secretary prepares and reserves documents of the general meeting, manages shareholders' materials, conducts disclosures and coordinates investor relationships. To fulfill their obligations, the secretary is entitled to participate in relevant meetings, inspect relevant documents and inform him or herself of the financial and operating situations of the company. In addition, Article 28 underlines that the board of directors and managers shall positively support the secretary to fulfill his or her obligations. To guarantee the independence of the secretary, it claims that no interference can be imposed on his or her work. Moreover, Article 45 of the *Information Disclosure Regulation* provides a more detailed provision.

[327] Wu Xia, '国有控股上市公司会计信息披露监管的探讨(Discussion on the Supervision of Disclosure of Accounting Information of State-owned Listed Companies)', 2 (2011) *审计与理财* (*Auditing and Finance*), pp. 40-41.

[328] Niu Jianbo, Wu Chao and Li Shengnan, '机构投资者类型、股权特征和自愿性信息披露 (Institutional Investor Types, Equity Characteristics and Voluntary Disclosure)', 25 (2013) *管理评论* (*Management Review*), pp. 48-59.

the securities market and impose stricter sanctions on severe misconduct. Equally, the CSRC should regulate the disclosure of both state-owned and non-state-owned listed companies. Correspondingly, “inward” supervision refers to more effective corporate governance within a listed company. Under the concentrated ownership structure, both the controlling shareholder and management may have incentives to abuse information asymmetry. Hence, the controlling shareholder should increase his or her supervision of management disclosure. However, if the controlling shareholder fails to supervise, or even actively abuses information asymmetry, then the solution may orient towards the involvement of the audit committee and the secretary of the board of directors and look at whether the participation of qualified minority shareholders can have certain restrictions on the controller. In addition, courts should gradually play a greater role in regulating breaches of disclosure obligations. Consequently, shareholders’ incentive to monitor could also be encouraged.

3.3.2 Supervision

In this part, the internal supervision of Chinese listed companies is first discussed in law, following which the functioning of internal supervision is assessed from an academic viewpoint. Current challenges and future developments are summarised in the end of the subsection.

3.3.2.1 Supervision in legislation

Chinese legislation regulating the internal supervision system of a listed company mainly consists of the *Chinese Company Law*, the *Chinese Corporate Governance Code*, the *Guiding Opinion on the Establishment of Independent Director System in Listed Companies* and the *Provision on Strengthening the Protection of the Rights and Interests of Public Shareholders.*

In China, a listed company consists of two boards, namely the board of directors and the supervisory board. For the board of directors, independent directors are also required. Supervisors and independent directors are in charge of internal supervision.

The supervisory board

The supervisory board is regulated in the *CCL* mainly through three Articles. Article 117 provides that it should have at least three members, and the supervisors should include both shareholder representatives and a minimum one-third of employee representatives.[329] A director or senior manager is forbidden from concurrently holding the position of supervisor.[330] Supervisors' power to oversee directors and senior management personnel is grounded in Article 118, which entitles them, as non-voting participants, to attend board meetings at which they may raise questions or give suggestions on discussed issues.[331] The supervisory board also has the competence to conduct an investigation when it notices any abnormality in the operation of the company, and an accounting firm can be hired, with the cost paid for by the company.[332] When a director or senior manager's behaviour damages the company's interests, the supervisory board has the power to require a correction. Ultimately, the supervisory board has the power to make proposals to remove directors or managers, but it has no determination power on the issue. Article 119 centres on the supervisory board meeting, which is held at least every six months and where supervisors can also propose to convene interim meetings of the supervisory board.[333]

Independent directors

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[329] Under Article 117, the articles of association can stipulate the specific proportion of employee representatives on the supervisory board. However, employee representatives shall make up no fewer than one-third of the members of the supervisory board.

[330] Moreover, based on Article 52 of the *CCL*, the term of office of a supervisor is three years and re-election is possible. In addition to the *CCL*, Article 45 of the *CCGC* sets down the qualifications of supervisors, namely a supervisor shall be equipped with professional knowledge or working experience.

[331] Besides the right to attend meetings of the board of directors, Article 48 of the *CCGC* prescribes that the supervisory board may request that directors, managers, other senior management personnel and internal or external auditing personnel be present at the meeting of the board of supervisors and to answer related questions.

[332] In addition to the supervision of directors and managers, Article 118 *CCL* also affirms the supervisory board's power to inspect any company financial issues, to propose to convene interim shareholders' meetings, to convene and preside over the general meeting when the board of directors fails in this duty, to submit proposals to the general meeting, to bring a lawsuit against a director or senior management person when conditions prescribed in Article 151 have been satisfied (However, according to Article 151, the board of supervisors does not enjoy independent power to bring an action against directors or senior management personnel. The precondition for exercising this power is a written request submitted by the shareholders), and other powers granted by the articles of association.

[333] Regarding voting rules and deliberation procedures, the law grants discretion to the articles of association, but it confirms that resolutions passed by the supervisory board shall be passed by simple majority, and supervisors presented at the meeting shall sign their names on the meeting minutes.

According to Article 122 of the *CCL*, the independent director system is a prerequisite for a listed company. Nevertheless, the *CCL* does not specify any details but leaves them to other regulations or rules.

The *CCGC* defines the independent director system in terms of two general aspects, namely directors should be independent from major shareholders and act as the guardians of minority shareholders. Article 35 of the *CCGC* states that a listed company should have independent directors who have no connections with the firm or major shareholders. Article 36 mandates that independent directors should not be influenced by major shareholders, actual controllers or other entities or individuals who may have interests in the listed company.[334] Moreover, Article 37[335] emphasises that independent directors should "particularly focus on lawful rights and interests of small-and-medium shareholders".[336] Since the latest 2018 *CCGC* revision, the audit committee is mandatory for Chinese listed companies. However, other special committees, such as the strategic committee, the nomination committee, the remuneration committee and the evaluation committee, are still left to the discretion of listed companies. Special committees, i.e. audit committees, nomination committees, remuneration and evaluation committees, should consist of a majority of independent directors.[337]

Additionally, the *Guiding Opinion on the Establishment of Independent Director System in Listed Companies* (hereinafter *"Independent Director Opinion"*)[338] provides more detailed provisions on independent directors relating to proportion, qualifications, independence, minority representation and power.

Article 1 (3) of the *Independent Director Opinion* states that independent directors should occupy at least one-third of a board of directors. With regard to qualifications, independent directors should include at least one professional accountant,[339] and they should have five or more years' working

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[334] Article 36 also states that independent directors are entitled to special powers on certain issues based on the articles of association and the legislation.
[335] Article 37 also states that if there is any conflict between shareholders or directors, independent directors should fulfill their responsibilities, to safeguard the listed company.
[336] It has been claimed by academics that the independent director system was introduced especially for the interest of minority shareholders. See: Zhou Ling, 'Independent Director System and Its Legal Transplant into China', 6 (2011-2012) *Journal of Comparative Law*, pp. 262-291.
[337] Article 38, *CCGC*.
[338] *关于在上市公司建立独立董事制度的指导意见* (*Guiding Opinion on the Establishment of Independent Director System in Listed Companies*), China Securities Regulatory Commission, date of issue August 21st 2001.
[339] Article 1, *Independent Director Opinion*.

experience in law, economics or other relevant fields.[340] Besides the qualification requirement, a candidate still needs to pass the "independence" test to become an independent director. Furthermore, the *Independent Director Opinion* defines the concept of independence by excluding conditions of dependence. Article 3 deprives certain personnel and their lineal relatives of the chance to become an independent director, for example an individual shareholder who directly or indirectly holds more than 1% of the issued shares or who is one of the top ten shareholders of the listed company; a person who works for an entity which holds directly or indirectly more than 5% of the issued shares, or this entity is one of the top five shareholders of the listed company.[341] To ensure the independence of independent directors, the CSRC is given the power to examine their qualifications.[342] Furthermore, the CSRC further authorises this examination power to the two stock exchanges.[343]

The *Independent Director Opinion* also encourages minority representation. It endows a shareholder who either independently or jointly holds more than 1% of the issued shares of a listed company with the right to nominate candidates for independent directors. However, the general meeting still has the final say on any appointments.[344]

Concerning the authorities, the *Independent Director Opinion* stipulates that independent directors have special powers for certain issues, such as major related-party transactions, the employment of an accounting firm, interim general meetings, meetings of the board of directors, the engagement of external auditing and consulting institutions and the solicitation of proxy voting.[345] Independent directors have the right to express their independent

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340 Article 2, *Independent Director Opinion*.

341 Besides the above two types of people, Article 3 also stipulates that the following persons shall be excluded from the position of independent director: employees of the listed company or its subsidiaries, and their lineal relatives as well as principal social relations (lineal relatives refers to parents, spouses, children, etc. and principal social relations include siblings, parents-in-law, spouses of siblings, siblings of spouses, etc.); any person who fits any of the three types mentioned above in the past one year; any person who provides the listed company or its subsidiaries with financial, legal or consulting services and other services; other personnel determined by the articles of association and the CSRC.

342 For those whose qualifications have been questioned by the CSRC, they can still become candidates for director positions but not be independent directors. Article 4, *Independent Director Opinion*.

343 Jamie Allen, Li Rui, Guo Peiyuan, Li Zhaowen, Zhang Zhengjun, and Zhou Chun, *Awakening Governance: The Evolution of Corporate Governance in China*, Asian Corporate Governance Association China Corporate Governance Report 2018, available at https://www.acga-asia.org/specialist-research.php. Last visited February 2019.

344 Article 4, *Independent Director Opinion*.

345 Pursuant to Article 5 of the *Independent Director Opinion*, a "major related-party transaction" shall be a total amount of more than 3 million RMB or higher than 5% of the net asset value according to the latest

opinions to the board of directors or the general meeting on issues that are likely to be contra to minority shareholders' interests.[346]

In addition to the *Independent Director Opinion*, an important order was issued in 2013 by the Organisation Department of the Communist Party of China. The order states that, within the first three years of retirement, party incumbents and former major cadres are forbidden from serving as independent directors of listed companies.[347]

Last but not least, the *Provision on Strengthening the Protection of the Rights and Interests of Public Shareholders* (hereinafter *Public Shareholder Provision*)[348] asserts that sufficient information is necessary for the effective functioning of the independent director system, and it particularly stresses cooperation between the secretary of the board of directors and independent directors.

3.3.2.2 Supervision in practice

Research provides mixed evidence on the effectiveness of the internal supervision of Chinese listed companies. Some academics hold the opinion

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auditing. A major related-party transaction first shall be acknowledged by independent directors, and subsequently it shall be submitted to the board of directors for discussion. And before independent directors make their judgment, they can hire an intermediary agency to provide an independent financial report. Besides, independent directors have the power to propose to the board of directors those they wish to hire or dismiss in terms of accounting firms, convening interim general meetings and convening meetings of the board of directors. Also, they can independently decide to engage external auditing and consulting institutions, as well as solicit proxy votes before the general meeting. If it fails any of the powers mentioned above, the listed company is obliged to disclose the related information. Last, Article 5 also confirms the simple majority rule for independent directors' resolutions. And, if a listed company is equipped with special committees, such as a remuneration, auditing and nomination committee, then more than half of the committee members shall be independent directors.

[346] Article 6 specifies that independent directors shall issue independent opinions on the following issues: nomination and appointment of directors; employing or dismissing senior management personnel; the remuneration of directors and senior management personnel; related-party loans or other capital transactions which are more than 3 million RMB or higher than 5% of the net asset value according to the latest auditing, and also whether the listed company has taken sufficient measures to recover the loans; issues may infringe on minority shareholders' interests according to independent directors' judgment and other issues specified by the articles of association.

[347] *关于进一步规范党政领导干部在企业兼职（任职）的意见* (*Opinions on Furthering Regulating Part-time (Full-time) Employment in Enterprises of the Leading Cadres in the Party and Government*), issued by the Organisation Department of the Communist Party of China, date of issue October 19th 2013.

[348] *关于加强社会公众股股东权益保护的若干规定* (*Provision on Strengthening the Protection of the Rights and Interests of Public Shareholders*), issued by China Securities Regulatory Commission, date of issue December 7th 2004.

that the functioning of the supervisory board is not yet sufficient.[349] For instance, based on a sample of 55 Chinese listed companies on the SZSE which were sanctioned by the CSRC during 2009 and up to the first half of 2013, it has been shown that none of these listed companies' supervisory boards discovered illegal activity.[350] Moreover, the research noted that no supervisor had voted "no" or "abstention" for malpractices accused by the CSRC.[351] More often than not, supervisory boards of Chinese listed companies remain followers of boards of directors.[352]

Furthermore, scholars claim that the ineffectiveness of the supervisory board is the reason behind the transplantation of the independent director system in China.[353] According to the Survey of Independent Directors in China,[354] there were 6497 independent directors in Chinese listed companies in 2013. During 2010 to 2013, boards of directors of A share Chinese listed companies voted more than 60,000 times, but only 47 "no" votes and 94 abstentions by

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[349] Xi opines that the supervisory board is nothing more than a decorative representation of the internal monitoring system of a Chinese listed company. See: Xi Chao, 'In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China', 22 (2006) *Connecticut Journal of International Law*, pp. 1-46.
No better than a "decoration", Yang and Yang also found that some Chinese listed companies' supervisors can indeed perform their duties satisfactorily, but the majority of them still come across as "rubber stamps". See: Yang Jingyuan and Yang Zhouxiao, '上市公司监事会的履职现状及问题探究 (Research on the Status quo of the Performance of the Supervisory Board of Chinese Listed Companies and its Problems)', 10 (2013) *北方经贸* (*Northern Economy and Trade*), pp. 109-110.
[350] Zhang Zhibo and Wang Guo, '我国上市公司监事会治理的实践 (Monitoring Practice of Supervisory Boards of Chinese Listed Companies)', 1 (2014) *金陵法律评论* (*Jin Ling Law Review*), pp. 112-125.
[351] Ibid.
[352] Ye Yang, '上市公司监事会形同"鸡肋"，三方面摆脱尴尬处境 (Supervisory Boards of Listed Companies only Exist on the Surface, and This Awkward Situation Shall be Removed from Three Aspects)', 3 (2013) *证券日报* (*Securities Daily*), pp. 1-2.
[353] Jin Pu, '公司的平衡—论独立董事和监事会的并存 (Balance of a Company-the Co-existence of the Independent Directors and the Supervisory Board)', 7 (2011) *法制与社会* (*Legal System and Society*), pp. 100-102.
Also Zhou Mei, '德国监事会制度的最新发展及对中国监事会发展的启示 (Newest Development of the German Supervisory Board System and its Inspirations for the Improvement of the Chinese Supervisory Board)', 7 (2009) *中德法学论坛* (*Johrbuch des Deutsch-Chinesischen Instituts fur Rechtswissenschatt der Universitaten Gottlingen undd Nanjing*), pp. 92-108.
[354] 中国独董生态调查 (The Survey of Independent Directors in China), available at http://stock.hexun.com/2014-07-29/167063245.html. Last visited February 2019.
Compared with the 2004 Survey of Independent Directors in China, which found that 33.3% of independent directors never voted 'no' or abstained in a meeting of the board of directors. Whilst 35% of independent directors never issued an independent opinion on the controlling shareholder or senior managers, the functioning of the independent director system did not witness a big change between 2004 and 2014. See: Yang Yudong, Libin, Guwen and Li Minglang, '中国独董生存现状 (Status quo of Independent Directors in China)', 6 (2004) *上海证券报* (*Shanghai Securities News*), available at http://www.ce.cn/new_hgjj/ziliao2/200410/27/t20041027_2108400.shtml. Last visited February 2019.

independent directors were recorded. Based on annual reports, more than 1700 listed companies stated that their independent directors were absent from board meetings. Moreover, research identifies four big problems with the independent director system in China, namely corruption, poor or non-existent diligence, non-independence and incompetence.[355] These existing problems unavoidably lower independent directors' supervision of a company, particularly in relation to the controlling shareholder. In the "ST Xindu (ST 新都)" case, due to the manipulation of directors and the controlling shareholder, the company was trapped in numerous illegal guarantees and loans, which led to a 130 million RMB compensation package ruled by the court. After the incident, ST Xindu's independent directors raised various proposals, such as replacing the audit firm and removing directors who had been appointed by the company controller. However, the independent directors failed to make any changes due to the rejection of the general meeting.[356] Consequently, scholarly opinion asserts that the Chinese independent director system does not essentially solve the supervision problem but merely functions as "decoration", also known as "vase directors", or "puppets" of the controlling shareholder.[357]

In contrast to these critiques, some research and empirical studies acknowledge the value of the supervisory board and the independent director system, observing a progressive trend. The case study of Congquin (重庆百货大楼股份有限公司) highlighted a negative market response when a Chinese listed company failed to issue its supervisory board report.[358] Especially after the 2006 amendment of the *CCL*, which largely increased the role of the supervisory board, an improvement was recorded.[359] Concerning the

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355 Liu Xinglong, '独董换血更需换机制 (Reshape the Independent Director System) in 中国独董生态调查 (The Survey of Independent Directors in China)', available athttp://stock.hexun.com/2014-07-29/167061798.html. Last visited February 2019.

356 Yang Jiao, '*ST 新都：独董与大股东的战斗(ST Xindu: the Fight Between Independent Directors and the Controlling Shareholder) in 中国独董生态调查 (The Survey of Independent Directors in China)', available at http://stock.hexun.com/2014-07-29/167062580.html. Last visited February 2019.

357 Zhou Ling, 'The Independent Director System and Its Legal Transplant into China', 6 (2011) *Journal of Comparative Law*, pp. 262-291.

358 Jay Dahya, Yusuf Karbhari, Jason Zezong Xiao and Mei Yang, 'The Usefulness of the Supervisory Board Report in China', 11 (2003) *Corporate Governance: An International Review*, pp. 308-321.

359 The 2006 amendment strengthened the power of the supervisory board in several aspects, such as the ability to propose to replace a disqualified director or manager or to bring a fraud litigation, to express opinions in a meeting of the board of directors, to make proposals to the general meeting, to supervise the CFO, secretary or the VP, to use external consultation services, etc. See: Ding Shujun, Wu Zhenyu, Li Yuanshun

supervisory board's monitoring of executive compensation, research has uncovered significant differences before and after 2006.[360] A similar opinion is that improvements in the supervisory board are the outcome of the powers strengthened in the 2006 amendment, compared to the 1994 *CCL*.[361]

Moreover, the 2014 *Report on Performance of Duty of the Supervisory Board of Chinese Listed Companies* (hereinafter *Supervisory Board Report*),[362] which was based on 576 valid questionnaires received in July 2014 from three groups, i.e. supervisors, management personnel, shareholders and other related parties of Chinese listed companies, illustrated that 41.3% of the recipients considered the supervisory board's role in minority shareholder protection as "mediocre", while 39.9% chose "satisfactory", 11.3% answered "good", 6.6% replied "bad" and 0.9% selected "very bad". Likewise, the 2013 *Report on Performance of Duty of Independent Directors of Chinese Listed Companies* (hereinafter *2013 Independent Director Report*)[363] depicted a general picture of the independent director system in China. Based on 275 valid questionnaires received in August 2013 from four groups, i.e. independent directors, management personnel, shareholders and other related listed company parties, the statistics showed that 50.8% of recipients considered independent directors' roles in minority shareholder protection as "satisfactory", 41% responded "mediocre", 6% responded "bad", 1.6% responded "good" and one recipient (0.5%) responded as "very bad". However, both reports explicitly clarified that their empirical results may be more optimistic than the reality, due to the fact that the above questionnaires were not conducted anonymously, and thus the recipients may have given higher ratings. Despite some positive evidence, scholars generally agree that the

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and Jia Chunxin, 'Can the Chinese Two-Tier-Board System Control the Board Chair Pay?' 1 (2009) *Asian Journal of Finance & Accounting*, pp. 1-22.

[360] Ding Shujun, Wu Zhenyu, Li Yuanshun and Jia Chunxin, 'Executive Compensation, Supervisory Board, and China's Governance Reform: A Legal Approach Perspective', 35 (2010) *Review of Quantitative Finance and Accounting*, pp. 445-471.

[361] Ding Shujun, Wu Zhenyu, Li Yuanshun and Jia Chunxin, 'Can the Chinese Two-Tier-Board System Control the Board Chair Pay?' 1 (2009) *Asian Journal of Finance & Accounting*, pp. 1-22.

[362] 上市公司监事会履职状况报告 (2014 Report on Performance of Duty of the Supervisory Board of Chinese Listed Companies), available at http://www.capco.org.cn/content_file/66/4/_1420043918_jshlzbg.pdf. Last visited February 2019.

[363] 上市公司独立董事履职情况报告 (2013 Report on Performance of Duty of Independent Directors of Chinese Listed Companies), available at http://www.capco.org.cn/content/26295.shtml. Last visited February 2019.

internal supervision of Chinese listed companies still needs some improvement.[364]

3.3.2.3 Analysis

Concerning the internal supervision of Chinese listed companies, existing research has identified two main challenges, namely the lack of real power and the lack of independence.[365]

First, both the supervisory board and independent directors have "soft" powers in China. Pursuant to Chinese legislation, the supervisory board has the power to demand a correction or propose a general meeting to remove a director or manager.[366] This is very different from the typical two-tier board system, such as the German example, in which the supervisory board has substantial power to appoint and remove directors directly.[367] Concerning this difference, critical scholarly opinion claims that "the Company Law of China expects that the board of supervisors will perform a supervisory role essentially by simply saying that it will".[368] Without any genuine power to select or remove directors and managers, supervisors cannot effectively perform their monitoring duties, even if they wish to do so.[369] Furthermore, this lack of substantial supervisory power also worsens existing information asymmetry between the two boards and further lowers the efficiency of the supervisory board.[370]

Similarly, existing research has pointed out, from a legislative point of view, two deficiencies in the power of independent directors. According to Chinese legislation, independent directors have the power to issue independent opinions on major events, and they also have special powers under certain

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[364] Ding Shujun, Wu Zhenyu, Li Yuanshun and Jia Chunxin, 'Can the Chinese Two-Tier-Board System Control the Board Chair Pay?', 1 (2009) *Asian Journal of Finance & Accounting*, pp. 1-22.
[365] Zhou Ling, 'The Independent Director System and its Legal Transplant into China', 6 (2011-2012) *Journal of Comparative Law*, pp. 262-291.
[366] See paragraph 3.3.2.1
[367] Supra. 365.
[368] Donald C. Clarke, 'The Role of Non-Legal Institutions in Chinese Corporate Governance', in H Kanda, K S Kim and C J Mihaupt (eds.), *Transforming Corporate Governance in East Asia* (Routledge 2008), pp. 168-192.
[369] Zhao Jun, 'Comparative Study of US and German Corporate Governance: Suggestions on the Relationship Between Independent Directors and the Supervisory Board of Listed Companies in China', 18 (2009) *Michigan State International Law Review*, pp. 495-510
[370] Yang Jingyuan and Yang Zhouxiao, '上市公司监事会的履职现状及问题探究 (Research on the Status quo of the Performance of the Supervisory Board of Chinese Listed Companies and its Problems)', 10 (2013) *北方经贸* (*Northern Economy and Trade*), pp. 109-110.

circumstances.[371] Nevertheless, this legislation is considered too vague and general,[372] for instance, it does not specify how to exercise the special powers or outline procedural requirements and other related issues.[373] As a result, these special powers are rarely exercised by independent directors in practice.[374] Furthermore, the *CCL* only has one Article that regulates independent directors. Rules relating to the independent director system, in terms of selection, powers and obligations, are all stipulated by regulatory documents. This low legal authority may therefore make independent directors' supervision more difficult in practice.[375]

Second, independence from the controlling shareholder remains questionable for both supervisors and independent directors in Chinese listed companies. Based on Chinese legislation, the general meeting has the power to appoint both supervisors and independent directors and also to determine their remuneration and allowances.[376] Under the concentrated ownership structure, it is likely that the controlling shareholder exclusively dominates the appointment of both supervisors and independent directors. In fact, various studies have provided evidence to support this statement. An interview-based research, for instance, observed a common phenomenon, in that the company controller dominated the general meeting and manipulated the board of directors and the supervisory board.[377] Another investigation asserted that supervisors were basically selected by the controlling shareholder and they normally had close personal relationships with the controller or the directors.[378] Likewise, most independent directors were found to be directly or indirectly chosen by the controlling shareholder in practice, and thus they were

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[371] See paragraph 3.3.2.1
[372] Supra. 365.
[373] Ibid.
[374] Jamie Allen, Li Rui, Guo Peiyuan, Li Zhaowen, Zhang Zhengjun, and Zhou Chun, *Awakening governance: The Evolution of Corporate Governance in China*, Asian Corporate Governance Association China Corporate Governance Report 2018, available at https://www.acga-asia.org/specialist-research.php, last visited February 2019.
[375] Supra. 365.
[376] See paragraph 3.3.2.1.
[377] Jay Dahya, Yusuf Karbhari and Jayson Zezong Xiao, 'The Supervisory Board In Chinese Listed Companies: Problems, Causes, Consequences and Remedies', 9 (2002) *Asia Pacific Business Review*, pp. 118-137.
[378] Yang Jingyuan and Yang Zhouxiao, '上市公司监事会的履职现状及问题探究 (Research on the Status quo of the Performance of the Supervisory Board of Chinese Listed Companies and its Problems)', 10 (2013) *北方经贸* (*Northern Economy and Trade*), pp. 109-110.

prone to either promoting the interests of the controller or loosely supervising management.[379]

In Chinese state-owned listed companies, the chairman of the board of directors, or of the supervisory board and the CEO, are typically granted political titles.[380] The SASAC nominates supervisors and sometimes its own officers as full-time supervisors and as supervisory board chairmen.[381] It is also common practice to hire former government officials as supervisors or independent directors, in order to take advantage of their political connections as well as social networks for the development of the company.[382] Different from state-owned companies, which build a natural relationship with the government, private listed companies are more likely to seek this political affiliation.[383] However, this political affiliation also has its negative side-effects, in that the former government officials may pursue their personal interests through rent-seeking or corruption at the expense of the company.[384] Furthermore, political affiliation may lead to inferior supervision, known as "open one eye, close the other".[385] Consequently, the lack of independence from the controlling shareholder may damage the performance of any internal supervision system set up in Chinese listed companies.

Additionally, research shows that a highly concentrated ownership structure (without good corporate governane) is the root of the unsatisfactory internal supervision of Chinese listed companies. Unbalanced corporate governance creates a super controller that largely constrains the functioning of monitoring

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379 Zhou Ling, 'The Independent Director System and its Legal Transplant into China', 6 (2011-2012) *Journal of Comparative Law*, pp. 262-291.

380 Jay Dahya, Yusuf Karbhari and Jayson Zezong Xiao, 'The Supervisory Board In Chinese Listed Companies: Problems, Causes, Consequences and Remedies', 9 (2002) *Asia Pacific Business Review*, pp. 118-137.

381 Cu Weihua, '独立董事的价值：来自独立董事集中辞职的证据 (The Values of the Independent Directors: from the Evidence of the Concentrated Designation of the Independent Directors)', 37 (2015) *经济管理* (*Business Management Journal*), pp. 56-66.

382 Ran Guangkui, Fang Qiaoling and Luo Shuai, '中国公司的监事会真的无效吗? (Is the Chinese Supervisory Board really Useless?)', 1 (2015) *经济学家* (*Economist*), pp. 73-82.

383 Jamie Allen, Li Rui, Guo Peiyuan, Li Zhaowen, Zhang Zhengjun, and Zhou Chun, *Awakening governance: The Evolution of Corporate Governance in China*, Asian Corporate Governance Association China Corporate Governance Report 2018, available at https://www.acga-asia.org/specialist-research.php. Last visited February 2019.

384 Supra. 382.

385 Yao Sheng, '政治关联、环境信息披露与环境业绩：基于中国上市公司的经验证据 (Political Affiliation, Environmental Information Disclosure and Business: Empirical Evidence of Chinese Listed Companies)', 4 (2011) *财贸研究* (*Finance and Trade Research*), pp. 78-85.

mechanisms,[386] and so scholars argue that the solution is to re-balance the ownership structure and to establish internal "checks and balances".[387] Essential to minority shareholder protection, qualified minority shareholders, such as institutional investors and foreign strategic investors, should be allowed to own a greater proportion of shares and be encouraged to participate actively in the governance of the company.[388] In particular, research has found that in companies with institutional investors, the proportion of independent directors is positively related to the performance of the company.[389] Scholars also claim that "long-term" institutional investors are conducive to the functioning of independent directors and the protection of individual minority shareholders. However, "short-term" institutional investors may conspire with the controlling shareholder, which in turn exaggerates the lack of independence and exposes individual minority shareholders to greater dangers.[390] Meanwhile, research admits that neither institutional investors nor independent directors are currently active enough in supervision. To tackle this "passive" supervision, a "localisation of the legal transplantation" is suggested to encourage the participation of institutional investors and to liven up the independent director system.[391] Besides institutional investors, the recent ISC pilot project has portrayed the ISC as another qualified minority shareholder whose task is to safeguard minority interests. The participation of the ISC may support independent directors in supervising management. However, one may doubt whether the ISC, as a

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386 Li Wei'an and Hao Chen, '中国上市公司监事会治理评价实证研究 (An Empirical Research of Supervisory Board Governance in China's Listed Companies)', 8 (2006) *上海财经大学学报* (*Journal of Shanghai University of Finance and Economics*), pp. 78-84

387 Li Wei'an and Wang Shiquan, '中国上市公司监事会治理绩效评价与实证研究 (Appraisal and Empirical Research about the Governance of Supervisor Board of China's Public Companies)', 8 (2005) *南开管理评论* (*Nankai Business Review*), pp. 4-9.

388 Xu Huiling and Gao Long, '论我国独立董事制度与中小投资者利益保护 (The Chinese Independent Director System and Minority Shareholder Protection)', 10 (2013) *湖北经济学院学报* (*Journal of Hubei University of Economics*), pp. 37-39.

389 Wu Xiaohui and Jiang Yanfu, '机构投资者影响下独立董事治理效率变化研究 (Change of the Independent Director's Governing Efficiency under the Influence of Institutional Investor: Empirical Evidence from China's Listed Firms)', 5 (2006) *中国工业经济* (*China Industrial Economy*), pp. 105-111.

390 Jin Qiong, '对机构投资者、独立董事制度与公司治理的思考(A Thought on the Relations of Institutional Investors, Independent Director System and Corporation Governance)', 4 (2013) *铜陵学院学报* (*Journal of Tongling University*), pp. 45-48.

391 Chen Yihua, '监事会、独立董事与机构投资者-上市公司监督视阈下的制度整合与路径选择(The Supervisory Board, Independent Directors and Institutional Investors-the Alignment of Mechanisms and Choices of Approaches From the Perspective of Supervision of Listed Companies)', 10 (2015) *理论观察* (*Theoretic Observation*), pp. 80-83.

semi-governmental institution, can actively supervise the state controlling shareholder.

To encourage the participation of qualified minority shareholders, some suggestions have been made. Chinese legislation seems to promote "minority independent directors",[392] but its current provisions are still quite problematic. Article 3 of the *Independent Director Opinion* draws a parallel between 1% shareholding and the top ten shareholders. Subsequently, Article 4 grants shareholders with more than 1% of shares the right to nominate independent directors. Depending on a Chinese listed company's ownership structure, if a 1% shareholder is considered a top ten shareholder, the question is whether this threshold is too high for minority shareholders, or even qualified minority shareholders, to exercise their right set out in Article 4. Moreover, Article 4 merely prescribes the minority nomination right, and the final decision is still left to the general meeting. Under the concentrated ownership structure, genuine independence from the controlling shareholder is very difficult, or even impossible, in some companies. In line with this notion, research argues that a number of independent directors should be appointed by minority shareholders, resulting in a stronger regulatory stance to replace the minority "nomination" right with the "appointment" right.[393] Some scholars also call for a minority removal right, thus entitling minority shareholders a private course of action to remove unqualified independent directors.[394] Furthermore, research encourages share rewards for independent directors. According to the *Equity Incentive Plans*,[395] independent directors are currently excluded from the scope of share rewards. However, research claims that equity ownership can genuinely turn independent directors into minority shareholders, and so for their own sake, they will work for the minority interests.[396]

In sum, the main problems with the internal supervision of Chinese listed companies are the lack of real powers and the lack of independence. For the

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392 The term "minority independent directors" in this research refers to independent directors that are elected by minority shareholders (mainly qualified minority shareholders).

393 Zhang Zhong, 'The Shareholder Derivative Action and Good Corporate Governance in China: Why the Excitement is Actually for Nothing', 28 (2011) *UCLA Pacific Basin Law Journal*, pp. 174-209.

394 Shen Sibao and Jia Jing, 'Will the Independent Director Institution Work in China?', 27 (2005) *Loyola of Los Angeles International and Comparative Law Review*, pp. 223-248.

395 *上市公司股权激励管理办法* (*Measures for the Administration of Equity Incentive Plans of Listed Companiesl*), China Securities Regulatory Commission, date of issue 15th August 2018.

396 Supra. 394.

former, legislation should specify relevant rules that are necessary for the implementation of supervisory powers, such as related procedural rules and legal remedies, or even expand supervisory powers. Furthermore, the latter becomes a more intense issue in a highly concentrated ownership structure. The question is therefore whether independence against the controlling shareholder should be heightened. The mainstream academic opinion does not denounce the existence of a controlling shareholder, but it does oppose a super controller who strips away the safeguards that are supposed to be provided by internal supervision mechanisms. Scholars argue that this imbalance of power within Chinese listed companies is the reason why the independent director system was transplanted to guard minority interests. To genuinely improve internal supervision, a super controller should be transformed into a normal controller. One option is to encourage the growth of qualified minority shareholders so that a counteracting force against the controlling shareholder could be formed. To achieve the above goal, scholars recommend legislative adjustments that would motivate and facilitate the participation of qualified minority shareholders, especially through the independent director system, in order to strengthen the internal supervision of Chinese listed companies and to protect the interests of its minority shareholders.

3.4 Minority shareholder protection in takeover transactions

In this part, the discussion will examine two aspects, namely legislative and judicial protection. Legislative protection reveals what kinds of measures have been adopted in Chinese legislation to safeguard minority interests in takeover transactions. Judicial protection demonstrates the general legal remedies that minority shareholders can use to redress infringements found in takeovers. Relevant legislation in this regard mainly includes the *Chinese Company Law*, the *Chinese Securities Law* and the *Measures for the Administration of the Takeover of Listed Companies*.[397]

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[397] *上市公司重大资产重组管理办法* (*Measures for the Administration of the Material Asset Restructurings of Listed Companies*), issued by China Securities Regulatory Commission, date of issue 23rd October 2014, amended on 8th September 2016, and 18th October 2019. It is another legislation regarding M&As in China. Particularly, certain material asset restructurings, such as issuing new shares to purchase assets, or

3.4.1 Special protection of minority shareholders in takeover transactions

Chinese legislation has prescribed various forms of protection for shareholders in the context of mergers and acquisitions, namely by regulating the acquirer, the 5% disclosure rules, the mandatory bid rule, the sell-out right, anti-takeover measures, the two-thirds supermajority rule, the right to request a court to cancel a flawed merger resolution, the appraisal right and the exclusion of short-form mergers.

The acquirer

Article 6 paragraph 2 of the *Measures for the Administration of the Takeover of Listed Companies* (hereinafter "*Takeover Measures*")[398] forbids an investor to take over a listed company if the investor:

- has a large amount of unpaid due debts, and this indebted situation is in a continuous state;

- has committed or been suspected of any serious illegal act in the past three years;

- has seriously breached obligations in the securities market in the past three years,

- is a natural person and falls under Article 146 of the *CCL*,[399]

- meets other conditions which are prescribed by laws, regulations or commanded by the CSRC.

The 5% Disclosure Rule

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transactions prescribed in Article 13 which are regarded as backdoor listings, need to be approved by the CSRC or the merger and reorganisation review committee.

[398] *上市公司收购管理办法* (*Measures for the Administration of the Takeover of Listed Companies*), China Securities Regulatory Commission, date of issue October 23rd 2014.

[399] Article 146 of the *CCL* regulates five types of person who are forbidden from being directors, supervisors or senior management personnel: he or she has no/limited civil capabilities; fewer than five years have passed since he or she was sentenced due to economic crimes, such as corruption, bribery, etc.; fewer than three years have passed since he or she was held personally responsible for the bankruptcy of a company; fewer than three years have passed since he or she was held personally responsible for the revocation of a business licence of a company, due to a breach of law; he or she has rather heavy and overdue debts.

Article 63 of the *2020 CSL* amended Article 86 of the 2014 *CSL* that through the stock exchange, if the holding of voting shares by an investor, or the joint-shareholding of the investor and others in the form of agreements or other arrangements, has reached 5% of the issued shares of a listed company, the investor, within three days after the aforesaid fact happens, should submit a written report to the CSRC as well as the stock exchange, to inform the acquired listed company and make an announcement. More importantly, the investor should not continue to purchase or sell the shares of the listed company in this period except situations prescribed by the CSRC**.** In addition, after the voting shares of the investor, or the joint-shareholding of the investor and others, has reached 5%, then every subsequent 5% increase or decrease should be reported and announced following the requirements mentioned above. Likewise, the investor should stop purchasing or selling the listed company's shares from the day it happens to three days after the announcement except situations prescribed by the CSRC. In addition, Article 63 added two requirements, i.e. 1% disclosure and 36 months' restriction. After an investor holds or jointly hold more than 5% voting shares, every subsequent 1% increase or decrease should be reported to the company on the next day and make an announcement. If an investor breaches Article 63 paragraph one or two, for those shares exceed the statutory percentage, he/she/it cannot exercising voting rights for 36 months after the purchase.

The mandatory bid rule

Instead of a "strict" mandatory bid rule, which demands that the acquirer issue a full tender offer to all remaining shareholders of the target company once the threshold is reached, the Chinese rule grants discretion to the acquirer to issue a full or a part tender offer.

Based on Article 62 of the 2020 *CSL*, takeovers can be conducted through tender offers, negotiated acquisitions or other legal means. Respectively, tender offer takeovers and negotiated takeovers are prescribed in Article 65 and Article 73 of the 2020 *CSL*. The former applies to an acquisition that is conducted through a stock exchange, and the latter applies to a negotiated acquisition outside a stock exchange. Article 65 specifies that when the acquirer, either independently or collectively, holds 30% of a target company's listed voting shares through trading on a stock exchange, a tender offer should be issued to all shareholders of the target company for acquiring all or part of their shares, if the acquisition continues. In the case of a part tender offer, Article 65 further enumerates that if "the number of the shares committed to sell by the shareholders of the target company exceeds the number of the shares proposed to acquire, the acquirer should proceed on a prorating basis".[400] In comparison with Article 65, Article 73 accords the negotiated acquisition the exemption privilege. All other conditions being equal, Article 73 clarifies that the obligation to issue a full or part tender offer of the acquirer of a negotiated acquisition can be exempted based on regulations issued by the CSRC.

The *Takeover Measures* provides more detail provisions regarding the mandatory bid rule. However, these provisions are inconsistent with the 2020 *CSL*. It regulates tender offer takeovers, negotiated takeovers and indirect takeovers[401] in three different chapters.[402] For tender offers, Article 24 is similar to paragraph one of Article 65, except the latter specifies "listed voting shares" instead of "listed shares". For negotiated takeovers, Article 47 seems to distinguish "30% of issued shares" and "30% of all shares", the former triggers the obligation to issue a full or part tender offer, while the latter triggers the obligation to issue a full tender offer (both can be exempted by the CSRC under conditions). Meanwhile, Article 56 stipulates that for indirect takeovers, when the acquirer owns more than 30% of issued shares, a full tender offer should be made to the target's shareholders (can be exempted by the CSRC under conditions). The *Takeover Measures*' provisions of mandatory bid not only are inconsistent with those of the 2020 *CSL*, but also impose different treatments on different types of takeovers.

The sell-out right

If the company has been converted from a public company to a private company, without the protection of a sell-out right, shareholders of the target company may find themselves trapped in the converted company and under the complete control of the acquirer. Therefore, Article 74 of the 2020 *CSL* stipulates that after the expiration of the takeover period, if the target

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400 This refers to the proportion between the amount of shares proposed to acquire by the acquirer and the amount of shares committed to sell by shareholders. For example, let us assume that A is the acquiring company and B is the target company, which consists of two shareholders C and D. A proposes to acquire 100 shares of B, and shareholder C commits to sell 400 shares, and D shareholder commits to sell 600 shares. Consequently, the "prorating basis" here is 100 divided by 1000. In other words, A shall acquire 100/1000*400=40 shares from shareholder C, and 100/1000*600=60 shares from shareholder D.

401 Indirect takeovers refer to transactions in which the acquirer is not a shareholder of the target company, but intends to takeover the target through investments, agreements or other arrangements.

402 Chapters 3, 4 and 5, *Takeover Measures*.

company's share structure no longer satisfies listing conditions of the stock exchanges, the remaining shareholders of the target company have the right to sell their shares to the acquirer on the same terms[403] as those set out in the tender offer, and the acquirer is obliged to acquire such shares. As required by Article 50 of the 2014 *CSL*, a listed company's publicly-issued shares should be more than 25% of the total shares of the company. For a listed company whose total share capital is more than 400 million RMB, the publicly-issued shares should be more than 10%. In other words, when the acquirer possesses more than 75% of shares in a listed company, or more than 90% shares of a listed company whose total share capital exceeds 400 million RMB, then the remaining shareholders of the target company have the authority to exercise their sell-out rights. However, the revised 2020 *CSL* deleted Article 50. After 1st March 2020, investors should refer to regulations of the stock exchange on which a company is listed for specific requirements.

Anti-takeover measures

Chinese legislation provides some general provisions to regulate anti-takeover measures, such as Article 7,[404] Article 8[405] and Article 33 of the *Takeover Measures.* Particularly, Article 33 states that after the acquirer has made a suggestive announcement, and before the tender offer is over, without the approval of the general meeting, the board of directors of the target company should not dispose of company assets, make external investments, adjust the main business or arrange guarantees or loans etc. which have a significant

[403] In comparison with the "appraisal right of dissent shareholders" prescribed in Article 142 of the *CCL*, the sell-out right here has made an improvement by specifying that the price shall follow the terms of the tender offer.

[404] Article 7 forbids the controlling shareholder or the company controller of the target company to abuse his or her shareholder's right to damage the rights and interests of the target company or other shareholders. If the controlling shareholder or the company controller of the target company, or any related party, damages the rights and interests of the company or other shareholders, the controlling shareholder or the company controller shall eliminate the damage before transferring control of the target company. If the above person fails to eliminate this damage, then the income from the transfer of the shares shall be used to compensate for the damage, and if the income is insufficient to cover this cost, effective guarantees or arrangements shall be provided for the surplus, and the approval of the general meeting of the target company shall be obtained according to the articles of association.

[405] Article 8 confirms the duty of loyalty and the duty of care of the directors, supervisors and senior management personnel of the target company, and the above person shall treat all the acquirers fairly. The decisions and measures that are adopted for the takeover by the board of directors of the target company shall be in the interests of the company and shareholders, the board of directors shall not abuse its power to set up any inappropriate obstacle for the takeover, shall not appropriate the company's resource to provide any financial support to the acquirer and shall not damage the rights and interests of the company and its shareholders.

effect on the assets, liabilities, entitlements or performance of the company, unless it is under the normal operation or resolutions of the general meeting of the target company. Moreover, Chinese legislation prescribes that certain issues, such as a non-public issuance of new shares (revised by 2020 *CSL*)[406] and material asset restructuring,[407] require the approval of the CSRC. This approval condition may affect some anti-takeover measures such as the "poison pill"[408] and the "crown jewel".[409] Article 52 of the *Takeover Measures* restricts the acquirer's power to replace the board and to cause dramatic changes in the target company, but this only applies to negotiated acquisitions and is only valid throughout the transition period.[410]

In addition to the above defence measures prescribed in legislation, other anti-takeover instruments[411] can be employed in practice, particularly trading suspensions. Specifically, a target company can apply to have its shares suspended, to prevent the acquirer from buying when there is a threat. This measure was widespread during the collapse of the stock market in 2015.[412] Furthermore, existing securities law and regulations clarify neither the basis nor the length of such a suspension.[413]

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[406] Article 13, 2014 *CSL*. Article 12 of the revised 2020 *CSL* prescribes that an issuance of new shares by a listed company should follow conditions regulated by the CSRC.

[407] Article 13, *Material Asset Restructuring Measures*.

[408] The poison pill is a defensive measure against hostile takeovers. It attempts to increase the difficulty in the takeover by allowing shareholders, excluding the acquirer, to purchase additional shares at a lower price. More details see: http://www.investopedia.com/terms/p/poisonpill.asp. Last visited February 2019.

[409] The crown jewel is an anti-takeover defence which intends to lower the attractiveness of the target company for the acquirer by mandating the sale of the most valuable assets of the target company. More details see: http://www.investopedia.com/terms/c/crownjewels.asp. Last visited February 2019.

[410] Article 52 states that within the transition period, which starts from the conclusion of the acquisition agreement till the completion of the transfer of shares, the acquirer shall not reappoint the board of directors through the controlling shareholder's proposal. If it is necessary to reappoint the board of directors, the directors appointed by the acquirer shall not make up more than one-third of the board. And the target company shall not provide any guarantee for the acquirer and its related parties, shall not raise capital by publicly issuing shares, shall not conduct any substantial purchase, sell assets or make substantial investments, or other related-party transaction with the acquirer and its related parties, unless it is for the purpose of saving the target company from a crisis or severe financial problem.

[411] By ignoring the law, some measures, such as prolonging the terms of office of the board of directors or disregarding minority shareholders' voting rights and proposal rights, are adopted in practice. See: Jamie Allen, Li Rui, Guo Peiyuan, Li Zhaowen, Zhang Zhengjun, and Zhou Chun, *Awakening governance: The Evolution of Corporate Governance in China*, Asian Corporate Governance Association China Corporate Governance Report 2018, available at https://www.acga-asia.org/specialist-research.php. Last visited February 2019.

[412] Scholars believe that trading suspensions may cause market interruption, damage share liquidity and cause losses to the company and its minority shareholders. See: ibid.

[413] Though the SSE and the SZSE issued the "Memo on Trading Suspension and Resumption for Listed companies", these self-discipline rules are insufficient to provide clear guidance in reality. See: ibid.

The supermajority rule

Based on Article 103 of the *CCL*, in order to pass a merger resolution, it requires a two-thirds supermajority of shareholders who are present at the general meeting. Moreover, academic opinion holds that a merger resolution is regarded as a major event and should also follow the "majority of minority" rule.[414]

Cancellation of a flawed merger resolution

As mentioned previously in paragraph 3.2.1, Article 22 of the *CCL* grants shareholders the right to request a court to cancel a flawed resolution. Subsequently, if a merger resolution falls into Article 22, i.e. an invalid merger resolution whose content breaches laws or administrative regulations, or a revocable merger resolution whose procedure violates laws, administrative regulations or the articles of association, or its content violates the articles of association, a shareholder is entitled to the right to request a court to cancel the merger resolution. However, to exercise this right, a minority shareholder may be required to provide a lawsuit guarantee, which may turn out to be a huge obstacle in practice.[415]

The appraisal right

The dissenting shareholders' appraisal right, which is prescribed in Article 74 and 142 of the *CCL*, provides minority shareholders the chance to exit the company. Specifically, a shareholder who disagrees with the resolution on the merger or division can request the company to acquire his or her shares. Nevertheless, the *CCL* does not stipulate relevant procedural provisions to clarify the exercising of the appraisal right, and it is also silent on how to decide the repurchase price of the shares.

Last but not least, short-form mergers[416] are not allowed in China.

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[414] Liu Junhai, '论公司并购中的小股东权利保护 (Minority Shareholder Protection in Mergers and Acquisitions)', 5 (2012) *法律适用* (*Journal of Law Application*), pp. 36-45.

[415] See paragraph 3.2.3.

[416] A short-form merger often happens between a parent company and its subsidiary. When the shareholding reaches the threshold, for example 90%, then the merger can be conducted without the approval of shareholders. More details see: http://us.practicallaw.com/0-382-3820. Last visited February 2019. More discussion on short-form mergers can be found in chapter 4 section 4.4.

3.4.2 Minority shareholder protection by courts

As mentioned in 3.2.1, Chinese legislation affirms shareholders' right to sue. In takeover transactions, minority shareholders may rely on these judicial remedies, particularly a derivative action based on a breach of fiduciary duties, to defend their interests.

Derivative actions

The derivative action, as one of the most significant legal instruments for shareholder protection, is provided in Article 151 of the *CCL*. To exercise this right, the shareholder(s) is/are required to either independently or collectively hold 1% or more of the company shares for at least 180 consecutive days. Additionally, it demands a procedural precondition, i.e. shareholder(s) has/have to submit a written request to the supervisory board to issue an action in a court. If supervisors are the respondent of the lawsuit, the written request should be submitted to the board of directors. Only in a situation whereby the supervisory board or the board of directors decides not to bring a lawsuit, or fails to bring a lawsuit within 30 days upon receipt of the shareholder's written request, or in emergency cases, the shareholder(s) is/are entitled to file directly an action in a court in his/her/their own name(s) for the company's interest. Passing the above conditions, minority shareholders may bring a derivative action against directors, supervisors or senior management personnel, if Article 149 applies.[417] Article 151 additionally expands the scope of the respondent of the derivative action to cover any other person who damages the company's legitimate interests and causes losses. Academic opinion claims that "any other person" should cover at least company insiders, such as the controlling shareholder.[418] The revised 2020 *CSL* recently added Article 94 to clarify further that the ISC, if owns shares of a company, can bring a derivative action against directors, supervisors, senior managers, the controlling shareholder and the actual controller, regardless of thresholds prescribed in Article 151 *CCL*. In other words, minority shareholders are

[417] Article 149 of the *CCL* confirms the compensation liabilities of directors, supervisors and senior management personnel when they breach the law, administrative regulations or articles of association during performance of duties and damage has been caused to the company.
[418] Hui Huang, '中国股东派生诉讼制度：实证研究及完善建议 (Shareholder Derivative Action in China: Empirical Study and Reform Proposals)', 1 (2014) *人大法律评论* (*Renmin University Law Review*), pp. 232-264.

entitled to bring a derivative action against the controlling shareholder. Moreover, the *CCL Provisions IV* clarifies that before the end of the first trial, if other shareholders who pass the threshold file derivative actions with the same claims, these shareholders should be treated as co-plaintiffs.[419] If the plaintiff's claims are partly or fully recognised by the court, then the company should shoulder the burden of any reasonable litigation fees that have been paid by the shareholders.[420]

In addition to derivative actions, a minority shareholder can bring a direct action in a court when directors or senior management breach laws, administrative regulations or articles of association and infringe his or her interest.[421]

Fiduciary duties

Chinese legislation affirms the fiduciary duties of both directors and the controlling shareholder. In respect of directors' fiduciary duties, Article 147 of the *CCL* specifies that directors, supervisors and senior management personnel should abide by laws, administrative regulations and articles of association, and they should be loyal and diligent. In addition, bribery or any illegal gain derived from management power should be prohibited, and encroachment to company property should be banned.

Article 148 of the *CCL* explicitly lists eight types of prohibited action. Specifically, a director or senior manager should not:

- misappropriate company funds;

- deposit company funds in an account in his or her name, or the name of any individual;

- violate the articles of association by loaning company funds to others, or misuse company property to provide guarantees for others without a resolution of the general meeting or the board of directors;

- breach the articles of association or without a resolution of the general meeting to contract or trade with the company;

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[419] Article 24, *CCL Provisions IV*.
[420] Article 26, *CCL Provisions IV*.
[421] Article 152, *CCL*.

- abuse management power to exploit the company's commercial opportunity for his/her own or other people's interests, or independently run or run for others any business that is in the same field as the company that he/she serves, without a resolution of the general meeting;

- encroach on the commissions of company transactions;

- disclose business secrets without authorisation;

- conduct other actions which breach the duty of loyalty.

Moreover, income made through any of the above actions should be owned by the company.

The *Guidance on Listed Companies' Articles of Association* (*hereinafter "Guidance on AoA"*)[422] divides the fiduciary duties of directors further into the duty of loyalty[423] and the duty of diligence.[424] It also states that in the case of resignation or the expiration of a term of office, a director's duty of loyalty does not automatically end on its own but depends on the reasonable extension period, if there is any, required by the articles of association.[425]

Concerning the controlling shareholder's fiduciary duty, the *CCL* does not precisely adopt the exact expression in any of its Article. Instead, it chooses a general prohibition for all shareholders in Article 20, which forbids a shareholder from abusing his or her shareholder rights to damage the interest

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[422] *上市公司章程指引* (*Guidance on Listed Companies' Articles of Association*), China Securities Regulatory Commission, date of issue October 20th 2014.

[423] Article 97 of the *Guidance on AoA* mainly follows the prescription of Article 148 of the *CCL*, based on which additionally prohibits directors from accepting bribes or other illegal income, encroaching on company assets; abusing the related-party relationship for infringing company interests. And in particular, Article 97 endows the articles of association with the discretion to prescribe other director liabilities.

[424] Article 98 of the *Guidance on AoA* cites that directors' duty of diligence involves cautiously, carefully and diligently performing the powers granted by the company, to ensure the business operation is in accordance with law, administrative regulations as well as economic policies, and the commercial practice shall follow the scope of business prescribed in the business licence. They should also treat all shareholders fairly; present information on the operation of the company in a timely manner; sign written confirmations for the periodical reports of the company, and guarantee the disclosed information is correct, accurate and complete; truthfully provide relevant information and materials to the supervisory board and cause no obstacle to the supervisory board in performing its duties and other duties of diligencerequired by law, administrative regulation, departmental regulatory rules and articles of association. Besides, it accords the articles of association the discretion to prescribe other duties of diligence.

[425] Article 101, *Guidance on AoA*.

of the company or of other shareholders. Furthermore, those who breach the above conditions should be liable for compensation.[426]

In contrast, the *CCGC* explicitly states in its Article 63 that the controlling shareholder or the actual controller should bear fiduciary duty to the listed company and other shareholders. The exercise of power by the controlling shareholder should strictly follow the law, in that he/she/it should not infringe on the listed company and other shareholders' interests or pursue illegal interests by abusing his/her/its controlling position.[427]

Last but not least, the *CCL* provides general provisions to regulate the liabilities of both directors and controlling shareholders.[428]

3.4.3 Characteristics of takeovers in China

Mergers and acquisitions on the Chinese securities market have three main characteristics. First, unexpected takeovers are rare, and tender offers are uncommon.[429] Between 2014 and 2016, only four out of 1578 material asset restructures of Chinese listed companies employed tender offers,[430] and despite some hostile takeover attempts, the first success on the Chinese market only appeared very recently in 2018.[431] Zhengxing Biopharmaceutical and Chemical (振兴生化, hereinafter ST SH) was a listed company on the SZSE.

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[426] According to academic opinion, Article 20 of the 2013 *Chinese Company Law* is equal to the "controlling shareholder's fiduciary duty" in Common Law. See Nicholas Callcina Howson and Donald C. Clarke, 'Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China', available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1968732. Last visited on February 2019.
James V. Feinerman, 'New Hope for Corporate Governance in China', 191 (2007) *China Quarterly*, pp. 590-612.

[427] The controlling shareholder's fiduciary duty can also be found in Article 39 of the *Guidance on AoA* and Article 5 of the *Public Shareholder Provision*.

[428] Article 112 of the *CCL* prescribes that a director is liable for compensation if a resolution of the board of directors violates laws, administrative regulations or articles of association and causes tremendous losses to the company, unless he or she has expressed his or her dissenting opinion through a vote, and this objection is recorded in the minutes. Likewise, Article 149 stipulates that a director is liable for compensation if his or her performance of duty breaches laws, administrative regulations or articles of association and causes losses to the company. Regarding the controlling shareholder's fiduciary duty in mergers and acquisitions, Article 214 of the *CSL* specifies that if the controlling shareholder of the acquirer abuses the takeover, to damage the target company and its shareholders' interests, he or she shall rectify the malpractice, accept warnings and shoulder the burden of any forthcoming administrative fines.

[429] Jamie Allen, Li Rui, Guo Peiyuan, Li Zhaowen, Zhang Zhengjun, and Zhou Chun, *Awakening governance: The Evolution of Corporate Governance in China*, Asian Corporate Governance Association China Corporate Governance Report 2018, available at https://www.acga-asia.org/specialist-research.php. Last visited February 2019.

[430] Ibid.

[431] Ibid.

ST SH's biopharmaceutical product business had been profitable for eight consecutive years since 2008. However, due to the huge debts injected by its controlling shareholder and unfulfilled promises to spin-off an indebted subsidiary, ST SH was labelled an "ST" (special treatment) company by the SZSE. The conflicts of interest between ST SH's minority shareholders and the controlling shareholder were severe after years of malpractice. On 21st June 2017, Zhemin Tou Tianhong Partnership (浙民投天弘投资合伙企业 hereinafter ZMT) issued a tender offer to acquire 74.92 million shares of ST SH. After the tender offer, ZMT would become the biggest shareholder of ST SH with 29.99% shares. Subsequently, ST SH opted for a trading suspension based on material asset restructuring on 27th June. On 7th July, ST SH's controlling shareholder reported an irregular loan between ZMT and the Minsheng Bank to the CSRC. On 14th September 2017, ST SH's controlling shareholder brought a lawsuit against both ZMT and ST SH for breach of disclosure, tunnelling and insider trading. However, these actions failed to stop ZMT's acquisition. On 21st September, ST SH resumed its share trading. On 28th November, ST SH took another defensive measure. ST SH's controller transferred its shares (18.57%) to Hangyun Jiankang (航运健康 hereinafter HYJK) at a price of 43.2 RMB per share, which was higher than ZMT's offer of 36 RMB per share. After the transaction, HYJK would become the biggest shareholder of ST SH with 22.61% shares.[432] This transaction hit ZMT's acquisition so heavily that 12.63 million pre-accepted shares were revoked. Furthermore, ZMT could not modify its offer within 15 days of expiration of the offer according to the Chinese law.[433] The exception to this rule is the appearance of a competitive offer. However, a transfer of the controlling shareholder's shares is not regarded as a competitive offer. Nevertheless, ZMT still managed to win the hearts of ST SH's minority shareholders by acquiring 147 million shares, thereby marking the first successful hostile tender offer on the Chinese market.[434]

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[432] ST SH's controller also conducted a share-debt swap to transfer 4.04% shares to Shenzhen Cinda (深圳信达), on the condition that the latter would delegate its voting rights to HYJK for a year.

[433] Article 40, *Measures for the Administration of the Takeover of Listed Companies.*

[434] Zhou Jiahui, '我国上市公司敌意收购与并购防御研究-基于浙民投收购ST生化的案例分析 (Research on Hostile Takeover and Defensive Measures of Chinese Listed Companies-based on the case study of Zhemintou and ST Shenghua)', 28 (2018) *现代商贸工业* (*Modern Business Trade Industry*), pp. 142-143.

There are two main reasons why tender offers are rather rare in China. One is the high costs involved,[435] and the other is the concentrated ownership structure. Under such a structure, takeovers are more predictable and easier through negotiations with controlling shareholders.[436] In this context, the success of the ZMT takeover was the success of the collective action of minority shareholders. ST SH's controlling shareholder had abused its controlling position and exploited minority shareholders for years. The tense conflicts of interest between minority shareholders and the controller was the key that helped ZMT turn its game around despite the appearance of HYJK. The success of ZMT's tender offer demonstrates the powers of minority shareholders and the possibility of minority engagement.[437] In the meantime, this case also raised several regulatory questions, such as how to regulate trading suspensions and competitive offers.[438]

The second characteristic is that state-owned listed companies, though intensively guided by policies, are the primary players on the Chinese takeover market.[439] In 2017, 126 state-owned listed companies participated in mergers and acquisitions. Deals between state-owned listed companies account for a majority of the total value of all mergers and acquisitions on the Chinese market,[440] and normally, deals involving state-owned listed companies are driven by political interests. There are two policy burdens in SOEs: the strategic policy burden[441] and the social policy burden.[442] Under these burdens, it is difficult for the government to make evaluations simply based on

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[435] Before the 2014 amendment of the *Takeover Measure* and the *Measures for the Administration of the Material Asset Restructurings of Listed Companies*, an ex-ante non-objection letter from the CSRC is necessary before a tender offer can be issued.

[436] Jamie Allen, Li Rui, Guo Peiyuan, Li Zhaowen, Zhang Zhengjun, and Zhou Chun, *Awakening governance: The Evolution of Corporate Governance in China*, Asian Corporate Governance Association China Corporate Governance Report 2018, available at https://www.acga-asia.org/specialist-research.php. Last visited February 2019.

[437] Zhou Jiahui, '我国上市公司敌意收购与并购防御研究-基于浙民投收购ST生化的案例分析 (Research on Hostile Takeover and Defensive Measures of Chinese Listed Companies-based on the case study of Zhemintou and ST Shenghua)', 28 (2018) *现代商贸工业* (*Modern Business Trade Industry*), pp. 142-143.

[438] Ibid.

[439] Supra. 436.

[440] Ibid.

[441] Under the traditional development strategy of the country, SOEs sometimes need to take ownership of the task of investing or assisting in underdeveloped industries. See: Chen Shihua, Lu Changcong, Jiang Guangsheng and Wang Yaru, '国企高管政治晋升对企业并购行为的影响-基于企业成长压力理论的实证研究 (Impacts of Political Promotion of SOEs' Senior Management on Enterprises' M&A Decisions: Empirical Research based on the Theory of the Growth of the Firm)', 9 (2015) *管理世界* (*Management World*), pp. 125-136.

[442] SOEs' social responsibilities sometimes cause side-effects, such as redundancies and adverse employee welfare. See: ibid.

profitability.[443] Instead, the government must evaluate senior SOE managers' performance based on the "size-oriented" expansion of the company. An M&A is a good way to expand the size of a company in a short-term. Senior managers and directors of SOEs are "semi-government officials" who are keen to climb the political ladder.[444] Based on M&A statistics during 2004-2013, research has found that an SOE is more likely to conduct an M&A if its senior management is up against higher political promotion pressure.[445] In addition, government policies are another reason for SOEs to conduct M&As. In 2017, in order to reduce the amount of central SOEs, the SASAC announced that China Hentian Group (中国恒天集团) had merged into Sinomach (中国机械工业集团). Due to the fact that the merger was more like a political decision rather than a business investment, a post-merger synergy problem was uncovered.[446]

The third characteristic is government interference in M&As. The highly debated Vanke (万科) case is a good example to elaborate this government influence. In 1984, Vanke was founded by Wang Shi (王石 hereinafter WS), with Shenzhen Special Economic Zone Development Enterprise (深圳特区发展公司 hereinafter SZDE) as its controlling shareholder. In the next two decades or so, Vanke transformed from a concentrated SOE into one of the very few large Chinese listed companies with a dispersed ownership structure. In 2014, Vanke was voted as the number one listed company most respected by investors in China. In 2017, its management team ranked top among Asian executive teams in the real estate industry.[447] However, a vicious hostile takeover battle with Baoneng (宝能 hereinafter BN) forced Vanke to make a radical change.

Before BN, in 1994, several dissent shareholders attempted to seize control of Vanke through shareholder proposals demanding the restructuring of the

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[443] A well-run SOE may have a negative profitability report, due to policy burdens. Thus, it is unfair to judge the performance of its senior management based only on profitability.

[444] SOE senior managers are regulated based on standards of government officers/civil servants of the same level and with the same remuneration. All responsible persons in SOEs fall under the control of the Organisation Department of the Chinese Communist Party at all levels. See: Chen Shihua, Lu Changcong, Jiang Guangsheng and Wang Yaru, '国企高管政治晋升对企业并购行为的影响-基于企业成长压力理论的实证研究 (Impacts of Political Promotion of SOEs' Senior Management on Enterprises' M&A Decisions: Empirical Research based on the Theory of the Growth of the Firm)', 9 (2015) *管理世界* (*Management World*), pp. 125-136.

[445] This type of M&A transaction normally has worse long-term performance in comparison with M&A transactions that are not induced by management's political interests. See: ibid.

[446] Supra. 436.

[447] Ibid.

board of directors. The founder, WS, won this battle through numerous mediation sessions and the support of CSRC. Subsequently, WS further strengthened Vanke's relationship with central government by instructing the transfer of control from SZDE to Huarun (华润 hereinafter HR), a central-level SOE. After the transaction, HR became Vanke's largest shareholder with a 15% shareholding, albeit it rarely participated in any decision-making. Meanwhile, the management team at Vanke governed the company with a mere 1% shareholding.

In July 2015, BN acquired 5% of Vanke shares through the securities market. In December of the same year, BN quickly increased its ownership to 22.45%, which surpassed the biggest shareholder, HR. In the face of this hostile takeover, Vanke's management team first turned to HR for help but failed to persuade the latter to expand its ownership. A few days later, Vanke applied for a trading suspension based on material asset restructuring. This suspension lasted for more than six months. Before the suspension, another shareholder, Anbang (安邦), was reported to have held 6.18% of Vanke shares.[448]

In June 2016, Vanke's management sought out Shenzhen Metro (深圳地铁 hereinafter SZM), a wholly state-owned company, as a white knight by passing a resolution to issue new shares to purchase 100% shares of a subsidiary of SZM. However, this resolution was rejected by HR and BN in the shareholder meeting. After the failure of this defensive measure, WS publicly outed the alliance between HR and BN, the latter of which fought back by proposing an extraordinary shareholder meeting to remove the entire board. According to speculation, the central government intervened and BN withdrew its proposal.[449] In the meantime, Henda Group (恒大集团 hereinafter HD) purchased Vanke shares through the securities market, ending up with a total holding of 14.07% shares.

At this point, the battle drew great attention from both investors and the media, and eventually the government decided to intervene, to solve the problem. In January 2017, the China Insurance Regulatory Commission (hereinafter CIRC) promulgated a *Notice on Relevant Matters of Further*

[448] Different from BN, Anbang was willing to cooperate with Vanke.

[449] Supra. 436.

Strengthening Regulatory of Stock Investment of Insurance Capital,[450] which forbids insurance companies and non-insurance party to act in concert to takeover listed companies and specifies that if an insurance company uses insurance capital to purchase shares of listed companies, it has to receive the prior approval of the CIRC. Based on legislation, the CIRC imposed a series of administrative sanctions on Qianhai Renshou (前海人寿 hereinafter QR), an insurance subsidiary of BN that held shares of Vanke. One of the sanctions was to revoke the qualification of the actual controller of BN, Yao Zhenhua, and bar him from working in the insurance industry for 10 years. The CIRC also imposed sanctions on Hengda Renshou (恒大人寿), a subsidiary of HD.

To settle the takeover battle, SASAC, CSRC and the Shenzhen municipal government intervened to structure a deal whereby HR would transfer 15.31% of Vanke shares to SZM. BN officially announced its identity as a "financial investor" in Vanke, i.e. BN would no longer seek any board position or make any attempt to influence management. Later, in March of the same year, HD also irrevocably designated all 14.07% of Vanke share voting rights and proposal rights to SZM. In June, HD agreed to transfer all Vanke shares under its name to SZM despite this transaction causing 7 billion RMB losses for HD. SZM became the biggest shareholder of Vanke with 29.38% shares. On 30th June, all 11 candidates nominated by SZM were selected as directors, and Vanke's founder, WS, stepped down from the board after 37 years. In the end, Vanke defeated BN and won the takeover battle, at the price that Vanke returned to being a state-owned listed company.

The Vanke case exposes two vital issues relating to the Chinese market. One is the high risk of dispersed ownership in China.[451] Different from a majority of Chinese listed companies, Vanke is one of the very few companies that has dispersed ownership. Before the takeover battle, although HR was the biggest shareholder, Vanke was governed by its management team, and it was well-known for a culture of strong management and corporate governance. However, it is also this dispersed ownership that subjected Vanke to hostile takeover threats. The second issue revealed was that even for a modern listed company like Vanke, in times of difficulties, it would still turn to the

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[450] *《关于进一步加强保险资金股票投资监管有关事项的通知》*(*Notice on Relevant Matters of Further Strengthening Regulatory of Stock Investment of Insurance Capital*), issued by China Insurance Regulatory Commission, 24th January 2017.
[451] Supra. 436.

government instead of the market for a solution. One of the reasons was that the market was not adequate enough to safeguard Vanke in the face of a hostile takeover.[452] Many shareholders, including institutional investors, left Vanke at the start of the takeover battle, so it was difficult for management to fight against BN by soliciting other shareholders' support. Instead, timely government intervention led to a deal between the involved parties and prevented Vanke from falling into the hands of an immature acquirer.[453] Vanke, from a state-owned enterprise, developed into a dispersed listed company that was largely privately-owned and returned to being a state-owned listed company after the takeover battle. The firm's trajectory somewhat exposes the uncertainty of dispersed ownership in China and again seems to confirm the authority of the government's visible hand.

3.4.4 Analysis

According to whether a takeover is conducted through an acquisition or a merger, Chinese legislation prescribes various forms of protection for minority shareholders.[454] For the mandatory bid rule, research has shown that it is common practice to exempt listed companies from the mandatory bid obligation. One empirical study found that 874 companies triggered the mandatory bid rule between 21st July 2004 and 16th December 2012, and 843 of them (96.45%) were exempted by the CSRC.[455] Another research study recorded 477 cases between 2009 and July 2014, and 454 of these (95.18%) were exempted by the CSRC.[456]

Concerning the appraisal right, scholars claim that existing provisions are too general to make a difference. Without specifying implementation, the

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452 Ibid.

453 BN was a new insurance company that had no experience in the field of real estate. On the contrary, Vanke had gone through decades of development and established its own corporate management system and culture. Thus, the general view claimed that the defeat of BN was good news for the future of Vanke. See: ibid.

454 The form of tender offer is rarely used in practice, due to its high costs and the concentrated ownership structure. See: ibid.

455 Cai Wei, '强制要约收购制度的再审视：效率视角下的实证分析 (Review of the Mandatory Bid Rule: Empirical Analysis from the Efficiency Perspective)', 25 (2013) *中外法学* (*Peking University Law Journal*), pp. 847-859.

456 Sun Yizheng, 强制要约收购条款应适度修改 (The Mandatory Bid Rule Provision Shall be Moderately Amended), available at http://www.cs.com.cn/sylm/zjyl_1/201409/t20140915_4511398.html. Last visited February 2019.

appraisal right is rarely used.[457] Instead, the "voluntary cash offer", as an invention of Chinese listed companies, has usurped the appraisal right to a large extent in practice.[458] From 2004 to 2013, research recorded 54 voluntary cash offer cases, 50 of which were related to listed company mergers.[459] Under a voluntary cash offer, relevant shareholders can request the listed company or a third party to purchase their shares at a price that has been previously agreed on.[460] However, scholars have expressed their concerns that the voluntary cash offer may be abused by the controlling shareholder, to exploit minority interests in mergers, since no legal standard is currently available to regulate the prior-agreed purchase price, and this price may be underrated.[461] Additionally, the voluntary cash offer is stipulated merely as guidance issued by the stock exchanges,[462] without being incorporated into the *CCL*.

Regarding protection offered by courts, various empirical studies have been conducted. In particular, three important works have observed certain characteristics.[463]

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457 Zhou Qiao Hong and Zhou Hongli, '现金选择权与异议股东回购请求权研究 (Research on the Voluntary Cash Offer and the Appraisal Right)', 14 (2014) *财会月刊* (*Finance and Accounting Monthly*), pp. 102-105.
458 Lin Kai, '异议表意机制的法律分析———以我国上市公司合并协议中的现金选择权条款为背景 (Legal Analysis of the Objection Express Mechanism—Under the Background of the Voluntary Cash Offer in Merger Agreements of Chinese Listed Companies)', 1 (2014) *政治与法律* (*Political Science and Law*), pp. 88-100.
459 Supra. 457.
460 Article 3, *深圳证券交易所上市公司现金选择权业务指引（2011 年修订）*(*Shenzhen Stock Exchange's Guidance on the Voluntary Cash Offer of Listed Companies* (*Amended in 2011*)), Shenzhen Securities Exchange, date of issue September 6th 2011.
461 Lin Kai, '异议表意机制的法律分析———以我国上市公司合并协议中的现金选择权条款为背景 (Legal Analysis of the Objection Express Mechanism-Under the Background of the Voluntary Cash Offer in Merger Agreements of Chinese Listed Companies)', 1 (2014), *政治与法律* (*Political Science and Law*), pp. 88-100.
Zhou Qiao Hong and Zhou Hongli, '现金选择权与异议股东回购请求权研究 (Research on the Voluntary Cash Offer and the Appraisal Right)', 14 (2014) *财会月刊* (*Finance and Accounting Monthly*), pp. 102-105.
462 *深圳证券交易所上市公司现金选择权业务指引（2011 年修订）*(*Shenzhen Stock Exchange's Guidance on the Voluntary Cash Offer of Listed Companies (Amended in 2011)*), Shenzhen Securities Exchange, date of issue September 6th 2011.
上市公司重大资产重组信息披露工作备忘录 第六号 上市公司现金选择权业务指引（试行）(*Memorial of Disclosure of Material Asset Reorganizations of Listed Companies No.6 Guidance of Voluntary Cash Offer of Listed Companies (Trial)*), Shanghai Stock Exchange, date of issue August 3. 2012.
463 Wang Jun, '公司经营者忠实和勤勉义务诉讼研究-以 14 省，直辖市的 137 件判决书为样本 (On Actions against Directors or Officers for Breaching the Duty of Loyalty or the Duty of Care: An Empirical Study Based on 137 Cases from 14 Provinces in China)', 4 (2011) *北方法学* (*Northern Legal Science*), pp. 24-39.
Xu Guangdong, Zhou Tianshu, Zeng Bin and Shi Jin, 'Directors' Duties in China', 14 (2013) *European Business Organization Law Review*, pp. 57-95.
Lou Jianbo, Yan Hui and Zhao Yang, '公司法中董事，监事，高管人员信义义务的法律适用研究-以北京法院 2005-2007 年间的相关案例为样本的实证研究 (Research on the Application of Directors, Supervisors and Senior Management Personnel's Fiduciary Duties Prescribed in the Company Law: Empirical Research on

First, the amount of cases is still rather limited in practice. Based on three major databases,[464] Wang managed to find only 137 fiduciary cases from 2001 to 2010.[465] Lou et al. focused on the three-year period from 2005 to 2007 but only collected 13 director fiduciary cases, while Xu et al. employed the Beida Fabao database[466] and gathered just 33 "duty of loyalty" cases and four "duty of diligence" cases[467] from 2006 to 2012.[468]

Second, hardly any listed company shareholder uses the "fiduciary duty" as a weapon to guard the company's interests. Among 137 cases collected by Wang, 136 were related to non-listed companies, and only one example was connected with a listed company on the SZSE. Similarly, Xu et al.'s sample concerned exclusively closely-held companies, with no single case of a listed company. Accordingly, Xu et al. concluded that the private enforcement of fiduciary duties for shareholder protection still seriously lags behind expectation.[469]

Third, though the general observation remains that judges mechanically follow the wording of legislation in adjudications, some judges have started to interpret laws actively and innovatively. Among Wang's 137 cases, there were 78 whose respondents had been adjudicated liable for compensation, due to breaching their fiduciary duties. Furthermore, in 38 out of the 78 cases (41%), courts reached their judgments by interpreting the general provisions of Articles 147 or 149 of the *CCL*, which were beyond the eight specifically prohibited acts in Article 148. Xu et al. asserted that courts generally hold a conservative and less flexible attitude to fiduciary duty cases. Nevertheless,

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Relevant Cases of Courts in Beijing during 2005 to 2007)', 1 (2012) *商事法论集* (*Commercial Law Review*), pp. 530-564.

464 These three databases are Beida Fabao (http://vip.chinalawinfo.com/), Beijing Fayuan Wang (bigy.chinacourt.org) and Shanghai Fayuan Wang (hshfy.sh.cn).

465 These 137 cases cover 14 provinces or municipalities' local, medium and higher courts. Among which, 100 cases were judged during 2007 to 2010.

466 Beida Fabao (http://vip.chinalawinfo.com/).

467 In only one out of these four cases did the court rule the plaintiff's claim on the basis of duty of diligence.

468 Also based on the Beida Fabao database, under the cause of action of "liability disputes of the infringement of shareholders' interests" and also under the labels of "duty of loyalty" and "duty of care", this research recorded 34 results. After excluding repeated results, this research collected 32 cases from 1st January 2010 to 1st March 2017. Moreover, under the cause of action of "liability disputes of the infringement of the company's interest" and also under the labels of "duty of loyalty" and "duty of care", this research recorded 468 results. After excluding repeated results, this research collected 410 cases. In comparison with the 137 cases collected by Wang's research from 2001-2010, an increase in fiduciary duty cases was witnessed for the period from 1st January 2010 to 1st March 2017.

469 Likewise, based on the Beida Fabao database, this research found zero cases under the cause of action of "disputes of M&A of listed companies" between 1st January 2010 and 1st March 2017.

they also acknowledged judicial innovation by highlighting three representative cases[470] in their sample and observing that these innovative judges more often exist in economically-advanced cities, such as Beijing and Shanghai. Moreover, Xu et al. recorded a similar standard[471] of the "business judgment rule" in Chinese judicial practice despite the fact that the *CCL* does not provide any provision on this issue. Specific to the controlling shareholder's fiduciary duty, Lin and Cabrelli claimed that related litigations were very rare in China.[472] Additionally, Clarke and Howson were confident that the Sanlian Shangeshe case[473] was the only example concerning minority shareholders who had brought a derivative action against the controlling shareholder of a listed company during the post-2006 and early-2010 period.[474]

In response to this reality, academics point out some legislative problems. It is suggested to consider whether the threshold of the derivative action in Article 151 *CCL*, i.e. 1% shareholding and 180 consecutive days, imposes too heavy a burden, considering the characteristics of Chinese shareholders.[475] Statistics for the first three months of 2007 illustrate that 85.6% of investors on the SSE

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[470] In case one (北京京华四方贸易有限公司), the court substantially interpreted the law to rule that the duty of loyalty should apply to the respondent (a department manager) instead of mechanically following the literal meaning of Article 216, which defines senior management personnel as managers, vice managers, financial responsible persons, secretaries of the board of directors and other staff prescribed in the articles of association. In case two (上海星耘房地产咨询有限公司), the court adjudicated that a resigned director still owes a duty of loyalty to the company he or she previously served during certain periods, even though the existing 2013 *Chinese Company Law* does not clarify whether fiduciary duty applies to former directors or not. In case three (武汉科地光通信有限责任公司), the court went into the essence of the fiduciary duty and concluded that its application should balance the goals of shareholder protection and the efficient functioning of the board of directors. In other words, the application of fiduciary duty shall not go to the extreme of super-risk-averse directors and thus unnecessarily lose commercial opportunities.

[471] Please refer to case three of the "three representative cases" mentioned above.

[472] Lin Shaowei and David Cabrelli, 'Legal Protection for Minority Shareholders in China', 8 (2013), *Frontiers of Law in China*, pp. 266-303.

[473] In 2009, minority shareholders of the Sanlian Shangshe (三联商社) brought a derivative action for horizontal competition, illegal usage of a trademark and tunnelling. However, minority shareholders lost the lawsuit according to the ruling of the Supreme People's Court of Shandong Province on 17 October 2012. Details see http://info.homea.hc360.com/2009/12/131352469142.shtml. And http://finance.ifeng.com/stock/gsgg/20121018/7166629.shtml. Last visited on February 2019.

[474] Nicholas Callcina Howson and Donald C. Clarke, 'Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China', available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1968732. Last visited February 2019.
Based on the Beida Fabao database, under the cause of action of "company disputes" and also under the label of "controlling shareholder", this research collected zero case of listed company from 1st January 2010 to 2nd March 2017.

[475] Xu Guangdong, Zhou Tianshu, Zeng Bin and Shi Jin, 'Directors' Duties in China', 14 (2013) *European Business Organization Law Review*, pp. 57-95.

held their shares for fewer than three months.[476] Furthermore, on the SZSE, 68.7% of investors held their shares fewer than three months in 2006, and 77% of investors held their shares fewer than three months during the first eight months of 2007.[477] Another report in 2009 revealed that 44.22% of the surveyed shareholders held their shares for less than one month, 39.18% of the surveyed shareholders held their shares more than one month, but fewer than 6 months, and only 16.6% of the surveyed investors held their shares for more than half a year.[478] On the SSE, shareholders in 2013 typically held their shares for 66.5 days.[479] Consequently, the above data highlight that most shareholders on the Chinese securities market cannot pass the 180-day requirement of Article 151.

Besides, individual minority shareholders on the Chinese securities market may face significant difficulty in fulfilling the 1% shareholding demand. In the *2009 Chinese Securities Investors Survey*, 64.83% of the surveyed shareholders had a shareholding of less than 100,000 RMB, and 85.08% had a shareholding of less than 300,000 RMB.[480] According to the *SSE Statistics Annual*, up to the end of 2015, 50.55% of the shareholders were individuals who had a shareholding of less than 100,000 RMB, and 74.21% individuals had less than 300,000 RMB.[481] Another report in February 2016 demonstrated that 97.95% of individual shareholders had less than 1 million RMB share capital. Meanwhile, 52.72% of institutional investors had more than 1 million RMB in share capital.[482] Consequently, the above statistics reveal that it is barely possible for individual

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[476] 中国资本市场发展报告(China Capital Markets Development Report), China Securities Regulatory Commission, available at http://www.csrc.gov.cn/pub/zjhpublic/G00306220/200810/P020090310669067184693.pdf. Last visited February 2019.

[477] Ibid.

[478] 2009 年中国证券投资者综合调查分析报告 (2009 Chinese Securities Investors Survey), available at http://www.doc88.com/p-770875327007.html. Last visited February 2019.

[479] 上海证券市场投资者结构与行为报告 2013 (2013 Report on the Structure and Behaviours of Securities Investors on SSE), available at http://wenku.baidu.com/link?url=Ih6pGAOaQToBcDRDxj_BE5eoLBXTK5I05RdwHzxZwIGEt1YSCQop-eypwNIL4WH_CYaJtGwi_q15ot-T4bG6Oshw5slW1z51DCyqRShmQEi. Last visited on February 2019.

[480] Supra. 478.

[481] 上海证券交易所统计年鉴 2 0 1 6 卷 (SSE Statistics Annual 2016 Vol.), available at http://www.sse.com.cn/aboutus/publication/yearly/documents/c/tjnj_2016.pdf. Last visited February 2019.

[482] 中国股市投资者全景图：个人账户高达 99.71% (An Overview of the Investors on the Chinese Stock Exchange: the Number of Individual Shareholders Accounts for 99.71%), available at http://finance.sina.com.cn/money/smjj/smdt/2016-04-01/doc-ifxqxcnr5189753.shtml. Last visited February 2019.

minority shareholders on the Chinese securities market to pass the 1% shareholding requirement set out in Article 151.[483]

Minority shareholders who manage to pass the Article 151 threshold may still lack the incentive to bring derivative actions. The nature of a derivative action determines that the compensation goes back to the company rather than directly to the shareholder who brought the lawsuit. Considering the concentrated ownership structure, there is a potential danger that the litigation reward, again under the domination of the controlling shareholder, may still fail to give justice to minority shareholders, since controller expropriation was probably the cause of the litigation in the first place.[484] In a situation where the state is the minority expropriator, the protection of a derivative action may turn out to be of little account.

In addition, there are other elements that may disencourage shareholder litigation in general considering litigation costs, courts' negative attitude towards securities cases and the absence of class action.[485] The *CCL* does not touch upon the burden of litigation costs in shareholder litigation. According to Article 118[486] of the *Chinese Civil Procedure Law*,[487] the plaintiff should pay the litigation fee according to related provisions. This means that a minority shareholder has to hire a lawyer and pay the litigation fee, in order to bring an action.[488] Article 29 of the *Measures on the Payment of Litigation Costs* (hereinafter *Litigation Costs Measures*)[489] stipulates that the losing party should be responsible for any litigation costs, but the plaintiff still needs to pay the lawyer's fee and the cost of court enforcement.[490] The *CCL Provisions IV* clarified in 2017 that shareholders' litigation fees may be refunded by the

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483 The 1% shareholding threshold has even been claimed as the "foremost barrier" to derivative action. See Zhang Zhong, 'The Shareholder Derivative Action and Good Corporate Governance in China: Why the Excitement is actually for Nothing', 28 (2011) *UCLA Pacific Basin Law Journal*, pp. 174-209.

484 Iman Anabtawi and Lynn A. Stout, 'Fiduciary Duties for Activist Shareholders', 60 (2008) *Stanford Law Review*, pp. 1255-1308.

485 After 1st March,2020, Article 95 of the revised 2020 *CSL* will establish a Chinese style of "class action" to deal with securities compensation suits

486 Paragraph one of Article 118 of the *Chinese Civil Procedure Law* prescribes that "any party filing a civil lawsuit shall pay litigation costs according to relevant provisions. For property cases, besides litigation costs, other fees shall be paid according to relevant provisions".

487 *中华人民共和国民事诉讼法* (*Civil Procedure Law of People's Republic of China*), Standing Committee of the People's Congress, amended on 31st August 2012.

488 Under the ISC pilot project, if minority shareholders bring an action through the ISC, then the ISC will take care of the lawyer's fee.

489 *诉讼费用交纳办法* (*Measures on the Payment of Litigation Costs*), State Council, date of issue 19th December 2006.

490 Article 10, *Litigation Costs Measures*.

company if the former win the lawsuit. These litigations are normally rather lengthy, with an average duration of 2.5 years.[491] If the minority shareholder wins the lawsuit, some research claims that the reward of the litigation may not be as good as expected, and the enforcement of the compensation is another headache in practice.[492]

The courts' negative attitude towards private securities litigation is another factor that disincentivises minority shareholders and result in them not bringing an action. In 2001, the Supreme People's Court completely shut down civil securities litigation, and in 2002, it promulgated a *Notice*[493] *to* accept private securities cases caused by false statements, under certain conditions. Subsequently, in 2003, the Court enacted *Provisions*[494] which expanded the scope of false statement cases. However, other serious claims, such as insider trading and market manipulation, were still rejected by the Court. Since 2002, class actions have been ruled out for private securities litigation in China.[495] However, the recent promulgated 2020 *CSL* added Article 95 to affirm a Chinese style of "class action" for securities compensation suits. After 1st March 2020, Chinese shareholders are entitled to bring a representative action under certain conditions to seek compensations, due to false statements for instance. In particular, the revised 2020 *CSL* further strengthens the ISC's role as minority shareholders' guardian. It prescribes that the ISC can act as minority shareholders' litigation representative with 50 or more shareholders' authorizations in securities compensation suits, the ISC wil be exempted from both the 1% shareholding and 180 consecutive days in bringing a derivative action, and the ISC provides general support for shareholder litigation. If the ISC represents shareholders in bringing an action, the ISC will take care of the lawyers' fees.

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491 Xu Guangdong, Zhou Tianshu, Zeng Bin and Shi Jin, 'Directors' Duties in China', 14 (2013) *European Business Organization Law Review*, pp. 57-95.

492 Zhang Tiesheng, '证券民事诉讼与投资者保护 (Securities Civil Litigations and Investor Protection)', 11 (2009) *财政研究* (*Public Financial Research*), pp. 58-61.

493 *最高人民法院关于受理证券市场因虚假陈述引发的民事侵权纠纷案件有关问题的通知* (*Notice on Related Issues of Civil Tort Cases caused by Securities False Statement*), Supreme People's Court, date of issue 15th January 2002.

494 *最高人民法院关于审理证券市场因虚假陈述引发的民事赔偿案件的若干规定* (*Provisions on Adjudicating of Civil Compensation Cases based on Securities False Statement*), Supreme People's Court, date of issue 9th January 2003.

495 See the *2002 Notic*e and the *2003 Provisions.*

In December, 2017, the Shenzhen Financial Tribunal, which is the first special commercial tribunal in China, was established. On 25th April 2018, Zhou Qiang, the president of the Supreme People's Court, clarified the *Decision* (*Draft) of Establishing Shanghai Financial Court* in the second meeting of the 13th Standing Committee of the National People's Congress.[496] *Provisions of the Supreme People's Court on the Jurisdiction of the Shanghai Financial Court*[497] was issued on 7th August 2018,[498] and on 20th August 2018, the Shanghai Financial Court was officially established[499] to focus on relevant financial cases in Shanghai. At the beginning of 2019, the Shanghai Financial Court and Beijing People's Courts had innovatively started the standard adjudication mechanism to help resolve group actions in securities disputes.[500] For group actions, the court selects a model case. The ruling of this model case is regarded as the standard adjudication guiding other parallel cases[501] in different aspects, such as factual findings and the application of law.

To strengthen judicial protection, legislation should further clarify the essence of fiduciary duties, the existing provisions of which are regarded as too general, considering the absence of case law in China. Legislation simply states that directors and controlling shareholders owe fiduciary duties to the company and other shareholders, without clarifying the essential tenets of fiduciary duties and what constitues judicial standards for a court to rule a breach of fiduciary duty. Scholars claim that the legal texts on "fiduciary duties" are too vague and empty to have an influence in reality.[502] Furthermore, the lack of detailed rules on directors' fiduciary duties, especially the duty of diligence,

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496 《关于在上海设立金融法院的决定（草案）》的说明, available at http://www.npc.gov.cn/npc/xinwen/2018-04/27/content_2053989.htm, last visited February 2019.

497 *最高人民法院关于上海金融法院案件管辖的规定* (*Provisions of the Supreme People's Court on the Jurisdiction of the Shanghai Financial Court*), issued by the Supreme People's Court, date of issue 7th August 2018, date of effect 10th August 2018.

498 Shanghai Financial Court has the jurisdiction to review first-trial financial and commercial cases that should have been under the jurisdiction of the Intermediate People's Court of Shanghai Municipality, and appeals of commercial cases or financial-related administrative cases.

499 Available at http://www.xinhuanet.com/legal/2018-08/21/c_1123299289.htm, last visited February 2019.

500 *《关于依法公正高效处理群体性证券纠纷的意见（试行）》* (*Opinion on Legally, Justly and Efficiently Resolving Group Actions of Securities Disputes* (*Trial*)), Beijing Higher People's Court, date of issue 29th April 2019.

《上海金融法院关于证券纠纷示范判决机制的规定》(*Regulation about Standard Adjudication Mechanism for Securities Disputes*), Shanghai Financial Court, date of issue 6th January 2019.

501 Parallel cases share common factual disputes and legal disputes with the model case. Article 2, *Regulation about Standard Adjudication Mechanism for Securities Disputes*.

502 Xu Guangdong, Zhou Tianshu, Zeng Bin and Shi Jin, 'Directors' Duties in China', 14 (2013) *European Business Organization Law Review*, pp. 57-95.

has left it with no substantial effect in practice.[503] Likewise, the absence of detailed rules of enforcement procedures and legal remedies regarding the controlling shareholder's fiduciary duty has tremendously increased the difficulty in starting litigation.[504] Moreover, the *CCL* does not directly confirm the controlling shareholder's fiduciary duty but leaves it to other legislation, such as the *CCGC*. Some scholars point out that Chinese legislators prefer to provide more general prescriptions in law and delegate subordinate legislation to stipulate more comprehensive rules, such as departmental regulatory provisions or normative documents. However, the main legal sources for a judicial ruling are laws and administrative regulations, and lower-level legislation only functions as a reference for a court. In other words, the controlling shareholder's fiduciary duty, and the relevant rules laid down by legislation with lower legal effect, may have less authority in judicial application.[505] Consequently, academics assert that elements, i.e. the lack of a well-defined fiduciary duty, no supplementary detailed rules, no clarified judicial standards to determine breaches of fiduciary duties, conservative judges and their formative rulings, the general legal environment of weak enforcement, etc., have all increased the uncertainty of the outcomes of litigation.[506]

Since the establishment of the SSE and the SZSE in 1990, the Chinese securities market has gone through fewer than three decades of development. As relatively new activities, takeover transactions have brought a big challenge to both Chinese listed companies and courts, and due to inexperience in this area, it is unsurprising that derivative actions based on fiduciary duty have not been widely used by minority shareholders. To improve the current situation, legislation should be more specific and clear; for example, it should clarify how to ascertain the purchase price of the appraisal right, and outline the substantial contents of fiduciary duties and judicial review standards. Moreover, judicial attitudes to securities cases ought to be more friendly and

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503 Ibid.

504 Lin Shaowei and David Cabrelli, 'Legal Protection for Minority Shareholders in China', 8 (2013) *Frontiers of Law in China*, pp. 266-303.

505 Deng Rui and Guan Yanfang, '控股股东的诚信义务与中小股东利益的保护 (Controlling Shareholder's Fiduciary Duty and Minority Shareholder Protection', 2 (2011) *特区经济* (*Special Zone Economy*), pp. 145-146.

506 See Kang Yong, Shi Lu and Elizabeth D. Brown, 'Chinese Corporate Governance: History and Institutional Framework', available at http://www.rand.org/content/dam/rand/pubs/technical_reports/2008/RAND_TR618.pdf. Last visited February 2019.

open. To increase minority shareholders' incentives to litigate, shareholder-friendly rules should be stipulated (It is encouraging to see that the revised 2020 *CSL* recently adopted the representative litigation and granted the ISC an enhanced role in shareholder litigation). Last but not least, statistics show that the threshold for exercising the right to a derivative action may be too hash for individual minority shareholders. In comparison, qualified minority shareholders are more capable of overcoming the threshold and are better motivated to exercise this litigation right (The revised 2020 *CSL* removed the 1% shares and 180 days restrictions for the ISC in bringing a derivative action). Thus, a potential option is to encourage the growth of qualified minority shareholders. The newly established ISC project especially may change this situation, since the ISC, as a semi-governmental institution, may reduce the litigation costs for minority shareholders and overcome the collective action problem. The ISC should gradually take an active role in bringing derivative actions, in order to redress minority shareholder expropriations in takeover transactions.[507]

3.5 Conclusion

In a Chinese listed company, the general meeting of shareholders, the board of directors and the party organisation are three main bodies that influence decision-making. Chinese legislation prescribes a strong general meeting, which may turn out to be a double-edged sword for minority shareholders. Legislation also provides shareholders with certain rights when a threshold is reached, but individual minority shareholders may face significant difficulty in fulfilling these threshold requirements. Comparatively, qualified minority shareholders have a better chance and incentive to exercise rights with a threshold. Various minority rights are found in legislation despite limitations such as the provisions are rather unclear for implementation, the exercise of these rights depends on the general meeting and the rights have low legal authority. In addition, the ISC was established as the representative of minority

[507] The ISC has shown the impact of supporting minority shareholders seeking to exercise the right to suit. Until May 2017, the ISC had represented minority shareholders to bring four direct actions against four companies based on torts. These four cases mainly concerned securities false statements that were previously sanctioned by the CSRC or other administrative organs. However, the effect of the ISC in supporting minority derivative actions, especially in change of control transactions, still waits to be established in the future. See: http://www.isc.com.cn/about_us/. Last visited February 2019.

shareholders seeking to exercise actively shareholder rights and to safeguard minority shareholders' interests.

To protect minority shareholders through transparency, Chinese legislation has prescribed comprehensive disclosure rules. However, the implementation of these rules still faces two major obstacles. One is the side-effect of the highly concentrated ownership structure, namely a low incentive to disclose and a low incentive to monitor. The other is the immature institutional environment, which includes the integrity of intermediate agencies, the quality of accounting rules and enforcement by the CSRC and the Chinese courts.

The internal supervision of a Chinese listed company consists of both the supervisory board and a set of independent directors. Different from the traditional one-tier and two-tier boards, the supervisory board and independent directors in China have relatively soft powers, which are often found to be overlapping and without clarification in terms of enforcement. Moreover, the controlling shareholder normally dominates the appointment of both supervisors and independent directors. Unsurprisingly, independence from the controlling shareholder raises doubt in Chinese listed companies.

Last of all, the Chinese market of corporate control is in the process of developing. Three characteristics are summarised herein based on practice. First, a majority of M&As in China are conducted through negotiated acquisitions instead of tender offers. Second, transactions between state-owned listed companies occupy a majority of the total value of Chinese M&As. Third, government interference still seems to be more effective than the market in resolving takeover challenges. These characteristics are closely related to the ownership structure, the securities market, the political system and the legal environment. To improve judicial protection in takeover transactions, various improvements need to be made; for instance, the law should clarify the essence and implementation of fiduciary duties, and courts should progressively become more professional and more willing to resolve takeover issues.

Chapter 4 Minority Shareholder Protection in the US

4.1 Introduction

In the US, listed companies are regulated by both states and federal government. Guided by the internal affairs doctrine, state corporate laws govern the internal affairs of a company, and the federal government looks after the trading of securities.[508] In response to serious corporate scandals, the federal government has intervened further in regulating public companies on the securities market.[509]

The federalisation of securities regulations can be traced back to the *1933 Securities Act*, which emphasises disclosure through securities registration, to achieve the goals of well-informed investors and no deceit, misrepresentation and other fraudulent activities in securities trading.[510] Compared with the *1933 Securities Act*, which regulates the primary market, the *1934 Securities Exchange Act* focuses on the secondary market, and thus it is more relevant to this research. The *1934 Securities Exchange Act* took a major step by establishing the Securities and Exchange Commission with comprehensive powers to regulate all aspects of the securities industry, especially tender offers, proxy solicitations, periodical reporting and insider trading.[511]

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508 Mark J. Roe, 'Delaware's Competition', 117 (2003) *Harvard Law Review*, pp. 588-646.

509 It has been claimed that the federal government has become the biggest competitor of Delaware in corporate law. See: Mark J. Roe, 'Delaware's Competition', 117 (2003) *Harvard Law Review*, pp. 588-646. However, the opposite opinion asserts that corporate law competition is strongest between Delaware and other states, rather than with the federal government. See: Roberta Romano, 'The Market for Corporate Law Redux', in Francesco Parisi (eds.), *Oxford Handbook of Law and Economics Volume2: Private and Commercial Law* (Oxford: Oxford University Press, 2017), pp. 358-398.

510 See: https://www.sec.gov/about/laws.shtml. Last visited February 2019.

511 See: https://www.sec.gov/about/laws.shtml. Last visited February 2019.

Subsequently, a series of legislations further amended the *1934 Securities Exchange Act*. In 1968, the *Williams Act* was passed to govern tender offers. In 2002, the *Sarbanes-Oxley Act*, as a profound reform to improve corporate responsibility and financial disclosure, as well as to tackle fraud on the securities market, was put into effect.[512] In 2010, the promulgation of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* revealed the federal government's determination to reform several areas, such as consumer protection, corporate governance, disclosure and transparency.[513] In addition, the rules of self-regulatory organisations such as the New York Stock Exchange and the NASDAQ Stock Exchange play an important role in regulating listed companies.

On the state level, the primary legal source is *Delaware General Corporate Law* and Delaware case law for the reason that the majority of listed companies are from Delaware, i.e. more than 50% of all US listed companies, and more than 66% of the Fortune 500 companies, are incorporated in Delaware.[514] In a nutshell, corporate governance in the US is attributed to a combination of state corporate laws, federal securities regulations and listing rules for stock exchanges.[515]

Based on the above legal sources, this chapter will examine minority shareholder protection in US listed companies, with a focus on Delaware. Under a highly dispersed ownership structure, which creates the predominant agency cost between shareholders and management, US law generally describes shareholders as a class and grants special attention to minority shareholders in takeover transactions. For the above reasons, this chapter will delve into three main areas, namely shareholder rights, monitoring mechanisms and takeovers.

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[512] The SOX mainly covers the following aspects, strengthens the audit committee, demands top managers personally certify financial reports, emphasises disclosure, imposes harsher punishments, requires internal control tests and reports and sets up the public company accounting oversight board. See: https://www.sec.gov/about/laws.shtml. Last visited February 2019.

[513] See: https://www.sec.gov/about/laws.shtml. Last visited February 2019.

[514] See: https://www.businessinsider.com/heres-why-corporations-are-flocking-to-delaware-to-conduct-business-2016-8. Last visited February 2019.

[515] Robert B. Thompson, 'Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation', 38 (2003) *Wake Forest Law Review*, pp. 961-982.

Marc. I. Steinberg (ed.), *The Federalization of Corporate Governance* (New York: Oxford University Press, 2018), p.6.

4.2 Minority shareholder protection through shareholder rights in the US

In this part, the elaboration reveals the power disparity between shareholders and boards of directors. At the same time, it will underline rights that are important to minority shareholders. As mentioned in the introduction, state corporate laws regulate the internal affairs of a company, and the federal government stipulates rules pertinent to the securities market. Accordingly, shareholder rights mainly belong to the domain of state corporate laws, and the legal source in this part mostly refers to the *Delaware General Corporation Law* (hereinafter "*DGCL*").[516] Relevant federal securities rules will also be mentioned on occasion. Additionally, in order to provide a comprehensive discussion on shareholder rights, the *Model Business Corporation Act* (hereinafter "*MBCA*"),[517] as "the most important alternative to Delaware law",[518] will also be mentioned in the footnotes for reference, when its provisions are different from the *DGCL*.

Appointment and removal right

Modern listed companies consist of hundreds and thousands of shareholders. As a result, shareholder voting in listed companies is very often conducted through proxy voting. Shareholders' appointments and removal rights are influenced by both state corporate laws and federal proxy rules.

State corporate laws generally prescribe that shareholders are entitled to the most essential right to appoint and remove directors. According to *DGCL*§211(b), the appointment of directors can be conducted by either an annual meeting of shareholders or the unanimous written consent of shareholders.[519] However, the power to nominate candidates remains with

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516 *Delaware Code*, Title 8 Corporation, version of February 3, 2016, available at http://delcode.delaware.gov/title8/title8.pdf. Last visited February 2019.

517 *Model Business Corporation Act* (2016). Due to the inconsistency of state corporate laws, the *MBCA* was drafted by the American Bar Association to bring some guidance and clarity, and it has been adopted by 24 states, available at https://en.wikipedia.org/wiki/Model_Business_Corporation_Act. Last visited February 2019.

518 Stephen M. Bainbridge, *Corporate Law* (New York: Foundation Press, 2015), p. 10.

519 In the latter case, if shareholders cannot reach unanimous written consent, then the appointment can only be effected when such an election fulfills all director vacancies, which are supposed to be appointed through an effective annual shareholder meeting.

the current board, which normally just re-nominates incumbent directors. Under the default rule of plurality voting,[520] candidates who receive the most votes win, regardless of the amount of "withhold" votes.[521] In other words, a candidate may secure his or her seat with just one vote (even if the vote is from the candidate him- or herself).[522] In an uncontested election, each candidate nominated by the board is guaranteed to be elected, since the proxy card lists only the board-nominated slate that equals to the number of seats and shareholders can only check the "vote" or "withhold" box, i.e. each board candidate is in fact the only vote receivers and one single vote is sufficient to guarantee his or her election.[523]

To change this situation, shareholder activists have argued that majority voting serves shareholders' appointment rights better than plurality voting.[524] The *DGCL* §216 provides shareholders with the ability to replace plurality voting with majority voting by amending company bylaws.[525] Many companies have accepted the idea[526] and adopted majority voting in one of two forms. The first example is "plurality plus" (also known as the "Pfizer Model"),[527] which combines plurality voting with a resignation requirement. Normally, this policy is stipulated in the corporate governance principle instead of the company charter. If a candidate receives more "withhold" votes than "for" votes in an uncontested election, the candidate is still elected – as long as he or she has at least one "for" vote. However, in this case, the candidate should promptly

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In comparison, the *MBCA* §8.03 (c) also prescribes that shareholders have the right to appoint directors, and it specifies this director selection should be carried out at the annual meeting of shareholders, except where articles of incorporation demand a staggered board.

520 *DGCL* §216 (3).

521 Shareholders cannot directly vote against the board nominees. See: Joshua R. Mourning, 'The Majority-Voting Movement: Curtailing Shareholder Disenfranchisement in Corporate Director Elections', 85 (2007) *Washington University Law Review*, pp. 1143-1194.

522 Randall S. Thomas and Patrick C. Tricker, 'Shareholder Voting in Proxy Contests for Corporate Control, Uncontested Director Elections and Management Proposals: A Review of the Empirical Literature', 70 (2017) *Oklahoma Law Review*, pp. 9-126.

523 William K. Sjostrom, JR. & Young Sang Kim, 'Majority Voting for the Election of Directors', 40 (2007) *Connecticut Law Review*, pp. 459- 510.

524 See: https://www.lexology.com/library/detail.aspx?g=245f961e-7bff-401a-8799-50ff1004164c. Last visited February 2019.

525 *DGCL* §216 also forbids the board of directors from amending or repealing the bylaw amendment in which shareholders demand a majority vote.

526 Supra. 523.

Statistics show that almost 90% of S&P500 companies adopted majority voting in one of its forms. But only 29% of Russell 2000 companies applied majority voting to uncontested elections. See: https://www.cii.org/files/issues_and_advocacy/board_accountability/majority_voting_directors/CII%20Majority%20Voting%20FAQ%201-4-17.pdf. Last visited February 2019.

527 Supra. 523.

submit his or her resignation. Furthermore, the board governance committee will suggest the board to accept or reject the resignation.[528] In contrast, the other form is "majority plus" (also known as the "Intel Model"),[529] which consists of majority voting and a resignation requirement. This form is typically established in the bylaw and states that if a candidate receives more "withhold" votes than "for" votes in an uncontested election, the candidate will not be elected, in which case, if the candidate is an incumbent director, then he or she should resign. The board governance committee will then recommend whether the board accepts the resignation or not. Despite not being re-elected, the "holdover rule"[530] will continuously keep the incumbent director on the board until his or her successor is elected or qualifies.[531] In fact, many companies have replaced plurality voting with majority voting.[532]

In parallel with the appointment right, shareholders also have the removal right. *DGCL* §141(K) states that a majority agreement of shareholders with voting rights can remove a director or even the entire board, with or without cause.[533] Meanwhile, *DGCL* §141(K) also provides two exceptions, namely directors can only be removed for cause in companies with a staggered board structure or cumulative voting. For companies with a staggered board structure,[534] shareholders can only remove directors with a cause, unless the certificate of incorporation prescribes otherwise. For companies with cumulative voting,[535] if shareholders intend to remove only part of the board,

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[528] See: https://www.lexology.com/library/detail.aspx?g=245f961e-7bff-401a-8799-50ff1004164c. Last visited February 2019.
[529] Supra. 523.
[530] *DCGC* §141 (b).
[531] See: https://www.lexology.com/library/detail.aspx?g=245f961e-7bff-401a-8799-50ff1004164c. Last visited February 2019.
[532] Joshua R. Mourning, 'The Majority-Voting Movement: Curtailing Shareholder Disenfranchisement in Corporate Director Elections', 85 (2007) *Washington University Law Review*, pp. 1143-1194.
[533] The exception to this rule is that if the certificate of incorporation provides for classes or series of directors, or in a corporation which adopts cumulative voting, if the vote against the removal of a director is cumulatively sufficient to elect this director based on the selection of the entire board, then removal with a cause is mandatory. Comparatively, *MBCA* §8.08 stipulates that shareholders have the right to remove one or more directors, with or without cause. However, it clarifies that the articles of incorporation may forbid the removal of directors with no cause.
[534] The "staggered board", which consists of three classes of directors with different terms of office, i.e. after the expiration of the terms of office of the first class of directors, shareholders need to wait for another year to remove the second class, and after removing the second class, shareholders still need to wait for another year to remove the third class, was prescribed in *DGCL*§141 (d).
[535] *DGCL* §214 states that if provided by the certificate of incorporation, a shareholder deserves a number of votes equal to the shares he or she holds, multiplied by the amount of directors that need to be chosen. The shareholder can freely decide to allocate all of his or her votes on one candidate or distribute them among more than one, or even all, candidates.

and shareholders who disagree with the removal are capable of cumulatively electing such a director, then this removal can only be conducted with a cause.

For a shareholder resolution to be valid, a quorum is required to be present at the general meeting. Considering the characteristics of a modern listed company, it is infeasible for a majority of shareholders to be present in person due to time, physical distance or other reasons. Instead, voting by proxy has become a common practice for listed companies.[536] Acknowledging the overwhelming impact of proxy voting, federal proxy rules intend to create similar opportunities as voting in person for shareholders through disclosure and due procedures.[537] Federal proxy rules,[538] i.e. Securities Exchange Commission (hereinafter "SEC") Regulation 14A, which implements *1934 Securities Exchange Act* (hereinafter*" SEA"*) section 14 (a), stress two main arrays of rules associating with proxy statement and shareholder proposals.[539] For the former, it particularly states that pursuant to *SEA* Rule 14a-3, a proxy solicitation demands the solicitor provide a proxy statement based on Schedule 14A of Regulation 14A.[540] For director elections, an annual report should also be provided to shareholders.[541] Besides, the solicitor should provide a proxy card,[542] which lists the names of director nominees with boxes for both a "for" vote and a "withhold" vote.[543]

If shareholders intend to nominate their own candidates, there are two ways to achieve this end.[544] One is to suggest the candidate to the board committee, which has full discretion to include the candidate or not in the proxy statement.

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536 Supra. 523.

537 See: Briefing Paper: Roundtable on the Federal Proxy Rules and State Corporation Law, available at: https://www.sec.gov/spotlight/proxyprocess/proxy-briefing050707.htm. Last visited February 2019.

538 Federal proxy rules mainly refer to SEC regulation 14 A, 17 C.F.R. §240.14a-01 to 14a-10, which mainly cover rules relating to proxy solicitations, information provided to shareholders, proxy requirements, proxy statement, filing requiremernts, delivery of soliciting materials, shareholder proposals, prohibition of false or misleading information, and forbidden solicitations.

539 James J. Park, 'Reassessing the Distiction Between Coporate and Securities Law', 64 (2017) *UCLA Law Review*, pp. 116-182.

540 *SEA* Rule 14a-8, 17 C.F.R. §240.14a-3(a), 17 C.F.R. §240.14A-101.

541 17 *CFR* §240.14a-3 (b).

542 17 *CFR* §240.14a-4(b).

543 Proxy materials normally include the proxy statement, the proxy card and the annual report. See: supra. 529.

544 Danielle Vukovich, 'Proxy Access Voting: Evaluating Proxy Access and the Recent Phenomenon of Corporations Adopting Shareholder Protective Policies', 19 (2018) *San Diego International Law Journal*, pp. 437-472.

The other is to introduce a much higher cost to conduct a proxy contest.[545] In the latter case, solicitors have to distribute the proxy statements at their own cost and fund other relevant activities. The expense of a proxy contest is usually significantly heavy, ranging from $267,000 to $2.17million.[546]

To relieve these costs, the SEC attempted to facilitate shareholders' solicitation by using company proxy materials. In 2003, the SEC issued a proxy access proposal, consisting of a trigger event, a 5% threshold and a holding period of at least 2 years. Fulfilling these conditions, shareholders would be qualified to nominate their candidates; however, this proposal faced many controversies and ended up being rejected. After several attempts to regulate the proxy access in 2007 and 2009, on 25th August, 2010, under the authorization of *Dodd-Frank Act*,[547] the SEC adopted proxy access Rule 14a-11 with a threshold of 3% and a holding period of a minimum 3 years. Candidates nominated by shareholders could account for a maximum 25% of the entire board. Shortly after its adoption, a suit was filed by the Business Roundtable and the Chamber of Commerce. The Court of Appeal for the District of Columbia Circuit vacated the proxy access rule on 22nd July, 2011.[548] Despite the failure of Rule 14a-11, the SEC did successfully amend Rule 14a-8[549] regarding shareholder proposals in 2010 by restricting its election exclusions. Before the amendment, Rule 14a-8 excluded proposals in which shareholders could demand proxy access.[550] Now, based on Rule14a-8, eligible shareholders may pursue proxy access by submitting shareholder proposals to request an amendment of a company's governing documents regarding nomination procedures.[551]

Correspondingly, the *DGCL* amended its §112 to permit companies to adopt proxy access through bylaws. Subject to conditions provided in these bylaws,

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[545] Marcel Kahan and Edward Rock, 'The Insignificance of Proxy Access', 97 (2011) *Virginia Law Review*, pp. 1347-1434.

[546] Research has recorded that the average cost is $267,000 for companies with capital less than $300 million, $643,000 for companies with capital between $300 million and $1billion and $2.17 million for companies with capital of more than $1 billion. See: ibid.

[547] Section 971 of the *Dodd-Frank Act* officially authorized the SEC to prescribe proxy access rules which may allow eligible shareholders to nominate board candidates by using the company's proxy materials.

[548] Ibid.

[549] Rule 14a-8 prescribes the shareholder proposal right, more discussion of which can be found below in this section.

[550] Reilly S Steel, 'Proxy Access and Optimal Standardization in Corporate Governance: An Empirical Analysis', 23 (2017) *Fordham Journal of Corporate & Financial Law*, pp. 173-255.

[551] See: http://www.stblaw.com/docs/default-source/memos/firmmemo_07_30_15_proxy-access-proposals.pdf. Last visited February 2019

one or more shareholder nominees, together with nominees of the board, will be included in proxy materials. Statistics have shown that proxy access is becoming progressively more available. In 2016, more than 50% of the S&P 500 companies adopted proxy access through bylaws,[552] and in 2017, 60% of S&P 500 companies[553] and even 80% of S&P100 companies had embraced it.[554] In 2018, more than 71% of S&P 500 companies and 48% of Russell 1000 companies had adopted proxy access.[555]

Approval right

Besides the fundamental right to appoint and remove directors, US law safeguards shareholder interests by requiring shareholder approval for major decisions, namely amending certificates of incorporation, adoption, amendments or annulments of bylaws, mergers or consolidations, the sale of all assets or the dissolution of a corporation. For these major decisions, *DGCL* §102(b)(4), which declares that a higher threshold of shareholder voting can be required by the certificate of incorporation, makes the "supermajority rule" possible.[556]

Regarding the certificate of incorporation, *DGCL* §242(b) clarifies that it is the board of directors that can propose such amendments, and the board should list and declare the advisability of proposed amendments. Subsequently, shareholders have the power to approve or disapprove these proposed amendments at a special shareholder meeting or the next annual shareholder meeting, but they have no power to change the content of the amendment.[557]

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[552] Danielle Vukovich, 'Proxy Access Voting: Evaluating Proxy Access and the Recent Phenomenon of Corporations Adopting Shareholder Protective Policies', 19 (2018) *San Diego International Law Journal*, pp. 437-472.

[553] See: https://media2.mofo.com/documents/frequently-asked-questions-about-shareholder-proposals-and-proxy-access.pdf. Last visited February 2019.

[554] See: https://www.cii.org/proxy_access. Last visited February 2019.

[555] See: https://corpgov.law.harvard.edu/2019/02/01/the-latest-on-proxy-access/ Last visited February 2019.

[556] And *MBCA* §7.27 further provides that any modification to the greater quorum or shareholding voting threshold shall be passed by the same quorum or voting requirement.
DGCL also affirms shareholders' right to vote via proxies. Its §212 (c)(2) further specifies that the authorisation of proxies can be conducted through electronic methods, such as telegram and cablegram. Furthermore, *DGCL*§211 (a)(2) prescribes that voting rights of shareholders or their proxies can be exercised by means of remote communication in lieu of physical presence, if authorised by the board of directors. Similar rules can also be found in *MBCA* §7.09 and §7.22.

[557] §242 (b)(1) specifies that changes prescribed in §242 (a)(1) or (7) do not require shareholder voting unless the certificate of corporation requires so. §242(a)(1) covers changes to the name of the corporation; (7) includes deleting names of the incorporator(s), the first group of board of directors and the initial shareholders;

Similarly, shareholders merely have approval power for a merger or consolidation. According to *DGCL* §251(b) and (c), it is the board of directors that decides the terms and conditions and drafts the merger or consolidation agreement. After the board of directors passes the resolution, this agreement is transmitted to each constituent corporation's annual or special meeting for shareholder approval.[558] Even if it has been approved by shareholders, §251(d) prescribes that the merger or consolidation agreement can endow the board of directors with the power to terminate the agreement before it becomes effective according to §103. The merger or consolidation agreement can also award amendment power to the board of directors before effecting the agreement, as long as the amendment does not cover changes to shares, securities or their related rights, changes to the certificate of incorporation and changes which have adverse impacts on shareholders' interests. Another occasion that requires shareholder approval is the sale of all, or substantially all, assets of a corporation, pursuant to *DGCL* §271(a).[559]

Comparatively speaking, shareholders enjoy broader power regarding dissolution and the bylaws. *DGCL* §275 specifies two ways to dissolve a corporation, namely a co-determination by the board of directors and shareholders, or the unanimous agreement of shareholders. In the former case, the board of directors, based on its majority opinion, takes the initiative in proposing a dissolution. Subsequently, this board resolution is submitted to the shareholder meeting for approval. In the latter case, all shareholders with voting rights can independently decide to dissolve the corporation with written

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and provisions, which serves the effectuation of amendments of stocks while these amendments are put into effect.

In comparison, *MBCA* §10.03 directly prescribes that it is a must for proposed amendments to be passed by the board of directors. Except for situations described in §10.05, §10.07 and §10.08, the director-accepted proposed amendment will be transmitted to shareholders for a decision. (§10.05 prescribes amendments of articles of incorporation, which can be solely decided by the board of directors. In other words, it confirms that in eight specific situations, the amendment does not involve shareholder approval; § 10.07 regulates the restatement of the articles of incorporation and §10.08 refers to amendments that are caused by reorganisation). In addition, §10.03 also affirms that it is within the authority of the board of directors, on any basis, to condition its submission of the proposed amendments.

558 Under circumstances set out in §251 (f)(g)(h), in the case of the absence of a clear demand in the certificate of incorporation, the authorisation of a merger can be accomplished without shareholder voting for a constitute corporation which still exists after the merger.

559 §271(b) specifies that the board of directors has the power to terminate the sale proposed in situation §271(a). Further, §12.02 (a) of *MBCA* establishes the standard of "significant continuing business activity", and it states that a sale of assets which leaves the corporation with less than 25% of its total assets requires shareholder approval. As for the sale of assets without shareholder approval, please refer to *MBCA* §12.01.

consent. In other words, a board resolution is not needed in this case.[560] Regarding the bylaw, *DGCL* §109(a) prescribes that shareholders with voting rights have the power to adopt, amend or repeal bylaws. However, the certificate of incorporation can also endow the board of directors with this power, which will not affect shareholders' bylaw power as mentioned above.[561]

For shareholder approval, *DGCL* §212(a) affirms that a shareholder is entitled to one vote for each share he or she holds.[562] Meanwhile, *DGCL* §151(a) regulates the "dual-class" share structure, which explicitly permits various classes of shares, or series of shares, and voting power among different classes, or series of shares can vary from full voting power, limited voting power to even no voting power. Furthermore, shareholders of different classes or series may have different preferences, designations, qualifications, limitations, restrictions or other special rights.[563] To balance out the dual-class shares, "group voting" has been established by statutes under different conditions. *DGCL* §242(b)(2) clarifies that if an amendment which attempts to change the amount, the par value, the power, preferences or special rights of a certain class of shares adversely impacts the interests of shareholders of this class, then group voting should apply, even if these shareholders were originally entitled to no voting rights.[564]

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[560] DGCL §275 (e) clarifies that the dissolution resolution can grant the board of directors the power to abandon the proposed dissolution, regardless of whether or not it is based on the authorisation or consent of the shareholders.

[561] In contrast, *MBCA* § 10.20 describes the amendment or revocation power of the bylaws more as a shared competence between shareholders and the board of directors. For the latter, it can only be restricted if the articles of incorporation or the bylaw itself expressly accords the powers to shareholders alone, except in circumstances set out in §2.06 (d), if, in amending, repealing or adopting a bylaw, shareholders have directly deprived directors of the authority to make an amendment, repeal or reinstate the bylaw (Based on §2.06 (d), the board of directors' power shall be exempted from limitation if it is for the purpose of "a reasonable, practicable, and orderly process").

[562] The precondition for the right to vote is that the certificate of incorporation does not prescribe otherwise and §213 has been followed. And §213 regulates the board of directors' power of fixing a record date for the determination of shareholders.

[563] Similarly, *MBCA* §6.01 (c) also stipulates that authorised shares can entitled to "special, conditional, limited or no voting right".

[564] Group voting also applies in circumstance where the interests of shareholders of a series are negatively influenced by the amendment according to DGCL §242 (b)(2).
Distinguished from the "adversely affected" condition under the *DGCL*, *MBCA* §10.04 (a) adopts another approach by explicitly listing eight situations under which group voting can be referred to. §10.04 (a) prescribes that group voting shall apply if the modification touches upon the exchange or reclassification of a class of shares into another class, or shares of another class into this class, or amends the rights, preferences or limitations of shares, or creates a new superior class of shares, or through strengthening the rights,

Fiduciary duties

The fiduciary duties play an important role in holding directors bound to shareholders. Fiduciary duties are composed of the duty of care and the duty of loyalty, the former requires directors to act with the extent of care that reasonablely prudent third partys would use in similar situations,[565] the latter demands directors to avoid acting with conflicts of interest, such as self-dealing or looting a company opportunity,[566] and both duties are mainly developed by case law. For the duty of care, the Delaware court applies "a reasonable person" standard in *Graham v. Allis-Chalmers Mfg. Co*.[567] In this case, the court ruled in favor of the directors, since they had fulfilled the duty of care by paying attention to the extent that an "ordinarily careful and prudent" man would pay.[568] In *Aronson v. Lewis,*[569] the court asserted that the business judgment rule, which assumes a board's decision is made in "good faith", on a "well-informed" basis and in the "best interests of a company", is the default rule for duty of care disputes. Also, the rule reflects the ideology of director primacy and managerial authority.[570]

Though the business judgment rule has been affirmatively confirmed in the case law, its application is not always undisputable. In *Smith v. Van Gorkom*,[571] for instance, the board approved the merger without being timely informed, without sufficient material information or reliable reports. Consequently, the court asserted that protection of the business judgment rule should not be overly extended to cover an unadvised decision, and the "procedural or process due care" should be held as a precondition of the business judgment rule.[572] However, the court thoroughly changed its attitude from merely a procedural review to a substantial review in *Cede & Co. v. Technicolor, Inc*.[573]

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preferences or amounts of authorised shares to make it superior to the rest of the class, or limit or deny preemptive rights of shares or cancel rights to distribute certain shares of the class.

[565] Stephen M. Bainbridge, *Corporate Law* (New York: Foundation Press, 2015), p. 107.

[566] See: https://www.investopedia.com/terms/d/duty-loyalty.asp Last visited February 2019.

[567] 188 A.2d.125 (Del 1963).

[568] Correspondingly, the duty of care can also be found in statutes such as MBCA §8.30 (b), which defines the care a director shall pay is equal to what a reasonable peer who shares a similar position would do under comparable conditions.

[569] 473 A.2d 805 (Del. 1984).

[570] In another case *Joy v. North* 692 F.2d 880 (2d Cir.), cert, denied, 460 U.S. 1051 (1983), the court acknowledged that directors are rarely held accountable for their inferior decisions, and the business judgment rule had formally scripted this reluctance to inculpate bad business choices.

[571] 488 A.2d 858 (Del.1985).

[572] Stephen M. Bainbridge, *Corporate Law* (New York: Foundation Press, 2015), p. 111.

[573] 634 A.2d 345 (Del.1993).

In *Technicolor,* the court described the objective of the business judgment rule as being to prevent unreasonable judicial interference in commercial choices. In comparison with *Van Gorkom*, which described the purpose of the business judgment rule as the protection of and deference to managerial authority, the statement in *Technicolor* implied that the court had the judicial power to substantially review the reasonableness of the board's decision.[574] Different from the abstention interpretation of the business judgment rule, which isolates the court from touching upon the "care" issue, *Technicolor* diverted attention to the burden of proof. It claimed that the rule is rebutted as long as the plaintiff demonstrates the defendant's breach of fiduciary duty, i.e. the lack of good faith, loyalty and due care, in which case the burden of proof shifts to the defendant, to prove the "entire fairness" of the transaction.[575]

Despite the switch from abstention to intrusive review, the courts' attitude to the business judgment rule remains arguable.[576] In *Brehm v. Eisner*,[577] instead of citing *Technicolor*, the court went back to follow the abstention strategy by opining that deference should be granted to the board decision, if directors are disinterested or independent, in good faith, pursing a reasonable commercial purpose and with no gross negligence in the decision-making process. The court also imposes a procedural requirement for the board to examine all material information that is reasonably accessible.[578] However, in *McMullin v. Beran*,[579] the court cited the *Technicolor* case to emphasise the distribution of the burden of proof between parties, namely, if the plaintiff can prove the infringement based on loyalty, good faith or due care, then the defendant is obliged to justify the "entire fairness" of its decision. Accordingly, the business judgment rule still progressively evolves through the development of case law, particularly in Delaware.[580]

In addition to the duty of care, case law affirms directors' duty of loyalty. In the case *Solash v. Telex Corp.*,[581] the Delaware court described the breach of loyalty duty as a fiduciary, such as when a director or the controlling shareholder abuses their managerial position or the power of control to

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[574] Stephen M. Bainbridge, *Corporate Law* (New York: Foundation Press, 2015), p. 112.
[575] Ibid., p. 112.
[576] Ibid., p. 114.
[577] 746 A.2d 244 (Del. 2000).
[578] Supra. 574, p. 114.
[579] 765 A.2d 910 (Del. 2000).
[580] Supra. 574, pp. 114-115.
[581] No. 9518, 9528, 9525, 1988WL 3587 (Del. Ch. 1988).

directly or indirectly conduct an unfair transaction with the company. Moreover, *DGCL*§144 (a) stipulates that a conflict of interest transaction is not void by default, or because of the presence or participation of the interested directors or because the interested votes have been counted in the approval, if any of the following three preconditions have been fulfilled. The first precondition requires the disclosure of material facts and a good faith authorisation by a majority of disinterested directors. The second precondition demands also the disclosure of material facts plus good faith approval of shareholders. The last scenario dictates the transaction to be fair at its authorisation, approval and ratification.

Meanwhile, in order to avoid risk-averse directors, *DGCL* §102(b)(7) grants the company the discretion to decide freely on its certificate of incorporation a liability elimination or limitation provision for directors. Nevertheless, this provision only applies to situations that concern directors' duty of care. In other words, directors' liabilities cannot be reduced or exempted for any breach of duty of loyalty, bad faith, intentional misconduct, intentional violation of law, situations prescribed in *DGCL*§174 or transactions which improperly benefit their personal interests. Moreover, the liability limitation provision can only limit directors' monetary damages.[582]

The controlling shareholder also owns a fiduciary duty towards the company and its minority shareholders. The Delaware court confirms this duty in *Allied Chemical & Dye Corp. v. Steel & Tube Co.*,[583] by ruling that the controlling shareholder was acting in bad faith to exploit minority shareholders' interests, and this misuse of power was treated as a fraud. In another case, *Sinclair Oil v. Levien*,[584] Sinclair Oil was the controlling shareholder and owned 97% of its subsidiary's shares. A minority shareholder of the subsidiary brought a derivative action against three parent-subsidiary transactions. The court held that the business judgment rule was rebutted, due to the self-dealing of the controlling shareholder. In other words, the parent company simultaneously acted on both sides of the transaction and abused its control to extract

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582 However, it has been claimed that the overlapping of the causes of actions between duty of loyalty and duty of care may have degraded the liability limitation provision in practice, since plaintiffs can circumvent this provision by phrasing their claim under a breach of the duty of loyalty. See: Supra. 574, pp. 148-149. In addition, *MBCA*§2.02 (b) (4) prescribes a comparable provision as *DGCL*§102 (b) (7).

583 14 Del. Ch.1, 64, 120 Atl. 486, 122 Atl. 142 (1923).

584 280 A.2d 717 (Del. 1971).

unjustifiable benefits exclusively, and all at the expense of minority shareholders of the subsidiary.

Indeed, the conflicts of interest between controlling and minority shareholders become more evident in takeover transactions, so more analysis on the issue will be conducted in 4.4 of this chapter.

Right to sue

To enforce fiduciary duties and other legal protection for shareholders, the right to sue is one of the most significant shareholder rights. In the US, there are two basic ways that a shareholder can bring a lawsuit, namely a direct suit and a derivative suit. In the former, the shareholder plaintiff brings a claim based on his or her own rights, to seek remedies for his or her own interests. In the latter case, the shareholder plaintiff brings a claim on behalf of the company, to redress any breach of duty by the defendant, in the interests of the company.

To distinguish between these two suits, in the case *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*,[585] the Delaware court relied on a "two-pronged" standard, i.e. who is the victim of the caused harm, the company or the individual shareholder(s)? Furthermore, who is entitled to the return of the judicial remedy, the company or the individual shareholder(s)? If the company is the victim and the receiver of the judicial remedy, then it is a derivative action. If the shareholder who filed the lawsuit is the victim and the receiver of the judicial remedy, then it is a direct action. Further, this standard was analysed in the case *Feldman v. Cutaia*.[586] The court stated that if the company was the only entity to suffer from the damage caused, and the entitlement to remedy is also exclusively enjoyed by the company, then it is a derivative lawsuit. In contrast, if the shareholder is the one who independently shoulders the loss, and the shareholder also has the right to bring an individual claim, then it is a direct lawsuit. In another case, *NAF Holdings, LLC v. Li & Fung Trading Ltd.*,[587] the Delaware Supreme Court reaffirmed the primary difference between a direct action and a derivative action, namely whether the claim is a personal claim made by a shareholder or a claim of the company. The former is a direct action, and the latter is a derivative action.

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[585] 845 A. 2d 1031 (Del. Sup. 2004).
[586] 951 A.2d 727 (Del. 2008).
[587] C.A. No. 641, 2014, 2015WL3896792 (Del. 2015).

In Delaware, to bring a derivative action, a shareholder has to satisfy the "continuous ownership" requirement, namely the plaintiff should be a shareholder both at the time of the dispute and at the time of filing the action.[588] Moreover, a shareholder has to cross one of these two hurdles before a derivative case can be established in court, i.e. submit a pre-suit demand to the board of directors by presenting the claim, requesting the board to bring an action and also demonstrating that a refusal of a lawsuit is a mistake, or by exhibiting facts to show that it is futile to make demands of the board.[589] For the "demand futility", the Delaware Supreme Court enunciated in the case *Aronson v. Lewis*[590] that the plaintiff should bring specific fact-based claims, which raised reasonable doubt to the disinterested or independence of the directors or to the fact that the alleged transaction was a genuine business judgment.

Even in a demand-exempted situation, the board of directors may designate a special litigation committee, consisting of only independent directors, to investigate and make recommendations to the court on the continuation or dismissal of the case at hand. Regarding the recommendation of the special litigation committee, different states have different judicial review standards.[591] The Delaware Supreme Court rejected a default application of the business judgment rule in *Zapata Corp. v. Maldonado*.[592] Besides procedural requirements, the Delaware court set up a two-step examination regarding the dismissal of an action. The first examination empowers the court to review issues such as the independence and good faith of the committee, as well as the reasons behind the recommendation. The burden of proof at this stage lies with the company. The second step grants the court a final say on the dismissal of the action, relying on its own judgment. The rationale behind the second step is to guarantee that the court functions as the last defence, even though the committee's dismissal recommendation has passed the first-step examination. In other words, a special committee's dismissal

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588 *Brambles USA, Inc. v. Blocker*, 731 F.Supp.643 (D. Del. 1990).

589 In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 120 (Del. Ch. 2009).

590 473 A.2d 805 (Del. 1984).

591 The New York court opined that the business judgment rule determines judicial deference to recommendations made by the special litigation committee. *Auerbach v. Bennett*, 419 N.Y.S.2d 920 (1979). However, the Delaware Supreme Court rejected the *Auerbach* but insisted on a less deferential attitude. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

592 430 A.2d 779 (Del. 1981).

recommendation, which fulfils the technical requirements but fails the essence of law, will not impede a legitimate action from being presented in court.

To facilitate shareholder litigations, both federal and state rules affirm the "company pay" rule. Generally speaking, the court will order the company to pay the shareholder plaintiff's derivative litigation costs, as long as the litigation results in monetary recovery or substantial non-monetary recovery to the company.[593] This shareholder-friendly rule aims at removing obstacles to shareholder derivative actions. Due to the nature of a derivative lawsuit, the recovery of the legal remedy goes directly to the company instead of the shareholder who went through all of the legal proceedings as the plaintiff. If there is no preferential treatment in relation to litigation fees, it will affirmatively stop a shareholder's incentive to bring a derivative action in the interests of the company but at the expense of him or herself. In addition to the litigation fee, the activism of the plaintiff's attorney is another element that promotes derivative litigations.[594]

In addition, a "class action" is a crucial weapon employed to lower the litigation cost and to encourage shareholder litigation.[595] In a class action, the shareholder plaintiff may bring a direct or derivative claim, and the result of such a claim will be binding for the entire class. To prevent extorted results, class action settlements require the approval of the court.[596] Shareholders who disagree with the settlement may have a new opportunity to opt-out of the class at the discretion of the court.[597] Regarding litigation costs, the "common fund doctrine", which allows the winning attorney to receive a

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[593] Supra. 574, p. 210.

[594] However, it has been claimed that the plaintiff's attorney turns out to be the biggest winner in a derivative litigation, thanks to the huge amounts they charge in fees. See: Supra. 574, p. 210.
Using Delaware as an example, it has been claimed that the chance of awarding a higher attorney fee in a winning action attracts more litigations. See: Donald E. Pease, 'Delaware's Disclosure Rule: the "Complete Candor" Standard, its Application, and Why Sue in Delaware', 14 (1989) *Delaware Journal of Corporate Law*, pp. 445-498.

[595] Celine Gainet, 'Controlling Shareholders' Fiduciary Duties Owed to Minority Shareholders-A Comparative Approach: The United States and France', in Chris A. Malin (eds.), *Entrepreneurship, Finance, Governance and Ethics* (Netherlands: Springer, 2013), pp. 137-174.

[596] Rule 23 (e), *Federal Rules of Civil Procedure*.

[597] Rule 23 (e)(4), *Federal Rules of Civil Procedure*.
In the case In re Celera Corp. S'holder Litig., No. 212, 2012 (Del. Dec. 27, 2012), the Delaware Supreme Court reversed the Court of Chancery's ruling and affirmed the class member's discretionary opt-out right.

reasonable proportion of the class compensation awarded by the court, is commonly used in practice.[598]

Satisfying respective requirements, class actions can be brought in either the federal court or state courts. For federal securities fraud class actions, which mainly target false or misleading company disclosures,[599] the *Securities Litigation Uniform Standards Act of 1998* (hereinafter *SLUSA*) amended the *Securities Act* 1933[600] and removed state courts' jurisdiction over such cases to the federal court.[601] To bring a federal securities fraud class action, the *Federal Rule of Civil Procedure* 23 sets out four conditions: first, the number of parties, i.e. the plaintiff, the defendant or both, is so numerous that it is unfeasible to bring all of the members together; second, the class has common questions relating to law or fact; third, the class's typical claims or defences are represented by those of the representative parties and last, the representative parties should fairly and adequately safeguard the class.[602] Despite moving securities fraud class actions to the federal court, the *SLUSA* still preserves state courts' jurisdiction over class actions related to acquisitions and a few other circumstances through the "Delaware carve-out".[603] In particular, state

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[598] Rule 23 (h), Federal Rules of Civil Procedure.
Also see: Chen Wenjing, 'An Overview of Shareholder Litigation', in *A Comparative Study of Funding Shareholder Litigation* (Singapore: Springer, 2017), pp. 15-66.

[599] This type of suit is normally brought in the name of shareholders who bought or sold securities at an unfair price, due to the false or misleading disclosure of the company, and to seek compensation for each shareholder involved. See: Robert B. Thompson and Randall S. Thomas, 'The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions', 57 (2004) *Vanderbilt Law Review*, pp. 133-209.

[600] *Securities Act 1933* Section 16 was amended. Pursuant to 15 U.S.C.77p(b), "covered class actions" related to false or withheld disclosures, or fraud regarding dealings of securities listed on a national stock exchange. 15 U.S.C.77p(c) further prescribes that the covered class actions in (b), should be removed to the federal court.

[601] Originally, securities issues were regulated by state "blue sky" laws. Due to the "nation-wide" nature of securities, applying one state's law to regulate nationally traded securities would lead to such a result that one state's law would prevail over the laws of other states. Consequently, federal securities regulations were enacted to provide a uniform standard to regulate securities. By taking advantage of the "class actions" in federal civil procedures, some meritless suits were brought to seek settlements. In order to curtail these strike suits, the *Private Securities Litigation Reform Act* of 1995 (hereinafter *PSLRA*) was promulgated to impose stricter standards for bringing a securities fraud class action. However, the *PSLRA* failed to reduce the amounts of securities class actions and indirectly created incentives for investors to divert these cases to state courts, to circumvent the harsh requirements of the *PSLRA*. Consequently, the *SLUSA* was adopted to correct the situation by excluding state courts' jurisdiction over securities fraud class actions. See: Kenneth Hsu, 'The Delaware Carve-Out's Carve: Examining and Repairing SLUSA's State Law Exception', 11 (2015) *Hastings Business Law Journal*, pp. 385-420.

[602] *Federal Rule of Civil Procedure 23* (a).

[603] 15 U.S. Code § 77p (1)(B) prescribes state preserved actions, which include: (1) any transaction that the issuer or its affiliate buys or sells securities exclusively from or to the issuer's equity securities holders; or (2) any recommendation, position, or other communication in terms of the issuer's sale of securities which is conducted between the issuer or its affiliate and the issuer's equity securities holders; and influences the equity holders' voting , response to a tender/exchange offer or dissenters'/appraisal rights.

acquisition-oriented class actions, which are based on state corporate law to redress misconduct, primarily breaches of fiduciary duties in M&As, can be brought in state courts.[604] To bring a class action in Delaware, four conditions prescribed in Rule 23 of the *Rules of the Court of Chancery of the state of Delaware* have to be met.[605]

Other shareholder rights

Aside from the above protection, shareholders are entitled to other rights, such as the dividend right, the inspection right, the right to call a special meeting and the proposal right.[606] First, the *DGCL* confirms shareholders' right to dividend. However, it is the board of directors that has the power to determine these dividends. Specifically, *DGCL* §170(a) grants declaration and distribution power to the board of directors unless there is any restriction in the certificate of incorporation. It also specifies that dividends should be withdrawn from the surplus of the corporation in the first place, and in the absence of such a surplus, alternatively, dividends can be extracted from net profits for the current fiscal year and/or the preceding fiscal year.[607]

Additionally, the *DGCL* §172 grants full immunity to directors or members of any board committee as long as the decision to declare or distribute dividends is made in good faith and based on trustworthy materials.[608] For directors who breach their duties, *DGCL* §174(a) prescribes the joint and several liability, which covers the full amount of illegally distributed dividends and interests for

[604] Robert B. Thompson and Randall S. Thomas, 'The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions', 57 (2004) *Vanderbilt Law Review*, pp. 133- 209.
[605] The four conditions required in Delaware are similar to the requirements of Federal Rules of Civil Procedures 23. See: https://courts.delaware.gov/rules/pdf/ChanceryCourtRules_FINAL_5-20-16.pdf. Last visited February 2019.
[606] The proposal right and the right to call a special meeting may be related to the appointment right. For instance, shareholders who fulfill relevant conditions may exercise the proposal right to propose proxy access to the company. And shareholders who satisfy relevant requirements may exercise the right to call a special meeting to restructure the board.
[607] *DGCL* §170 (a) clarifies that the specific definition of "surplus" shall refer to §154 and §244. According to which, a surplus consists of the discrepancy between the net assets and the capital of the corporation, net assets refer to the excess of the total assets over the total liabilities, and capital can be ascertained in two cases – for shares with a par value, the capital equals to the aggregate par value of all issued shares, and for shares without a par value, it is the discretion of the board of directors to designate a part of the received consideration of the issued shares as the capital.
[608] Trustworthy materials refer to corporate records and reports, information, opinions or statements provided by officers, employees, committees of the board of directors or other designated persons who have been appointed with care, based on his or her professional capabilities.

six years after the unlawful distribution.[609] Nevertheless, this liability can be exempted if a director expressly records his or her dissent in the corporate books.[610]

Second, the *DGCL* §220(b) maintains that a shareholder is entitled to the right of inspection, either exercised in person or through an agent such as an attorney. The preconditions for exercising this right are the "written demand under oath" and the "proper purpose". Furthermore, a shareholder who fulfils the conditions mentioned above may inspect, make copies and take extracts during business hours from the corporation's stock ledger, shareholder list and other corporation books and records, as well as related documents of a subsidiary of the corporation.[611] To safeguard this inspection right, *DGCL* §220(c) grants a shareholder the right to request the Court of Chancery to issue an order to compel the inspection if there is a rejection or no response after five business days.[612] Additionally, it imposes various conditions on inspecting different documents.[613]

Third, the right to call a special meeting is not a default right for shareholders in Delaware. Pursuant to *DGCL*§211(d), the board of directors may call a

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[609] The "illegal distribution of dividend" mentioned here refers to any willful or negligent breach of §160 or §173.

[610] In addition to the above prescriptions, *DGCL* §173 clearly stipulated that no dividend shall be distributed unless it is prescribed in this chapter. These dividend statutes reveal the legislative intention of preventing the transferring of interests from the corporation to its shareholders in the form of dividends (See: Supra. 574, p. 461). These provisions are very different from the dividend policy in China. See Chapter 3.

[611] Based on *DGCL* §220(b), the inspection of a subsidiary's books and records shall be subjected to certain conditions: first, the corporation is in control of the subsidiary's records in this regard, and second, the shareholder's exercising of the inspection right does not violate existing third-party related agreements, and in the absence of a legitimate denial right against the inspection.

[612] In comparison, the *CCL* only clarifies that the shareholder of a limited liability company is entitled to request the court to demand that the corporation implements the inspection in Article 33. However, in terms of a company limited by shares, Article 97 only states that shareholders have the right to inspection, raise a proposal or make an inquiry, without mentioning the legal remedy of the court.

[613] For the inspection of "books and records", §220 (c) lists three preconditions, namely shareholder status, compliance of procedures and the shareholder shall demonstrate a proper purpose for such an inspection. For "the shareholder list or stock ledger", other conditions being equal, §220 (c) transfers the burden of proof to the corporation, to verify that the shareholder inspection has no proper purpose.
Concerning the right to inspection, the *MBCA* mainly prescribes this right in § 16.01, §16.02 and §16.04. §16.01(e) imposes an obligation on the corporation to reserve at its head office a copy of related corporate records. With these documents, §16.02(a) provides a general inspection right to shareholders. Compared with the provisions in the *DGCL*, §16.02(a) does not mandate the "proper purpose" standard but requires the written inspection request to be submitted at the latest five days in advance. In addition, §16.04 moves the "court-ordered inspection" a step further by stipulating that the court order for inspection also demands the corporation covers the requesting shareholder's expenses, such as attorney fees. The only exemption to this obligation is that the corporation can demonstrate that its rejection of an inspection was conducted in good faith and was based on reasonable doubt.

special meeting, or another person or persons authorised by the certificate of incorporation or the bylaws may call a special meeting. In other words, shareholders can only exercise this right if the certificate of incorporation or the bylaws has authorised so.[614] In practice, the company's certificate of incorporation or bylaws may impose certain requirements, such as a threshold, notification obligations and clarification of the purposes and disclosure, before this right can be exercised.[615]

As briefly mentioned before in the appointment right, federal regulation 17CFR §240.14a-8 endows shareholders with the right to make a proposal. To exercise this right, a shareholder should continuously be in possession of at least 1% of voting shares, or $2000 market value, for at least one year, and they must continue to hold those securities through the meeting. If the shareholder fails the quantity requirement, then the corporation has the authority to exclude his or her proposal from any meeting for the next two calendar years. Concerning the exclusion of proposals, 17CFR §240.14a-8 specifies conditions under which a proposal can be excluded by the corporation[616] and emphasises that the burden of proof lies with the corporation.

Shareholder activism

Based on the above statutory rights, shareholder activism is one of the significant elements that help to transform protections in book into protections in action in the US. This phenomenon reflects self-governance, in that shareholders actively participate in corporate governance so that the agency cost can be reduced through enhanced monitoring. With the growth of institutional investors and hedge funds, shareholder activism has started to

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[614] Different from *DGC*L, *MBCA* §7.02 grants shareholders who pass the 10% threshold the right to call a special meeting. Meanwhile, it also allows the articles of incorporation to set a lower threshold or a higher threshold at a maximum of 25%.

[615] See: http://www.theactivistinvestor.com/The_Activist_Investor/Special_Meetings.html. Last visited February 2019.

[616] Excluding a shareholder proposal is normally allowed if the shareholder who submits the proposal is ineligible according to law, the proposal violates law, proxy rules, the proposal only redresses an individual grievance instead of shareholder interests as a whole, the proposal is insufficient in terms of relevance, the proposal intrudes on management authority to cover the corporation's daily operation, the proposal relates to certain issues of director selection or specific amounts of dividends, the proposal is beyond the ability of the corporation, the proposal is simply the duplication of another proposal, a unqualified resubmission or is in conflict with the corporation's proposals or the proposal has been substantially implemented by the corporation.

take a stand in terms of corporate governance.[617] Research has shown that the voting process is one of the main channels for shareholder activism.[618] The combination of shareholder activism and class action has enormously increased shareholder protection despite the limited amount of shareholder rights in US legislation.[619] Between 2014 and 2018, the average annual amount of activist campaigns was 272; specifically, 2015 saw the highest amount with 300 campaigns, and 2017 marked the lowest with 254 campaigns.[620] These activist campaigns pursued various governance goals, such as board representation, business strategies, dividend distributions and M&A-related issues.[621] To reach these goals, shareholder activists may exercise different shareholder rights to nominate their own board candidates, to request disclosures, to call a special meeting, to bring shareholder litigation, etc.[622] On average, activist shareholders managed to appoint one or more directors in 45% of proxy contests during 2014-2018. In 2018, activists won 67% of short slate contests and 43% of control slate contests, made public disclosures in 40% of campaigns, brought shareholder litigation in 2%-4% campaigns and called a special meeting in fewer than 5% of campaigns.[623]

Analysis

Based on the above examination of shareholder rights, this part intends to reveal its preeminent characteristics. In the US, shareholders are entitled to the most essential right to appoint and remove directors. However, it is the board of directors that has the nomination right. With the default rule of plurality voting, the board of directors controls the ballot and ensures their candidates are appointed. Changes have been made that more and more listed companies adopt the majority voting. Concerning the influence of majority

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617 Jennifer G. Hill, 'Good Activist/Bad Activist: The Rise of International Stewardship Codes', 41 (2018) *Seattle University Law Review*, pp. 497- 524.
618 Peter Iliev, Karl V. Lins, Darius P. Miller and Lukas Roth, 'Shareholder Voting and Corporate Governance Around the World', 28 (2015) *Review of Financial Studies*, pp. 2167-2202.
619 Willem J.L. Calkoen, *The One-Tier Board in the Changing and Converging World of Corporate Governance* (The Netherlands: Kluwer Deventer, 2012), p. 289.
620 2018 witnessed a 5.5% increase from 2017 with 268 campaigns. See: Sullivan & Cromwell LLP, Review and Analysis of 2018 US Shareholder Activism, available at https://www.sullcrom.com/files/upload/SC-Publication-SandC-MnA-2018-US-Shareholder-Activism-Analysis.pdf. Last visited March 2019.
621 Ibid.
622 Ibid.
623 In 2018, issuers also won 47% of control slate contests with a 14% vote split. The data for board nominations and disclosures are specific data from 2018, while data for shareholder litigation and calling a special meeting are the average annual proportions in the five-year period from 2014-2018. See: Supra. 620.

voting, academics hold mixed views. The proponent argues that majority voting may properly balance the power disparity between shareholders and the board of directors in director elections.[624] The opponent claims that the theory of majority voting fails to match the practice. Particularly, the "holdover rule" manages to keep a director on board despite he or she failing to be re-elected by shareholders.[625]

If shareholders intend to nominate their own candidates, they may need to prepare and mail their proxy materials to hundreds and thousands of shareholders. The high cost of a proxy contest has tremendously increased the difficulty of shareholder nomination. To strengthen shareholders' influence on board composition, several attempts have been made at the federal level. Despite the failure of a federal proxy access rule, Rule 14a-8 was amended to permit shareholders to propose proxy access to the company. In Delaware, shareholders may pursue proxy access by amending the bylaws. Shareholders also have the power to approve major decisions, but for majority of these decisions, they can only accept or veto the board's resolution as a whole, and they have no power to propose their own resolution or to revise the board's resolution. Besides, shareholders are endowed with other rights, such as the right to dividend. However, the power to determine the dividend stays with the board of directors.

The board of directors is in charge of most of a company's decision-making. *DGCL*§141 instructs that a company's business and affairs should be managed or oriented by the board of directors. To balance the power between shareholders and the board, directors are subjected to fiduciary duties. To enforce fiduciary duties and other legal protections, shareholders can bring direct or derivative claims. Satisfying relevant conditions, direct or derivative claims can be brought as a class action, which is a powerful weapon to overcome the collective action problem and to grant equal protection to shareholders of the same class. The company pay rule, the contingent fee and attorney activism encourage shareholders to seek actively judicial remedies.

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[624] Joshua R. Mourning, 'The Majority-Voting Movement: Curtailing Shareholder Disenfranchisement in Corporate Director Elections',85 (2007) *Washington University Law Review*, pp. 1143-1194.
William K. Sjostrom, JR. & Young Sang Kim, 'Majority Voting for the Election of Directors', 40 (2007) *Connecticut Law Review*, pp. 459- 510.

[625] Supra. 523.

For shareholders to exercise their rights fully and to seek judicial remedies, shareholder activism is another critical characteristic of US listed companies. Mixed opinions on shareholder activism are found in the academic world. In respect of different sorts of shareholders, some scholars believe that the engagement of institutional investors can overcome the collective action problem, while others argue that it may cause another agency cost between money managers and small shareholders.[626] It has also been claimed that hedge fund activism faces a smaller rational apathy issue, thanks to its undiversified and large shareholdings. Nevertheless, critics criticise hedge funds for their short-term orientation.[627] Responding to this accusation, it has been argued that a legal regime with unfriendly shareholder participation rules partly contributes to the notorious rational apathy issue.[628] To encourage the growth of long-term shareholders, a greater voice should be given to institutional investors.[629] Through a delicate design, a balanced institutional voice instead of institutional control can form vertical supervision between money managers and corporate managers, as well as horizontal supervision among shareholders in joint actions. As a result, improved corporate governance also benefits small shareholders.[630] Moreover, empirical research records that shareholder activism also exists in controlled listed companies, thus providing evidence to support shareholder engagement in corporate governance in general.[631]

In brief, US legislation endows shareholders with certain essential rights. In comparison with the board of directors, shareholders' governing powers are rather limited. However, the latter may rely on judicial protection to safeguard their interests, and shareholder activism may serve as an instrument to overcome collective action, the rational apathy problem and to bring shareholders together.

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626 Edward B. Rock, 'The Logic and (Uncertain) Significance of Institutional Shareholder Activism', 79 (1990) *Georgetown Law Journal*, pp. 445-506.

627 John C. Coffee, Jr and Darius Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance', 41 (2015) *Journal of Corporation Law*, pp. 545-607.

628 Julian Velasco, 'Taking Shareholder Rights Seriously', 41 (2007), *U.C. Davis Law Review*, pp. 605-682.

629 John H. Matheson and Brent A. Olson, 'Corporate Law and the Longterm Shareholder Model of Corporate Governance', 76 (1991) *Minnesota Law Review*, pp. 1313-1393.

630 Bernard S. Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice', 39 (1992) *UCLA Law Review*, pp. 811-893.

631 The empirical study is based on more than 200 activist activities in controlled listed companies during 2005-2014. See: Kobi Kastiel, 'Against All Odds: Hedge Fund Activism In Controlled Companies', 60 (2016) *Columbia Business Law Review*, pp. 60-132.

4.3 Minority shareholder protection through monitoring mechanisms in the US

With the passage of the *Sarbanes-Oxley Act* of 2002, corporate law reforms highlighted investor protection through various aspects. Here underlines particularly two of them, namely pursuing more accurate and reliable corporate disclosure, and strengthening internal supervision through the independent director system. After the 2008 financial crisis, the U.S. Securities and Exchange Commission (hereinafter "SEC") further incorporated the above reforms in the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. Correspondingly, stock exchanges, such as the New York Stock Exchange, adjusted their listing rules to meet the relevant requirements. The task of this part is to examine two monitoring mechanisms, i.e. disclosure and independence, in the US system. The legal sources elaborated below mainly cover the *Securities Act 1933* (*hereinafter "SA"*), the *Securities Exchange Act 1934* (hereinafter "*SEA*"), the *New York Stock Exchange Listed Company Manual* (*hereinafter "NYSE Manual"*), the *NASDAQ Stock Market Rules* (*hereinafter "NASDAQ Rules"*) and Delaware case laws.

4.3.1 Disclosure

Delaware statute imposes almost no active obligation on directors for information circulation, but it does assume that the deterrent effect of the "annual election of directors" is sufficient to motivate qualified disclosures.[632] Due to this lax disclosure on the state level, the New York Stock Exchange first attempted to regulate mandatory disclosure in 1907.[633] Subsequently, disclosure was federalised by the *Securities Exchange Act* and became the primary regulatory tool of the SEC.[634] Since then, disclosure has been a standard instrument of the federal government.[635] Correspondingly, there is

[632] Mark J. Roe, 'Delaware's Competition', 117 (2003) *Harvard Law Review*, pp. 588-646.
[633] Ibid.
[634] David Friedman, 'The Regulator in Robes: Examining the SEC and the Delaware Court of Chancery's Parallel Disclosure Regimes', 113 (2013) *Columbia Law Review*, pp. 1543-1584.
[635] Robert B. Thompson, 'Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation', 38 (2003) *Wake Forest Law Review*, pp. 961-982.

one disclosure regulatory regime at the state level and another at the federal level, represented by the Delaware Court of Chancery and the SEC. They have adopted two regulatory approaches, i.e. the Delaware court formulates "fiduciary-duty-based" disclosure, which stands on a case-by-case analysis, and the SEC grounds its authority on disclosure rules with the support of interpretations made by its staff.[636]

Federal statutory laws

On the federal level, disclosure obligations cover six main aspects, namely registration statements and periodical reports, 5% shareholding, tender offers, going-private transactions, proxy solicitations and the Rule 10b-5.

Disclosure of registration statement and periodical reports

At the initial registration stage, Section 7(a) of the *SA* demands a corporation to disclose information required by Schedule A[637] in its registration statement. After the registration, Section 13(a) of the *SEA* prescribes a corporation's quarterly report and annual report. In addition, Section 13(I) requires a "rapid and current" disclosure of any material changes, if the Commission holds the opinion that this disclosure is necessary or helpful to shareholder protection or is in the public interest.

5% shareholding disclosure

Pursuant to *17 CFR*[638] *240.13d-1*(*a*), any person who directly or indirectly holds more than 5% shares of any class should file a statement to the Commission on the basis of Schedule 13D, which includes basic information on the corporation and its shares, the identity of the shareholder, the source and amount of funds, the purpose of the transaction and contracts, understandings and relationships,

[636] David Friedman, 'The Regulator in Robes: Examining the SEC and the Delaware Court of Chancery's Parallel Disclosure Regimes', 113 (2013) *Columbia Law Review*, pp. 1543-1584.

[637] It lists 32 aspects, such as basic information of the corporation, its directors, the chief executive and financial and accounting officials and their remuneration, shareholders with more than 10% of any class of share, underwriters, capitalisation statements, securities statements, the price of the shares and the net proceeds, commissions and other expenses paid by the corporation, information on the vendors and legal counsels, material contracts, the balance sheet and the profit and loss statement.

[638] *Code of Federal Regulations* (*CFR*), available at https://www.gpo.gov/help/index.html#about_code_of_federal_regulations.htm. Last visited February 2019.

etc. However, if the transaction involves no change of control, he or she can submit a simplified statement on Schedule 13G[639] instead of Schedule 13D.[640]

Tender offer

Sections 13(d)-(e) and sections 14(d)-(f) were added to the *SEA* by the *Williams Act*. In particular, section 14(d) stipulates a third-party bidder's disclosure obligations.[641] Additionally, Regulation 14D, which was adopted under section 14(d), further augments the disclosure of tender offers. 17 CFR240.14d-3 specifies that a bidder who will own more than 5% of the target company's shares after the tender offer has obligations to file and transmit a tender offer statement.[642] 17CFR240.14d-6 stipulates that tender offer disclosures should include tender offer materials,[643] summary publication[644] and no transmittal letter.

Going-private transaction disclosure

In order to protect minority shareholders, *17 CFR 240.13e-3*[645] imposes a broader disclosure obligation on a going-private transaction based on Schedule 13E-3,[646] which requires the disclosure of many issues, such as the purpose of the transaction, whether there are alternatives to fulfill the above purpose and, if so, why the alternative has been ruled out, the reasons for adopting such a going-private transaction at such a moment, the impacts of this transaction

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639 More details of Schedule 13G, please refer to https://www.law.cornell.edu/cfr/text/17/240.13d-102. Last visit February 2019.

640 17*CFR* 240.13d-1 (b).

641 The disclosures should cover the bidder's identity and background, the source and amount of consideration, the bidder's shareholding in the target company and the purpose of the tender offer. See: William C. Tyson, 'The Proper Relationship Between Federal and State Law in the Regulation of Tender Offers', 66 (1990) *Notre Dame Law Review*, pp. 241-358.

642 The bidder should file a tender offer statement on Schedule TO to the SEC, deliver a copy of Schedule TO to the target company and any other bidder and provide listed securities exchanges and National Association of Securities Dealers with telephonic notice according to Rule 14d-6 (d)(2)(i) and (ii) and a copy of Schedule TO by mail.

643 Tender offer materials include Item 1 of Schedule TO and the remaining items (except Item 12) of Schedule TO for third-party tender offer, or a sufficient and fair summary.

644 Summary publications should include the bidder and the target's identities, Item 1004 (a)(1) of Regulation M-A, whether the tender offer has an acquisition purpose, instruction for shareholders to obtain tender offer materials, and if a tender offer is delivered by shareholder lists or security position listings, a request statement should be provided, the summary publication should state that tender offer materials will be delivered to parties on the lists.

645 Details refers to https://www.law.cornell.edu/cfr/text/17/240.13e-3. Last visit February 2019.

646 Details refers to https://www.law.cornell.edu/cfr/text/17/240.13e-100. Last visit February 2019.

regarding the target corporation, its subsidiaries and minority shareholders and also the fairness of the transaction for unaffiliated shareholders.[647]

Proxy solicitation disclosure

According to *17 CFR240.14a-3*, a solicitation can only be conducted if sufficient information has been provided to shareholders.[648] For the selection of directors in an annual meeting, in a special meeting or through written consent, the solicitation should provide not only the proxy statement, but also an annual report to shareholders. This annual report covers diverse information such as the financial statement, the balance sheet, changes or disagreements in terms of accounting or financial disclosure, the business of the corporation and its subsidiaries, identities of directors and executive officials and the market price and dividends payable to shareholders.[649] Moreover, Section 14(i) of the *SEA* reads that the proxy or consent solicitation of an annual meeting should specifically disclose compensation as required by the *Code of Federal Regulations*,[650] and clarify the relationship between executive compensation and performance.

Rule 10b-5

To prevent fraud, and to regulate manipulative and deceptive behaviours, 17 CFR240.10b-5 (b) forbids false material facts or the withholding thereof. Furthermore, the case law gradually substantiates its contents. For example, in *Blue Chip Stamps v. Manor Drug Stores*,[651] the Supreme Court affirmed the standing of a private party under Rule 10b-5 but limited it to only the seller and the purchaser. Based on Rule 10b-5, the SEC further established the

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[647] Besides federal securities rules, disclosing going-private transactions is also regulated by state corporate laws, especially case law. More discussion can be found in 4.4 of this chapter.

[648] 17 *CFR*240.14a-3 (a) lists the disclosure of proxy statements based on Schedule 14A and its exceptions, the disclosure of a written proxy statement incorporated in the registration statement relies on Form S-4 or F-4 OR Form N-14. More details please refer to https://www.law.cornell.edu/cfr/text/17/240.14a-3. Last visited February 2019.
And content of the Schedule 14 A can be found at https://www.law.cornell.edu/cfr/text/17/240.14a-101. Last visited February 2019.
17 CFR 240.14a-9 forbids false or misleading statements of material facts or the omission of such information.

[649] For more information on the disclosure of the annual report, refer to https://www.law.cornell.edu/cfr/text/17/240.14a-3. Last visit February 2019.

[650] See: section 229.402, title 17, *Code of Federal Regulations*.

[651] *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975). One of the offerees who did not accept the stock selling offer of the stamp company brought an action in front of the court based on Rule 10b-5 by claiming that the information disclosed by the prospectus was purposely made in an excessively negative way to discourage the offerees from purchasing the stocks. However, the Supreme Court rejected the claim on the basis that only the purchaser or the seller of the transaction has a standing under Rule 10b-5.

"disclosure or abstain rule" in its administrative ruling in *In re Cady, Roberts & Co.*,[652] according to which an insider with non-public material information should not trade on such information before its disclosure, and even if the disclosure is improper or impossible, the insider should still abstain from trading. This disclosure or abstain rule was later adopted by the court in *SEC v. Texas Gulf Sulphur Co*.[653] In the same case, the court further defined the meaning of "materiality", namely information that is significant enough to have an impact on the decision of a reasonable investor.[654]

State corporate law

In comparison with federal regulations, disclosure is very often addressed through fiduciary duty litigations in Delaware.[655] In *Singer v. Magnavox Co.*[656] the court affirmed that both directors and the controlling shareholder owe a "fiduciary obligation of honesty" to the company and its minority shareholders. Moreover, a director's disclosure obligation only exits when a shareholder action is needed.[657] The reason for drawing this line is to avoid any overlap between state and federal laws on disclosure. State corporate law regulates a company's internal affairs, which normally are related to shareholder actions. Meanwhile, federal securities law controls disclosure on a broader scope of national securities markets.[658]

In the case *Stroud v. Grace*,[659] the Delaware court affirmed this borderline by stating that the "duty of candor" demands directors fully and fairly disclose all available material information before seeking a shareholder action. However,

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[652] 40 S.E.C.907 (1961).

[653] *SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833, 848-849 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[654] In *TSC Industries, Inc. v. Northway* Inc. 426 U.S. 438(1976), the court defined "materiality" as information which is important enough to influence a reasonable investor on how to vote. And an amended version of this definition, which changed "how to vote" to "whether and how to buy or sell a security", was applied by court to Rule 10b-5 cases. See: Robert Charles Clark, *Corporate Law* (Boston and Toronto: Little, Brown and Company, 1986), p. 328.

[655] Robert B. Thompson, 'Delaware's Disclosure: Moving the Line of Federal-State Corporate Regulation', 167 (2009) *University of Illinois Law Review*, pp. 167-190.

[656] 380 A.2d 969 (Del. 1977).

[657] For example, *DGCL* §222(a) a written notice of a meeting which requires shareholder action; *DGCL* §242 (b) a notice of amendment of a certificate of incorporation; *DGCL* §251 (c) notice of a merger or a consolidation; *DGCL* §262 (b)(1) notice of the appraisal right. Furthermore, case law developed by the court also confirms that there is no fiduciary-duty-based disclosure obligation without shareholder action.
See: Nicole M. Kim, '*Malone v. Brincat*: The Fiduciary Disclosure Duty of Corporate Directors under Delaware Law', 74 (1999) *Washington Law Review*, pp. 1151-1180.

[658] Ibid.

[659] 606 A.2d 75 (Del. 1992).

the Delaware court departed from this rule in *Marhart Inc. v. Calmat Co*.[660] by expanding the directors' fiduciary disclosure duty to also cover situations that require no shareholder action. Subsequently, *Unimarts, Inc. v. Stein*[661] cleared up the *Marhart* confusion by limiting the fiduciary disclosure duty to only situations in which shareholder actions are involved.

Concerning the disclosure standard, the court in *Lynch v. Vickers Energy Corp.*[662] protected minority shareholders by stressing the majority shareholder's fiduciary duty of "complete candor" to disclose fully related information of the tender offer to minority shareholders. Additionally, the court emphasised that the majority shareholder should disclose all "germane" facts. By "germane", it was referring to information that is important enough to affect a reasonable shareholder's decision on the sale or possession of the shares. In *Rosenblatt v. Getty Oil Co*.,[663] the Delaware Supreme Court replaced the word "germane" with the "materiality" standard in *TSC Industries, Inc. v. Northway*.[664] The court also extended this disclosure duty to careless mistakes. In *Shell Petroleum, Inc. v. Smith,*[665] the court held the controlling shareholder liable for a computer error which caused an omission of reserves in the financial document disclosed to minority shareholders.

Moreover, the procedural effect of disclosure serves a great value in judicial reviews, since a fully informed shareholder approval may shield managerial wrongdoing in the absence of fraud, according to Delaware law.[666] Besides, a faultless disclosure is one of the preconditions for shifting the burden of proof in many circumstances. For example, in the case *Moran v. Household International, Inc*.,[667] based on *DGCL* §144, when the right conditions for the disclosure and approval of independent directors have been achieved, then it shifts the burden of proof to the plaintiff. As shown in 4.4 of this chapter, a proper disclosure before the approval of both the independent committee and minority shareholders induces a shift in the judicial review standard in freeze-out transactions.

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660 18 Del. J. Corp. L. 330 (Del. Ch. Apr. 22, 1992).
661 Nos. 14713, 14893, 1996 WL 466961 (Del. Ch. Aug. 12, 1996).
662 383 A.2d 278 (Del.1977).
663 493 A.2d 929 (Del.1985).
664 426 U.S 438 (1976).
665 606 A.2d 112 (1992).
666 Nicole M. Kim, '*Malone v. Brincat*: The Fiduciary Disclosure Duty of Corporate Directors under Delaware Law', 74 (1999) *Washington Law Review*, pp. 1151-1180.
667 500 A.2d 1346 (Del.Nov.19, 1985), aff'g 490 A.2d 1059 (Del.Ch.1985).

Analysis of disclosure

Research has investigated the practical effect of disclosure rules by assessing the disclosure of US listed companies. Particularly, the "information overload" problem, which obstructs shareholders' ability to distinguish effectively useful materials from the rest, has been identified.[668] This finding is supported by both the Chamber of Commerce's 2014 report on disclosure and the KPMG 2011 report. The former claimed that, first, disclosed information is "incomprehensible" itself, and second, it is too "time-consuming" for shareholders to go through everything.[669] The latter pointed out that minority shareholders are the biggest victims, since their ability to make a well-informed decision has been greatly damaged by the excessive information. It also revealed that the "complexity of accounting standards" and the "volume of mandated disclosure" are two top causes of information overload.[670] From the same report, it is also interesting to observe that the deterrent effect of public enforcement, i.e. worries about future rejection by the SEC or other regulators, may encourage the disclosure of immaterial information, whilst the fear of potential litigation is another consideration for disclosure.[671]

Correspondingly, potential improvements are suggested in four main areas. First, to safeguard shareholders' right to information, a "non-discriminatory" entry and a "reliable source" should be the foundation.[672] Second, disclosures of listed companies should follow the "materiality" standard,[673] i.e. they should be "non-duplicative", should avoid repetition, should remove irrelevant

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[668] Simon C. Y. Wong, 'A Call to Reform US Disclosure-Based Regulation', 2 (2010) *Butterworths Journal of International Banking and Financial Law*, pp. 77-79.
Teresa E. Iannaconi, William M. Sinnett, 'Disclosure Overload and Complexity: Hidden in Plain Sight', available at https://www.scribd.com/document/335028195/Disclosure-Overload-Complexity. Last visited February 2019.

[669] U.S. Chamber of Commerce, 'Corporate Disclosure Effectiveness: Ensuring a Balanced System that Informs and Protects Investors and Facilitates Capital Formation', available at https://www.uschamber.com/sites/default/files/021053_ccmc_disclosure.pdf. Last visited February 2019.

[670] Teresa E. Iannaconi, William M. Sinnett, 'Disclosure Overload and Complexity: Hidden in Plain Sight', available at https://www.scribd.com/document/335028195/Disclosure-Overload-Complexity. Last visited February 2019.

[671] Ibid.

[672] SEC, 'Report on Review of Disclosure Requirements in Regulation S-K', available at https://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf. Last visited February 2019.

[673] Besides the "materiality" standard developed by case law, the SEC Staff Accounting Bulletin and the Financial Accounting Standard Board provide some criteria to determine whether the information is material or not. See: Ernst & Young, 'Disclosure Effectiveness: What Companies can do Now', available at http://www.ey.com/Publication/vwLUAssets/EY-disclosure-effectiveness-what-companies-can-do-now/$FILE/EY-disclosure-effectiveness-what-companies-can-do-now.pdf. Last visited February 2019.

information and focus on the material documents.[674] Third, the delivery and presentation of the information should increase its “readability” and “navigability”,[675] and the disclosure should be reoriented from “document-based” to “interactive data-based”.[676] Precisely, various methods, such as cross-referencing, tabular presentation formatting and the layering of information, are actively encouraged.[677] Fourth, research clearly underlines the significant role of SEC enforcement and the “redress-seeking” channel in keeping shareholders well-informed. The 2015-2016 record demonstrates “active and aggressive” public enforcement by the SEC, with more than 200 financial reporting and disclosure actions being brought and over 245 individuals charged.[678] In respect of the redress channel, the critical opinion states that the existing highly disclosure-reliance approach creates incoherence between the limited shareholder rights and the “hand-off regulatory approach”. Shareholders have few channels for redress except for an expensive and lengthy proxy fight and litigation. To address this gap, and to hold directors accountable to shareholders, practitioners are proposing to strengthen shareholder rights.[679] Moreover, research has observed that institutional ownership is beneficial to company disclosure, and even passive shareholders are better-off, thanks to enhanced transparency.[680] These arguments indicate that a proper degree of shareholder participation may be valuable to transparency.

[674] SEC, ‘Report on Review of Disclosure Requirements in Regulation S-K’, available at https://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf. Last visited February 2019.
[675] Ibid.
[676] U.S. Chamber of Commerce, ‘Corporate Disclosure Effectiveness: Ensuring a Balanced System that Informs and Protects Investors and Facilitates Capital Formation’, available at https://www.uschamber.com/sites/default/files/021053_ccmc_disclosure.pdf. Last visited February 2019.
[677] Teresa E. Iannaconi, William M. Sinnett, ‘Disclosure Overload and Complexity: Hidden in Plain Sight’, available at https://www.scribd.com/document/335028195/Disclosure-Overload-Complexity. Last visited February 2019.
Ernst & Young, ‘Disclosure Effectiveness: What Companies can do now’, available at http://www.ey.com/Publication/vwLUAssets/EY-disclosure-effectiveness-what-companies-can-do-now/$FILE/EY-disclosure-effectiveness-what-companies-can-do-now.pdf. Last visited February 2019.
[678] Jones Day Whit Paper: SEC Enforcement in Financial Reporting and Disclosure-2016 Year in Review, available at http://www.jonesday.com/sec-enforcement-in-financial-reporting-and-disclosure2016-year-in-review-01-31-2017/. Last visited February 2019.
[679] Simon C. Y. Wong, ‘A Call to Reform US Disclosure-Based Regulation’, 2 (2010) *Butterworths Journal of International Banking and Financial Law*, pp. 77-79.
[680] Andrew Bird and Stephen A. Karolyi, ‘Do Institutional Investors Demand Public Disclosure?’, 29 (2016) *Review of Financial Studies*, pp. 3245-3277.

On the basis of the illustration above, two aspects of disclosure can be highlighted. First, it consists of both positive and negative obligations.[681] The former attempts to ensure that shareholders' well-informed decision-making is based on the direct dissemination of information, while the latter safeguards shareholder interests by prohibiting false information or the omission of information. Especially, the disclosure of financial information in annual and quarterly reports regularly updates shareholders of changes to and the operation of the corporation. The disclosure of intention may give existing shareholders an early warning of a potential takeover, once the 5% shareholding threshold is reached. If a change-of-control transaction develops into a going-private transaction, a broader disclosure obligation is imposed, in order to safeguard the interests of minority shareholders. Likewise, a proxy solicitation should be conducted with transparency, to ensure voting reflects the true will of minority shareholders.[682]

Second, disclosure in the US is regulated by both statutory regulations and case law, and it is a collective effort by both the federal government and the states. Disclosure is one of the primary regulatory tools used in federal securities regulations, and it follows a "rules-based" approach. These statutory disclosure rules can be found in different legislation, such as the *Securities Act*, the *Securities Exchange Act*, and accounting rules, and normally, they are very specific and technical. While these characteristics preserve the consistency and formalisation of disclosure, in practice they may cause an information overload problem. In contrast, on the state level, disclosure is incorporated into the fiduciary duty. This "principle-based" approach, developed by case law, ensures flexibility and adaptability, but it may increase uncertainty and indeterminacy.[683] Last, enforcement, which consists of the SEC, securities fraud litigations and breach of fiduciary duty litigations, substantially contributes to the implementation of disclosure rules in the US.[684]

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681 Robert B. Thompson, 'Delaware's Disclosure: Moving the Line of Federal-State Corporate Regulation', 167 (2009) *University of Illinois Law Review*, pp. 167-190.

682 The information right of shareholders of a public company is much better than their counterpart in a private company, thanks to the disclosure legislation provided by the federal securities laws. In comparison, shareholders' information right is quite narrow under state laws, even in Delaware. In addition, directors are held liable for breaching the "complete candor" duty, albeit only when it concerns "material" information. See: Julian Velasco, 'The Fundamental Rights of the Shareholder', 40 (2006) *UC Davis Law Review*, pp. 407-467.

683 William J. Carney and George B. Shepherd, 'The Mystery of Delaware Law's Continuing Success', available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=999477. Last visited February 2019.

684 Further discussion on litigations can be found in section 4.4 of this chapter.

4.3.2 Independence

In addition to disclosure, an internal independent supervision body is another powerful instrument to guard shareholders' interests. In this regard, the US follows the one-tier board structure, which combines both managerial and supervisory tasks. The board of directors usually consists of inside directors and outside directors, the latter of which can be further divided into independent directors and non-independent directors. Different from the two-tier board structure, internal supervision of the one-tier entity relies on independent directors instead of a separate supervisory board. Since the passage of the *Sarbanes-Oxley Act* in 2002, independent directors' role in corporate governance, particularly in shareholder protection, has drawn great attention. One of the far-reaching reforms of the Act is the requirement that a listed company should have a fully independent audit committee.[685] Following this lead, listing rules for stock exchanges affirm a "majority independent director board" and "mandatory special committee" requirements.

Listing rules for stock exchanges

Statutory laws in this part will mainly refer to listing rules for the two most influential US stock exchanges, namely the *New York Stock Exchange Listed Company Manual* and the *NASDAQ Stock Market Rules*.[686]

Independence

According to the *NASDAQ Stock Market Rules* (hereinafter "*NASDAQ Rules*")[687] 5605(a)(2), an "executive officer" or an "employee" should not become an independent director. As for an individual who is related to the company, the board of directors has the discretion to determine the independence of such a person. Moreover, its paragraphs (A) to (G) list conditions that forbid a person becoming an independent director, such as past employment relationship, direct or indirect continuous receipt of compensation in the past, the family

[685] Steven T. Petra, 'Do Outside Independent Directors Strengthen Corporate Boards?', 5 (2005) *The International Journal of Business in Society*, pp. 55-64.

[686] Academic opinion also highlighted that the 2002 Reform did not touch upon the incumbent-dominated electoral system, which caused great difficulty in achieving the goal of competitive elections in practice. See: William B. Chandler III and Leo E. Strine, JR., 'The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State', 152 (2003) *University of Pennsylvania Law Review*, pp. 953-1005.

[687] *NASDAQ Stock Market Rule* (2009), available at http://nasdaq.cchwallstreet.com/. Last visited February 2019.

member of a previous executive officer and other affiliated or interest-related relationships.[688] Similarly, the *New York Stock Exchange Listed Company Manual* (hereinafter "*NYSE Manual*")[689] §303A.02 prescribes "independent tests", which also grant the discretion to the board of directors to decide whether there exists a "material relationship" that may degrade the independence of the director. Additionally, it lists five circumstances under which a director would lose his or her independence.[690] Last but not least, both the *NASDAQ Rule* and the *NYSE Manual* claim that ownership of shares alone does not deprive a director of his or her independence.[691] As a result, it is evident that the US statutory definition of independence focuses on independence against management.

Majority independent board

Both the *NYSE Manual* §303A.01 and the *NASDAQ Rule* 5605(b)(1) demand a listed company's board of directors be composed of a majority of independent directors. However, both *NYSE Manual* §303A.00 and *NASDAQ Rule* 5015(c) exempt a "controlled company"[692] from this majority independent board requirement. It is believed that the controlling shareholder has the power to

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688 More details see: http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?searched=1&selectednode=chp_1_1_4_3_8_5&CiRestriction=independent+director&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F. Last visited February 2019.

689 *New York Stock Exchange Listed Company Manual* (2015), available at http://nysemanual.nyse.com/LCM/Sections/. Last visited February 2019.

690 Similar to the NASDAQ rule, unqualified conditions cover past employment relationships, the past receipt of direct compensation by the director or his/ her family members and other affiliated relationships. For more details see: http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F. Last visited February 2019.

691 NASDAQ Rules IM-5605, see: http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?searched=1&selectednode=chp_1_1_4_3_8_5&CiRestriction=independent+director&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F;
NASDAQ Rule IM-5605-6 even specifically asserts that appointing significant shareholder representatives to the compensation committee may help monitor better executive compensation.
NYSE §303A.02 Commentary, see: http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F. Last visit February 2019.

692 A controlled company refers to a company whose shareholders, alone or as a group, can dominate more than 50% of the voting power when it comes to director elections. See: NYSE Rule § 303A.00 and NASDAQ Rule 5615 (c)(1),
http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F,
http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?searched=1&selectednode=chp_1_1_4_3_8_21&CiRestriction=exemption&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F. Last visited February 2019.

dominate the board with his or her representatives, in which case the majority independent board is no longer necessary.

Special board committees

The *NYSE Manual* demands three special committees, namely the "nominating/corporate governance committee", the "compensation committee" and the "audit committee". Meanwhile, the *NASDAQ Rule* does not strictly require a nomination committee.

Nominating/corporate governance committee

Pursuant to *NYSE Manual* §303A.04, it is mandatory for a listed company to have a nominating/corporate governance committee consisting of only independent directors. Furthermore, the company should draft a written charter that clarifies the responsibility, purpose and annual evaluation of the committee, as well as the qualifications, appointment and removal of committee members. In contrast, the *NASDAQ Rule* does not specifically call for a nominating committee but prescribes in 5605(e)(1) an independent directors' oversight function on nomination. Based on this point, a listed company has two options, namely to select or recommend director nominees either with a majority of independent directors or a fully independent director nomination committee. However, both the *NYSE Manual* and the *NASDAQ Rule* grant an exemption to controlled companies regarding the above requirement.[693]

Compensation committee

NYSE Manual §303A.05 (a) stipulates that a listed company must have a compensation committee comprised of exclusively independent directors. Furthermore, §303A.02 (a)(ii) particularly emphasises that members of the compensation committee should be independent from management. Likewise, §303A.05 (c)(iv) highlights that a consultant, legal counsel or other advisor should be independent from management. In parallel, *NASDAQ Rule* 5605(d)(1) states that it is compulsory for every listed company to have a written charter

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[693] See: NYSE Rule § 303A.00 and NASDAQ Rule 5615 (c)(1), http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F, http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?searched=1&selectednode=chp_1_1_4_3_8_21&CiRestriction=exemption&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F. Last visited February 2019.

for its compensation committee, and 5605(d)(2)(A) demands that the compensation committee should have no fewer than two independent directors. Nevertheless, 5605(d)(2)(B) clarifies that if it is in “the best interests of the company and its shareholders”, and in “exceptional and limited circumstances”, the board can approve the appointment of a non-independent director to the compensation committee. Both *NYSE Manual* and *NASDAQ Rule* prescribe the exemption of controlled companies.[694]

Audit committee

In comparison with other two special committees, the audit committee has a stricter independence requirement, since there is no exemption for controlled companies.[695]

NYSE Manual §303A.06 affirmatively confirms the necessity of an audit committee for a listed company based on Rule 10A-3 of the *SEA 1934*. Furthermore, §303A.07 specifies additional requirements, such as an audit committee should consist of at least three independent directors, should have a written charter and should have an internal audit function. Similarly, *NASDAQ Rule* 5605(c) demands a written charter for the audit committee for each listed company, and the committee should be composed of at least three independent directors, except in “exceptional and limited circumstances” as stated in 5605(c)(2)(B). 5605(c)(3) enumerates the responsibilities and authority of the audit committee based on Rules 10A-3(b)(2),(3),(4) and (5) of the *SEA 1934*.

For exemptions relating to the majority independent board and two special committees, as previously mentioned, disclosure obligations have been imposed. In general, §303A.04,05,06 of *NYSE Manual* requires the disclosure of written charters for three special committees. Particularly, a broader disclosure requirement is imposed on a situation which deviates from the independent requirement. For example, both *NYSE Manual* §303A.00 and *NASDAQ Rule* IM-5615-5 stipulate that if a controlled company intends to seek

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[694] See: NYSE Rule § 303A.00 and NASDAQ Rule 5615 (c)(1), http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F, http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?searched=1&selectednode=chp_1_1_4_3_8_21&CiRestriction=exemption&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F. Last visited February 2019.

[695] Ibid.

an independence exemption, it must follow relevant disclosure requirements. Besides, *NASDAQ Rules* 5605(c)(2)(B),(d)(2)(B) and (e)(3) assert that the appointment of non-independent directors in special committees, in "exceptional and limited circumstances", should be accompanied by disclosures through websites, proxy statements or other reports, as required.

State corporate law

On the state level, the Delaware court adopts a "highly fact-intensive" approach, based on a case-by-case analysis rather than a strict "bright-line" approach, to find whether a director is independent or not.[696] By examining the concrete facts of the case at hand, the court will find the independent director either a "faithful monitor" or a "rubber-stamp". If the answer points to the former, the court will respect the independent decision.[697] Moreover, the independent standards established by the Delaware case law may vary in terms of listing rules on elements such as "employment and personal relationships, financial ties and nomination to the board".[698] Instead of formulating an abstract concept, the court prefers to look into the case details, to ascertain whether independent directors have approved the transaction in dispute and whether the relationship between independent directors and a company can be regarded as independent.[699]

Different from listing rules, Delaware courts do not impose a mandatory requirement but determine that independent directors should play an important role by granting deference to their decisions. As mentioned in 4.2 of this chapter, in the demand-exempted situation, shareholders' derivative action can be dismissed if a special litigation committee, which consists exclusively of independent directors, proves that a dismissal decision is for the

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696 Jay P. Lefkowitz, Andrew B. Clubok, Yosef J. Riemer, and Matthew Solum, "Director Independence: Interplay Between Delaware Law and Exchange Rules", available at https://corpgov.law.harvard.edu/2013/10/07/director-independence-interplay-between-delaware-law-and-exchange-rules/. Last visited February 2019.

697 Stephen M. Bainbridge, 'Independent Directors and the ALI Corporate Governance Project', 61 (1993) *George Washington Law Review*, pp. 1034-1083.

698 For instance, the current employment relationship does not necessarily exclude a director from being found as independent but depends on the extent of this relationship. However, listing rules clearly preclude a current employee from taking up the position of independent director; for past employment relationships, listing rules establish a "three-year" threshold. Nevertheless, the Delaware court generally does not find a past employment relationship undermines independence; for financial ties, the Delaware court may not strictly follow the thresholds set in the listing rules; for the element of nomination of a director to the board, it does not preclude independence on its own according to the Delaware case law. Yet this element has not been addressed by the listing rules. More details see: supra. 696.

699 Ibid.

best of a company. Moreover, independent directors have substantial value in related-party transactions and takeovers. *DGCL*§144 (a)(1) affirms the cleansing effect of independent director approval, in that a related-party transaction is not necessarily void if conditions of proper disclosure and good-faith independent director approval are fulfilled. In several important cases, such as *Unocal Corp. v. Mesa Petroleum Co.*,[700] *Moran v. Household International, Inc.*[701] and *Paramount Communications, Inc. v. Time, Inc.*,[702] Delaware courts affirmed that the anti-takeover measure is permissible if the decision is independently made by a board with a majority of independent directors.[703] As shall be demonstrated in 4.4 of this chapter, the approval of a special negotiating committee of independent directors, plus that of a majority of minority shareholders, shifts the judicial review standard from the entire fairness to the business judgment rule in freeze-out transactions. Accordingly, the independent director system, as a legal instrument utilised to balance the separation between ownership and control, naturally serves the goal of shareholder value. Meanwhile, it may also shield the managerial authority from an aggressive corporate control market.[704]

Analysis of the independent director system

Academic research demonstrates that the independent director system has become common practice among US listed companies. Gordon, for instance, examined an extensive period ranging from 1950 to 2005 and pointed out a dramatic proportion change of independent directors, from 20% to 75%, in large US listed companies.[705] The *2011 U.S. Director Compensation and Board Practices Report* presented an even higher percentage of more than 80% of independent directors in listed companies.[706] Besides, the *Report* also confirmed that a simple majority independent director requirement had been widely accepted by listed companies. Furthermore, the *2015 Spencer Stuart*

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700 493 A.2d 946 (Del. 1985).
701 500 A.2d 1346 (Del. 1985).
702 571 A.2d 1140 (Del. 1990).
703 Jeffrey N. Gordon, 'The Rise of Independent Directors in the United States, 1950-20005: Of Shareholder Value and Stock Market Prices', 59 (2007) *Stanford Law Review*, pp. 1465-1568.
704 Ibid.
705 Ibid.
706 The Conference Board, NASDAQ OMX and NYSE Euronext, The 2011 U.S. Director Compensation and Board Practices Report, available at http://corpgov.law.harvard.edu/2011/11/11/the-2011-u-s-director-compensation-and-board-practices-report/. Last visited February 2019.

Board Index (hereinafter the *2015 Index*)[707] continued to display this growing trend by recording 84% of independent directors on the boards of S&P500 companies,[708] as well as an increase of 376 new independent directors, which was the highest rate of growth since 2008.

Existing literature presents mixed results concerning the functioning of the independent director system. One strain of research positively supports its value.[709] Daily and Dalton, based on the data of 100 fast-growing small public companies in the US, observed a positive connection between the participation of independent directors and better firm performance.[710] Similarly, Barnhart et al. found a notable relationship between board composition, especially independent directors and firm performance.[711] Petra divided the function of the board into two categories, namely decision management and decision control. The prior relates to the performance of the firm, and the latter refers to control over management.[712] Based on previous studies, Petra concluded that the independent director system fails to play a substantial role in decision management, but it does function efficiently in decision control in certain aspects, such as shareholder advocacy[713] and financial reporting.[714] Additionally, by examining independent directors' trading records, Ravina and Sapienza claimed that, averagely speaking, independent directors are informed correctly in both good times and bad times, and the better the corporate

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[707] Spencer Stuart, Spencer Stuart U.S. Board Index 2015, available at https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015. Last visited February 2019.

[708] S&P500 index is founded on the market capitalisation of the top 500 common stock listed companies on the NYSE or NASDAQ. See: https://en.wikipedia.org/wiki/S%26P_500_Index. Last visited February 2019. A list of S&P 500 companies, see: https://en.wikipedia.org/wiki/List_of_S%26P_500_companies. Last visited February 2019.

[709] Steven T. Petra, 'Do Outside Independent Directors Strengthen Corporate Boards?', 5 (2005) *Corporate Governance: The International Journal of Business in Society*, pp. 55-64.

[710] Catherine M. Daily and Dan R. Dalton, 'The Relationship between Governance Structure and Corporate Performance in Entrepreneurial Firms', 7 (1992) *Journal of Business Venturing*, pp. 375-386.

[711] Scott W. Barnhart, M. Wayne Marr and Stuart Rosenstein, 'Firm Performance and Board Composition: Some New Evidence', 15 (1994) *Managerial and Decision Economics*, pp. 329-340.

[712] Supra. 709.

[713] In particular, it claimed that shareholders are likely to receive more benefits in front of tender offers or takeover threats, if the board of directors is under the control of independent directors. See:
John W. Byrd and Kent A. Hickman, 'Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids', 32 (1992) *Journal of Financial Economics*, pp. 195-221.
Philip A. Gibbs, 'Determinants of Corporate Restructuring: the Relative Importance of Corporate Governance, Takeover Threat, and Free Cash Flow', 14 (1993) *Strategic Management Journal*, pp. 51-68.

[714] It has been stated that independent directors can restrain frauds in financial reports. See: Mark S. Beasley, 'An Empirical Analysis of the Relation between the Board of Director Composition and Financial Statement Fraud', 71 (1996) *The Accounting Review*, pp. 443-465.

governance, the better informed the independent directors.[715] Another innovative research connected changes in the stock price with the sudden deaths of independent directors in US companies, and affirmed independent directors' contributions to shareholders.[716] In a recent comparative study, empirical evidences shown that a higher percentage of independent directors discourages the board to take excessive risks.[717]

In contrast, other research negates the effectiveness of the independent director system.[718] Hermalin and Weisbach, for example, based on a sample of 142 companies on the NYSE, revealed the absence of a linkage between board composition and company performance.[719] Bhagat and Black, whose research covered 934 of the largest US companies, found that bad performance induced a company to increase the amount of independent directors, and yet this change brought no practical improvement to the company. A bigger proportion of independent directors did not create a corresponding advantage in financial returns, and in many cases they caused further degeneration in performance.[720] Relevantly, Agrawal and Knoeber, by examining various agency cost-reducing mechanisms, claimed that independent directors are negatively correlated to company performance.[721] In addition, by delving into specific board committees, Klein's research confirmed the substantial value of insider directors, particularly on financial and investment committees, which was against the rationale behind the regulatory requirement of independent special committees.[722] A recent research also found that independent directors fail to curtail frauds and malfeasances.[723]

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[715] Enrichetta Ravina and Paola Sapienza, 'What Do Independent Directors Know? Evidence from Their Trading', 23 (2010) *Review of Financial Studies*, pp. 962-1003.

[716] Bang Dang Nguyen and Kasper Meisner Nielsen, 'The Value of Independent Directors: Evidence from Sudden Deaths', 98 (2010) *Journal of Financial Economics*, pp. 550-567.

[717] Zahid Irshad Younas, Christian Klein, Thorsten Trabert and Bernhard Zwergel, 'Board Composition and Corporate Risk-Taking: A Review of Listed Firms From Germany and the USA', 20 (2019) *Journal of Applied Accounting Research*, pp. 526-542.

[718] Sanjai Bhagat and Bernard S. Black, 'The Non-Correlation Between Board Independence and Long-Term Firm Performance', 27 (2001) *Journal of Corporation Law*, pp. 231-273.

[719] Benjamin E. Hermalin and Michael S. Weisbach, 'The Effects of Board Composition and Direct Incentives on Firm Performance', 20 (1991) *Financial Management*, pp. 101-112.

[720] Supra. 718.

[721] Anup Agrawal and Charles R. Knoeber, 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders', 31 (1996) *Journal of Financial and Quantitative Analysis*, pp. 377-397.

[722] April Klein, 'Firm Performance and Board Committee Structure', 41 (1998) *Journal of Law & Economics*, pp. 275-304.

[723] S. Burcu Avci, Cindy A. Schipani and H. Nejat Seyhun, 'Do Independent Directors Curb Financial Fraud? The Evidence and Proposals for Further reform', 93 (2018) *Indiana Law Journal*, pp. 757- 805.

Furthermore, various studies have ascribed the ineffective monitoring of independent directors to the lack of true independence and the lack of incentives. First, it is hard to ensure genuine independence at the nomination stage, due to office politics. Hermalin and Weisbach stated that substantial differences between inside and outside directors no longer exist, since both selections are under the control of the top management.[724] Clark also observed insider manipulation of the board.[725] Namely, the nomination committee, more than often, is dominated by insiders, or outside directors who conspire with the insiders. Consequently, this nomination committee determines independent director candidates. Through various layers of manipulation, the nominated independent directors are often friends of the CEO or other insiders, or peers from an equal social class with shared values.[726] Second, insufficient incentives and resources are reasons behind the unsatisfactory performance of independent directors at the post-nomination stage. Being independent, by nature, suggests the absence of any personal incentive to be actively involved.[727] Besides, factors such as part-time employment, information asymmetry and budgetary limitations considerably constrain the functioning of independent directors in practice.[728]

To address the above issues, it has been claimed that incentives can be provided from monetary, career and legal liability aspects.[729] Regarding legal liability, existing data display a low punishment rate for independent directors. During 1980 to 2005, Black, Cheffins and Klausner only recorded 13 cases in which outside directors of public companies made an individual financial payment according to a judgment or settlement. The research also highlighted that the personal financial liability risk of an independent director was way lower than expected, on account of the popularity of the director and officer

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[724] Benjamin E. Hermalin and Michael S. Weisbach, 'The Effects of Board Composition and Direct Incentives on Firm Performance', 20 (1991) *Financial Management*, pp. 101-112.

[725] Robert Charles Clark, *Corporate Law* (Boston and Toronto: Little, Brown and Company, 1986), p. 183.

[726] Ibid., p. 183.

[727] Ibid., p. 184.

[728] Ibid., p. 184.

In a very recent research, Bainbridge reaffirmed "part-time employment", "information asymmetry" and "insufficient incentives" as elements that cause the inefficiency of independent directors, and further proposed to replace individual independent directors with institutional ones. See: Stephen M. Bainbridge, 'Rethinking the Board of Directors: Getting Outside the Box', 74 (2019) *The Business Lawyer*, pp. 285-295.

[729] María Gutiérrez and Maribel Sáez, 'Deconstructing Independent Directors', 13 (2013) *Journal of Corporate Law Studies*, pp. 63-94.

insurance in public companies.[730] For securities cases, during 1996 to 2010, Brochet and Srinivasan found a small percentage of 11% named independent directors.[731] However, one should be aware that this low personal financial risk of independent directors may be an intentional legal design, since a larger cohort of academics still opines that director liabilities may induce risk-averse directors.[732] In contrast, an alternative solution to the incentive problem is to build up an independent director reward regime, which imposes lower costs than the existing liability regime.[733] In other words, stronger independence can be achieved through both rewards and sanctions, primarily from economic and reputation perspectives.[734] Research also identifies that independence may become more problematic in controlled companies, since independent directors are appointed by a controlling shareholder. To achieve true independence, some scholars additionally call for "enhanced-independence" directors who are accountable to minority shareholders and play a role in screening conflict of interest transactions with the company controller.[735]

Last, academic discussion goes back to two preliminary questions. The first debate is whether there is an optimal board structure. The pro-optimal board opinion claims that there exists a best board structure, which is superior to the rest.[736] Meanwhile, the con-optimal board opinion declines a universal

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[730] Bernard S. Black, Brian R. Cheffins and Michael Klausner, 'Outside Director Liability', 58 (2006) *Stanford Law Review*, pp. 1055-1159.

[731] Francois Brochet and Suraj Srinivasan, 'Accountability of Independent Directors: Evidence from Firms Subject to Securities Litigation', 111 (2014) *Journal of Financial Economics*, pp. 430-449.

[732] See: Roberta Romano, 'What Went Wrong with Directors' and Officers' Liability Insurance', 14 (1989) *Delaware Journal of Corporate Law*, pp. 1-33.
Bernard S. Black, Brian R. Cheffins and Michael Klausner, 'Outside Director Liability: A Policy Analysis', 162 (2006) *Journal of Institutional and Theoretical Economics*, pp. 5-20.

[733] Assaf Hamdani and Reinier Kraakman, 'Rewarding Outside Directors', 105 (2007) *Michigan Law Review*, pp. 1677-1711.

[734] Jeffrey N. Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices', 59 (2007) *Stanford Law Review*, pp. 1465-1568.

[735] Lucian A Bebchuk and Assaf Hamdani, 'Independent Directors and Controlling Shareholders', available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2741738. Last visited February 2019.

[736] The pro-optimal-board opinion, which finds support from scholars such as Morck, Shleifer and Vishny, demonstrated a non-monotonic relationship between Tobin's Q and director ownership. McConnell and Servaes' research revealed a curvilinear relationship between Tobin's Q and insider ownership. These researches, to a certain extent, proved the existence of a peak before the Tobin's Q goes down. See: Benjamin E. Hermalin and Michael S. Weisbach, 'The Effects of Board Composition and Direct Incentives on Firm Performance', 20 (1991) *Financial Management*, pp. 101-112.
Randall Morck, Andrei Shleifer and Robert W. Vishny, 'Management Ownership and Market Valuation: An Empirical Analysis', 20 (1988) *Journal of Financial Economics*, pp. 293-315.
John J. McConnell and Henri Servaes, 'Additional Evidence on Equity Ownership and Corporate Value', 27 (1990) Journal of Financial Economics, pp. 595-612.

optimal board structure but insists on a company-based optimal board.[737] Subsequently, the second question focuses on legal intervention vs. company freedom. Following the pro-optimal board logic, an optimal structure can generate the highest return for a firm. Reasonably, then, the optimal structure should be confirmed by a binding regulation which applies to all firms. In contrast, a con-optimal board means that the optimal structure of a specific firm should be left to the discretion of the company and be regulated by company bylaws.[738] As a matter of fact, this dispute was tested during the formulation of the American Law Institute's (hereinafter "ALI") *Principles of Corporate Governance*. Regarding the "one-size-fits-all" mindset in its Tentative Drafts, it was warned that if this mindset were indeed confirmed by mandatory rules instead of recommendations, it might be unjust for companies that invest in choosing the most proper structures for themselves.[739]

The above elaborations have demonstrated three characteristics of the US independent director system. First, under the dispersed ownership structure, the main agency cost for US securities market rests with shareholders and management. The main function of independent directors is to monitor management on behalf of shareholders. Accordingly, the US statutory definition of "independence" emphasises independence from management. If there is a controlling shareholder, some statutory independent director requirements are exempted. In other words, the task of protecting minority shareholders in these circumstances is left to other legal instruments, such as disclosures and fiduciary duty litigations. Second, to regulate the independent director system, strict "bright-line" requirements are found in the listing rules on the federal level. Furthermore, "fact-intensive" case law is developed by Delaware courts on the state level. This combined regulatory approach intends to underline both the predictability and the flexibility of law. Third, the independent director system is a design used mainly to safeguard shareholder

[737] The con-optimal-board opinion argues that the optimal board structure relies on the particular characteristics of a certain company and the specific industry of the company. See: Sanjai Bhagat and Bernard S. Black, 'Independent Directors', 2 (1998) *The New Palgrave Dictionary of Economics and the Law*, pp. 283-287.
Benjamin E. Hermalin and Michael S. Weisbach, 'The Effects of Board Composition and Direct Incentives on Firm Performance', 20 (1991) *Financial Management*, pp. 101-112.
[738] Ibid.
[739] Stephen M. Bainbridge, 'Independent Directors and the ALI Corporate Governance Project', 61 (1993) *George Washington Law Review*, pp. 1034-1083.

interests. However, Delaware courts may navigate around this instrument in favour of management on certain issues, such as the right to bring a derivative action, self-dealing transactions and takeovers, when relevant conditions are met.[740]

4.3.3 Analysis of both monitoring mechanisms

This part has examined two monitoring mechanisms in the US system – disclosure and independent directors – and found the interplay between federal securities regulations and state corporate laws.

Federal regulations and listing rules prescribe very detailed and technical disclosure obligations and mandatory requirements of independent directors, with a common goal of shareholder protection. For the former, disclosure of the transaction intention, when the 5% shareholding threshold is met, and the intensive disclosure obligations of going-private transactions both demonstrate the consideration of (minority) shareholder protection. For the latter, listing rules for stock exchanges demand independent directors be independent from management, but exempt some statutory independent director requirements for controlled companies. This statutory design highlights that independent directors' primary task is to monitor management.[741]

On the state level, the *DGCL* does not have many specific disclosure and independent director requirements. Instead, Delaware courts mostly regulate disclosures under fiduciary duties and determine the importance of independent directors by granting judicial deference to their decisions. Examinations of disclosure and independent directors have shown that the case-by-case analysis approach adopted by the court not only complements and substantiates law, but it also increases the adaptability and flexibility of law. Additionally, thanks to a strong private litigation culture, the court continuously engages in the implementation of disclosure and independent director rules. Simply put, the courts make a great contribution to the development of US corporate law.

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[740] More discussion can be found in section 4.4 of this chapter.

[741] The conflicts of interest between the controlling shareholder and minority shareholders becomes evident in takeover transactions. Accordingly, the Delaware courts recognise the cleansing effect of independent director approval based on a case-by-case analysis of independence. More discussion can be found in section 4.4 of this chapter.

Last but not least, despite mixed opinions on shareholder activism, existing academic research claim that a proper degree of shareholder participation may be beneficial to both disclosure and independence.

4.4 Minority shareholder protection in takeovers, especially by courts

Minority shareholder oppression becomes more evident in takeovers,[742] due to the conflicts of interest between the controller and minority shareholders. To explore the issue, this part will analyse the US system by elaborating two main forms of takeovers, the protection of judicial review standards, and the protection of the appraisal right.

4.4.1 Two main forms of takeover transaction

The discussion below will focus on the two most relevant forms of takeover transaction: one-step transactions and two-step transactions. Specifically, one-step transactions, also known as statutory mergers or long-form mergers, refer to mergers that require both the approval of the board and the approval of shareholders, as prescribed in *DGCL* §251(c).[743] Two-step transactions normally start with a tender offer as the first step, which is then followed by the second step of a back-end merger. Back-end mergers include three further types: (1) a long-form merger, which requires both the approval of the board and the approval of shareholders,[744] (2) a short-form merger, namely if the acquirer owns at least 90% of shares of the target after the first step, in which

[742] The wording of "takeovers" in 4.4 follows the board definition, which covers both sale of control transactions and freeze-out transactions.

[743] One-step mergers also require the target company to file a proxy statement to the SEC, while both short-form and medium-form mergers do not have this filing obligation. see: Audra Boone, Brian Broughman and Antonio J. Macias, 'Shareholder Decision Rights in Acquisitions: Evidence from Tender Offers', 331 (2017) *Indiana Legal Studies Research Paper,* pp.1-50, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2629424. Last visited February 2019.

[744] The term "long-form merger" mentioned here specifically refers to the second step of a two-step transaction, i.e. after the acquirer has become the controlling shareholder of the target through the first step, the controlling shareholder of the target now employs a long-form merger to freeze-out all remaining minority shareholders. This term should be distinguished from "one-step transactions", which describes a long-form merger between the target and a non-controller acquirer, i.e. the sale of control and the freeze-out of minority shareholders of the target all happen together in one transaction.

case a short-form merger could be completed without shareholder approval,[745] and (3) a medium-form merger,[746] which allows the acquirer to complete the second-step merger without shareholder approval, as long as the acquirer owns more than 50% or a higher threshold, if required by the articles of association, after the first-step tender offer. However, preconditions must be met before this type of transaction can be consummated: (i) the merger agreement expressly opts in to *DGCL* §251(h) and provides that the second-step merger will be effected as soon as practicable after the first-step tender offer and (ii) the first-step tender offer is open for all outstanding stocks of the target, and the consideration of the second-step merger should be the same amount and the same kind as the consideration of the first-step tender offer.

A complete takeover process can be divided into two phases: in the first phase, an acquirer intends to seize control of the target company and becomes its controlling shareholder, normally through tender offers; after becoming the controlling shareholder, such controller may decide to enter the second phase by freezing-out all minority shareholders, normally either through a long-form merger (the "merger route freeze-out") or through a tender offer plus a short-form merger (the "tender offer route freeze-out"). However, not every takeover has such a clear division of two phases. In a one-step transaction between a company and a third party,[747] the seize of control and the freeze-out is conducted simultaneously through the same merger. For a two-step transaction structured as a tender offer, followed by a medium-form merger, between a company and a third party, Delaware courts assert that despite its two steps, this type of transaction has similar effect as a one-step transaction since *DGCL* §251(h) requires both steps to be written in the merger agreement that is agreed by the board, both steps to have exactly the same consideration, the second-step to be conducted immediately after the first-step (if possible), and a majority of shareholders' acceptance of the tender offer is comparable to shareholder approval. Similar to one-step transactions, this type of transactions also has no clear division of two phases given that both steps are negotiated and agreed upon between the target and a third

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[745] If the parent company is the one that disappears after the merger, then approval of shareholders of the parent company is required. See: *DGCL* §253.
[746] *DGCL* §251 (h).
[747] The term of "a third party" here refers to anyone who is not the controlling shareholder of the target company.

party. Thus, the discussion below will put the first phase of takeovers, one-step transactions with a third party and the *DGCL* §251(h) two-step transactions with a third party into one group since they all happen/ are negotiated before the existence of a controlling shareholder; and the second phase of takeovers as another group due to the "self-dealing" of a controlling shareholder. Furthermore, in this research, a freeze-out, also known as cash-out, refers to a transaction between the target and its controlling shareholder in the second phase of a takeover, in which remaining minority shareholders of the target receive only cash consideration.

4.4.2 Minority shareholder protection in takeover transactions by judicial review

Three judicial review standards

To begin with, minority shareholder oppression is not an independent cause of action in Delaware; instead, minority shareholders are protected under the fiduciary duties.[748] In *Harbor Finance Partners v. Huizenga*,[749] the plaintiff brought a derivative action against the company's acquisition decision by claiming that the unfair transaction was purposely designed to benefit the controlling shareholders – at the expense of minority shareholders. In the analysis, Vice Chancellor Strine asserted that a shareholder oppression allegation does not necessarily protect minority shareholders from controlling shareholders. In contrast, the well-developed "fiduciary duty" case law in Delaware confers sufficient safeguards to minority shareholders by subjecting a conflicted-interest transaction to stringent judicial review standards.

Under the fiduciary duty, Delaware courts have established a delicate system of three-layer standards, namely the business judgment rule, the enhanced scrutiny standard and the entire fairness standard. Specifically, the business judgment rule is the default rule and the most lenient rule for the defendant. It applies to an independent and informed board decision that is made in good faith and in the interests of the company and its shareholders. Enhanced

[748] Byron F. Egan, How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408036. Last visited February 2019.
[749] 751 A.2d 879 (Del. Ch. 1999).

scrutiny is a less lenient standard, and it regulates a board decision to take defensive actions or an approval resolution that concerns a sale of control. The entire fairness standard is the strictest option and inspects an approved decision on a self-dealing transaction involving management or the controlling shareholder, or in the case that the plaintiff has successfully rebutted the business judgment rule.[750]

Judicial review of takeover transactions with a third party

The discussion in this section focuses on the first phase of takeovers, one-step transactions with a third party, as well as two-step transactions with a third party, structured as a tender offer plus a medium-form merger according to *DGCL* §251 (h).

The first phase of takeovers

When an acquirer intends to take over a target company, it creates an inherent conflict of interest between the board of directors and the shareholders of the target. On the one hand, directors face the danger of losing their jobs after the takeover. On the other hand, directors have fiduciary duties to safeguard shareholder interests. Driven by personal interests, directors may take unnecessary or excessive takeover defence measures to preclude a takeover transaction that benefits shareholders, or they may accept a sub-optimal bid at the expense of shareholders.[751] To protect shareholder interests in these circumstances, Delaware courts normally apply the medium-level judicial review standard, namely enhanced scrutiny.

For defensive measures, *Unocal Corp. v. Mesa Petroleum Co.*[752] is an important case, as it establishes a two-pronged test of reasonability and proportionality. Specifically, Mesa (who already owned about 13% of Unocal shares before the transaction) attempted to acquire Unocal through a two-step transaction, which consisted of a cash tender offer for around 37% of Unocal's shares as the first step. The second step would compel shareholders

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[750] Byron F. Egan, How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408036. Last visited February 2019.

[751] These conflicts of interest can be seen in the first phase of a two-step transaction or in a one-step transaction; for example, the target board prefers a certain bidder because such a bidder promises the board future employment or other personal interests, and the board takes defensive measures to ward off another bidder who has a better deal or reject a higher offer from another bidder.

[752] 493, A.2d 946 (Del. 1985).

who failed in the first step to exchange their shares with junk bonds. After consulting expert opinions, Unocal's board found that Mesa's two-tier offer was inadequate and coercive. To prevent minority shareholders from receiving Mesa's unfair junk bonds, Unocal directors adopted a self-tender offer to repurchase its own shares but excluded Mesa from this offer. When reviewing the case, the court opined that the enhanced scrutiny standard should apply, after considering a conflict of interest existed in the sale of control transaction. Hence, the board owed the burden of proof to demonstrate the following. First, its belief in an existing threat to the company was built on a reasonable basis. Second, the adopted defence action was a reasonable and proportionate one. In this case, Unocal's self-tender offer was a reasonable and proportional decision, which was made by an independent board in good faith after sufficient investigation, and to serve the valid purpose of minority shareholder protection. Thus, the Delaware Supreme Court reversed the ruling of the Court of Chancery and concluded that the Unocal board passed the enhanced scrutiny test and should be reviewed under the business judgment standard.

To protect shareholders from a sub-optimal bid, the *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc*.[753] case was a judicial turning point for shareholder protection and a decline in the dominant business judgment rule.[754] In this case, Pantry Pride was a third-party acquirer who issued cash tender offers in a takeover bid for Revlon. In response, Revlon's board of directors took defensive measures and later attempted to reject Pantry Pride's ongoing takeover by selling Revlon (with a compromised lock-up option) to another company, Forstmann. The Delaware court considered that if a break-up of the company becomes inevitable, then the directors' fiduciary duty shifts from guarding the independence of the company to negotiating the highest price available for its shareholders.[755] On the contrary, however, Revlon's board had taken defensive measures to end a competitive bidding contest rather than pursuing a shareholder-optimal bid. By seeking a sub-optimal deal with Forstmann, Revlon's directors shielded themselves from

[753] 506 A.2d 173 (Del.1986).

[754] George Parker Young, Vincent P. Circelli and Kelli L. Walter, 'Fiduciary Duties and Minority Shareholder Oppression from the Defense Perspective: Differing Approaches in Texas, Delaware, and Nevada', 45 (2013) *Texas Journal of Business Law*, pp.257-322.

[755] Moreover, Vice Chancellor Strine stressed the significant function of the court to protect minority shareholders from making decisions without full disclosure. See: Robert B. Thompson, 'Delaware's Disclosure: Moving the Line of Federal-State Corporate Regulation', 167 (2009) *University of Illinois Law Review*, pp. 167-190.

personal liabilities, accused by the note holders,[756] while damaging shareholders' interests. Consequently, Revlon's board was not entitled to business judgment protection, and the Delaware courts ruled that they had failed the *Unocal* reasonableness and proportional test and enjoined its takeover defences.

In another case, *Paramount Communications, Inc. v. QVC Network*, Inc.,[757] Paramount was a company with a dispersed ownership structure, while Viacom was a concentrated company with a controlling shareholder. Paramount and Viacom agreed on a two-step transaction with various defence measures. QVC then also proposed a two-step transaction to acquire Paramount. However, Paramount's board rejected the QVC offer, which was $1 billion higher than the one offered by Viacom. In reviewing this case, Delaware courts emphasised shareholders' risks in a sale of control transaction. Namely, a sale of control transaction gives rise to minority shareholders and decreases the voting power of this cohort. As compensation for their vulnerable minority status, minority shareholders should receive a control premium. Considering the minority interests at risk, Delaware courts applied the enhanced scrutiny standard to review a sale of control transaction, and they insisted on the *Revlon* demand of a maximum price for shareholders. Delaware courts further distinguished the case at hand with *Paramount Communications, Inc. v. Time, Inc.*, because the disputed Paramount and Viacom transaction in this case would result in a controlling shareholder, i.e. Viacom, while the surviving entity following the Time and Warner transaction would remain a dispersed company. Thus, Delaware courts found that the Paramount board did not pass the enhanced scrutiny standard in this case, due to unreasonable defensive measures and preferential treatment granted to the sub-optimal Viacom deal.

One-step transactions with a third party

On occasions, a company's board may decide that a merger with a third party is for the best of the company and its shareholders. In *Paramount Communications, Inc. v. Time, Inc.*,[758] after a thorough research and

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[756] At the initial defence stage, the Revlon board adopted two defensive measures, respectively a Rights Plan and a Notes Plan. The subsequent negotiation with Frostmann caused the Notes' market value to drop, and note holders claimed, in order to seek litigation.
[757] 637 A.2d 34 (Del. 1993).
[758] 571 A.2d 1140 (Del. 1989).

independent deliberation, Time's board concluded that a one-step transaction, to combine with Warner, would best serve the corporation's long-term interests. Delaware courts found that the initial stock-for-stock agreement between Time and Warner was an informed decision made by an independent board in the interests of the company, and it caused no sale of control (both Time and Warner were widely-held companies and the surviving company after the merger still remained widely-held) and should be measured under the business judgment standard. Subsequently, Paramount issued an all-cash offer to take over Time and later claimed that the board of Time had failed the *Revlon* duty by not seeking the maximum price for its shareholders. Responding to this claim, Delaware courts identified two general situations that invoked the *Revlon* duty. The first situation describes an active bid that concerns the sale of a company or a clear breaking-up thereof. The second situation involves abandoning a long-term strategy and breaking-up a company. The Delaware court did not find that there may have been an inevitable sale of Time, or abandonment of its long-term strategy, and thus it rejected the motion to invoke *Revlon*. Responding to Paramount's hostile offer, Time replaced the initial stock exchange merger agreement with a stock purchase agreement with Warner. Considering its defensive nature, Delaware courts applied the enhanced scrutiny standard to review the adjusted merger agreement, and they found the agreement had successfully passed the two-pronged test of *Unocal*.

In 2015, Delaware case law further evolved by granting judicial deference to shareholder approval in a one-step transaction with a third party that would otherwise be subjected to the enhanced scrutiny standard.[759] For a post-closing damage action, the Delaware court highlighted the cleansing effect of shareholder approval in *Corwin v. KKR Financial Holdings*.[760] Concerning a one-step stock-for-stock merger between KKR and KKR Financial Holding, the Delaware Supreme Court supported the Court of Chancery's finding that KKR was not the controlling shareholder of KKR Financial Holdings and rejected the application of the entire fairness standard. For a case which is

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[759] *The Corwin Effect: Stockholder Approval of M&A Transactions*, available at https://information.hunton.com/34/1537/uploads/the-corwin-effect-stockholder-approval-of-m-and-a-transactions.pdf. Last visited February 2019.
Iman Anabtawi, 'The Twilight of Enhanced Scrutiny in Delaware M&A Jurisprudence', 43 (2019) *Delaware Journal of Corporate Law,* pp. 161-211.
[760] 125 A.3d 304 (Del. 2015).

not subjected to the entire fairness standard, namely where the transaction excludes the self-dealing element between a company and its controlling shareholder, if the transaction was approved by a majority of disinterested shareholders under two conditions, respectively uncoerced and fully informed, then the business judgment rule applies.[761] Furthermore, the court underlined that *Unocal* and *Revlon* rulings are designed to deal mainly with "before closing" situations rather than post-closing damage claims. The cleansing effect of such shareholder approval is "outcome-determinative, even if the *Revlon* applies".[762] Delaware courts reaffirmed the reluctance to second-guess business decisions, i.e. when a business decision could be examined by the ballot, applying a stricter review standard would impose excessive litigation rents, and thus the business judgment rule applies.[763]

Furthermore, judicial deference to shareholder approval in *Corwin* is deeply rooted in two substantial "fully informed" and "uncoerced" elements.[764] In *In re Saba Software, Inc. Stockholder Litigation*,[765] the plaintiff, who was a former shareholder of Saba, brought a breach of fiduciary duty claim against the board of directors regarding an all-cash merger. The Delaware court found that the board purposely withheld material information from shareholders, and the merger was imposed on these shareholders at a time when Saba's common shares were delisted by the SEC, due to financial fraud. In this context, shareholders had no choice but to accept the merger at an undervalued price. Thus, the court rejected the idea of applying *Corwin*, because shareholder approval in Saba was conducted without full disclosure and under coercion. Instead, the court applied the *Revlon* enhanced scrutiny to review the case.

DGCL §251(h) two-step transactions with a third party

The *Corwin* effect does not stop at one-step transactions but extends also to two-step transactions with a third party, structured as a tender offer plus a medium-form merger. In *In re Volcano Corporation Stockholder Litigation*,[766]

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[761] The Delaware Supreme Court agreed with the Court of Chancery's narrow interpretation of *Gantler v. Stephens' 965 A.2d 695 (Del. 2009)* ruling and confirmed the cleansing effect of both voluntary and statutory shareholder approval.
[762] *Corwin v. KKR Financial Holdings* 125 A.3d 304 (Del. 2015) [308].
[763] *Corwin v. KKR Financial Holdings* 125 A.3d 304 (Del. 2015) [313].
[764] Francis Pileggi, *Chancery Applies Revlon Standard-Not Corwin-In Sale of Company*, available at https://www.delawarelitigation.com/2017/05/articles/chancery-court-updates/chancery-applies-revlon-standard-not-corwin-in-sale-of-company/. Last visited February 2019.
[765] C.A. No. 10697-VCS, 2017 WL 1201108 (Del. Ch. Mar. 31, 2017).
[766] 143 A.3d 727, 738 (Del. Ch. 2016).

Philips executed a two-step all-cash transaction with Volcano through a tender offer plus a medium-form merger under *DGCL* §251(h). Through the first-step tender offer, Philips acquired 89.1% of Volcano's shares. Immediately after the first-step, the second-step medium-form merger was consummated without shareholder approval. In terms of the plaintiff's breach of fiduciary duty claim, Delaware courts, first, followed the *Corwin* ruling and affirmed that fully informed and uncoerced disinterested shareholder approval leads to an irrebuttable application of the business judgment rule, unless "waste" has been proven, and second, the acceptance of the first-step tender offer by a majority of disinterested, fully informed and uncoerced shareholders has the same cleansing effect as the shareholder approval in *Corwin*. Delaware courts asserted that despite the two-steps, *DGCL* §251(h) transaction is substantially similar to a one-step merger in essence since the board of directors also needs to negotiate, declare advisability, approve and disclose material information regarding both the first-step tender offer and the second-step medium-form merger. Besides, *DGCL*§251(h) is structured to remove potential coercion in tender offers, by requiring the first-step tender offer to be issued to all shareholders of the target, the second-step merger to be conducted as soon as possible with the exact same consideration after the consummation of the first-step and the appraisal right provided to dissenting minority shareholders. Hence, the *Corwin* cleansing effect expands to cover also two-step *DGCL* §251(h) transactions with a third party,[767] in which case the business judgment rule applies.

The above examination of case law in takeover transactions with a third party has shown Delaware courts' efforts to establish equilibrium between (minority) shareholder protection and directorial authority. Generally speaking, Delaware courts respect directorial authority, as long as a business decision is made in good faith by a fully informed independent board in the interest of the company. However, considering the inherent conflicts of interests between the board and the shareholders in a sale of control or defensive measures, Delaware courts apply a medium review standard. To prevent directors trading shareholder interests for their personal interests, by accepting a sub-optimal deal, the *Revlon* doctrine commands the board to pursue the highest

[767] To invoke the *Corwin* effect, the transaction must not be subjected to the entire fairness standard. In other words, the *Corwin* effect only applies to a two-step *DGCL* §251(h) transaction with a third party. For a two-step *DGCL* §251(h) transaction between the target and its controlling shareholder, the entire fairness standard applies, unless certain procedural protection have been provided to shift the judicial review standard.

reasonable price for shareholders, if there is an inevitable or imminent sale of control or break-up of the company. To prevent the board arbitrarily warding off a profitable transaction, driven by personal interests, the *Unocal* test requires such defensive measures to be both reasonable and proportional. Reasonably, Delaware courts' protection for shareholders is not unlimited, in that the court should avoid second-guessing a business decision if shareholders have been granted the opportunity to decide for themselves. In *Corwin* and *Volcano*, Delaware courts confirmed the cleansing effect of fully informed, uncoerced and disinterested shareholder approval in both third party one-step transactions and two-step transactions structured as tender offers, plus medium-form mergers under *DGCL* §251(h), by replacing the enhanced scrutiny standard with the business judgment rule.

Judicial review of freeze-out transactions with a controller

Different from a one-step transaction with a third party, a *DGCL* §251(h) two-step transaction with a third party, and the first phase of takeovers (normally with a tender offer), this section focuses on the second phase of takeovers, whereby the controlling shareholder votes to freeze out all remaining minority shareholders. In this second phase, the controlling shareholder can structure a freeze-out transaction normally in one of two ways, namely through a long-form merger (hereinafter the "merger route freeze-out") or through a tender offer plus a short-form merger (the "tender offer route freeze-out"). Historically, Delaware courts applied different judicial review standards to these two routes. This discrepancy lasted until the turning point case *In re COX Communications, Inc. Shareholders Litigation* (hereinafter "*COX*")[768] in 2005, which established a unified approach to freeze-out transactions. In other words, Delaware courts' attitude to freeze-out transactions reveals a change from discrepancy to unification.[769]

For merger route freeze-outs, i.e. through a long-form merger, *Weinberger v. UOP*[770] was the landmark case, and it set out the most stringent judicial review standard for entire fairness in self-dealing transactions. In the first phase of the two-step transaction, Signal, in 1975, became the controlling shareholder of UOP with a 50.5% shareholding. Three years later, in 1978, Signal decided to

768 879 A.2d 604 (Del. Ch. 2005).
769 Fernán Restrepo and Guhan Subramanian, 'The Effect of Delaware Doctrine on Freezeout Structure & Outcomes: Evidence on the Unified Approach', 5 (2015) *Harvard Business Law Review*, pp. 205-236.
770 457 A.2d 701,703 (Del. 1983).

enter the second phase by acquiring the remaining shares of UOP. Subsequently, two UOP directors, who were also employees of Signal, issued a "feasibility report", which suggested a price of up to $ 24 for Signal. However, this report was never disclosed to minority shareholders of UOP. The UOP board approved the merger and advised minority shareholders to accept the price of $21, since it was a fair amount based on Lehman Brothers' opinion (with no disclosure of the fact that this opinion was made in a hurry). In reviewing this freeze-out transaction, the court asserted that the conflicts of interest caused by self-dealing, i.e. directors acting on both sides of the transaction and the controlling shareholder was the acquirer, determined that the entire fairness standard would be imposed. Moreover, the court clarified that entire fairness included both fair dealing and a fair price. In this case, the two UOP directors who were also employees of Signal used the UOP data to prepare a report exclusively for the use, and in the interests, of Signal. Obviously, these conflicting directors' behaviours contaminated the fairness of the merger agreement and failed the fair dealing test.

Another major concern of merger route freeze-out transactions was whether procedural protection, such as approving of a majority of minority shareholders or an independent committee, is sufficient to cause a shift in the judicial review standard or merely a shift in the burden of proof. Concerning the shield of "majority of minority" approval, Delaware courts affirmed in the *Rosenblatt v. Getty Oil Co.*[771] case that the informed approval of a majority of minority shareholders shifts the burden of proof to the plaintiff. Meanwhile, the controlling shareholder shoulders the burden to prove sufficient disclosure of material information.

For "approval of a special negotiating committee", in the *In re Trans World Airline Inc. Shareholder Litigation* (hereinafter *"TWA"*)[772] case, Delaware courts believed that the protection provided by a special independent committee may shift the review standard from entire fairness to business judgment rule, if relevant conditions are fulfilled.[773] However, this ruling was rebutted by *Citron v. E.I. Dupont de Nemours & Co.* (hereinafter *"Citron"*),[774] in which Delaware courts emphasised the danger of minority shareholder

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[771] 493 A.2d 929 (Del. 1985).
[772] Civ. A. No. 9844, 1988 WL 111271 (Del. Ch. Oct. 21, 1988).
[773] Fernán Restrepo, 'Do Different Standards of Judicial Review Affect the Gains of Minority Shareholders in Freeze-Out Transactions? A Re-Examination of Siliconix', 3 (2013) *Harvard Business Law Review*, pp. 321-359.
[774] 584 A.2d 490 (Del. Ch. 1990).

expropriation in a parent-subsidiary merger and insisted on the entire fairness standard. Thus, the approval of a special committee of independent directors only shifts the burden of persuasion to the plaintiff, in order to demonstrate that the transaction was unfair.

To solve the tension between *TWA* and *Citron*, Delaware courts explicitly stated in *Kahn v. Lynch Communication Systems Inc.*[775] that contrasting views exist concerning the effect of disinterested committee approval on the controlling shareholder's burden to prove the entire fairness of the transaction. One view asserts that such approval shifts the burden of proof to the plaintiff. However, another view claims such approval shifts the judicial review standard from the entire fairness to the business judgment.[776] By referring to *Weinberger* and *Rosenblatt*, Delaware courts recognised that the entire fairness should remain as the only judicial review standard in self-dealing mergers, since such transactions require cautious scrutiny.[777] Furthermore, the court also invoked *Rabkin v. Olin Corp.*[778] to clarify two preconditions for shifting the burden of proof, namely the controlling shareholder should not dominate the terms of the merger, and the independent committee should have actual bargaining power to guarantee an at-arm's-length transaction.[779] In sum, procedural protection, i.e. the approval of a special negotiating committee or a majority of minority shareholders, only shifts the burden of proof from the defendant to the plaintiff and causes no changes to the application of the entire fairness standard in a merger route freeze-out transaction.

Different from the merger route described above, Delaware case law created a chance for practitioners to circumvent the most stringent entire fairness standard by structuring their freeze-out transactions through the tender offer route, namely tender an offer to acquire 90% of the target's shares, followed by a short-form merger.

In the *In re Siliconix Inc. Shareholders Litigation* (hereinafter *"Siliconix"*)[780] case, Delaware courts rejected the application of the entire fairness standard to tender offer transactions in the absence of coercion or disclosure violations.

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[775] 638 A.2d 1110 (Del. 1994).
[776] Id. at 1116.
[777] Id, at 1117.
[778] Civ. A. No. 7547, 1990 WL 47648 (Del. Ch. Apr. 17, 1990).
[779] 638 A.2d 1110 (Del. 1994), at 1118.
[780] Civ. A. No.18700, 2001 WL 716787(Del. Ch. June 19, 2001).

Admittedly, the court recognised that a less stringent approach had been adopted for tender offers than for mergers. However, the court justified these different treatments based on two distinctions: first, the tender offer, as a transaction form itself, does provide sufficient protection to minority shareholders, since they are free to decide to accept or reject the offer. In contrast, minority shareholders are powerless in a merger, due to the overwhelming voting power of the controlling shareholder. Second, the role of the board substantially varies in mergers and public tender offers. The former requires an essential contribution of the board to initiate and recommend the merger, while the latter demands no statutory influence of the board, since it is a matter of selling the property of minority shareholders.

Shortly after *Siliconix*, Delaware courts refused to apply the entire fairness standard to a short-form merger in *Glassman v. Unocal Exploration Corp*. (hereinafter "*Glassman*").[781] In this case, the court based its decision on the very purpose of the short-form merger statute itself, by claiming that such a statute aims at speeding up the elimination of minority shareholders in a summary procedure, which is inconsistent with the "fair dealing" requirement of the entire fairness standard. In other words, the nature of a short-form merger, i.e. no notice, no board approval, no vote, etc., determines that it is impossible to apply the entire fairness standard.[782]

Combining *Siliconix* and *Glassman*, Delaware courts created a chance for controlling shareholders to avoid the entire fairness review by structuring a freeze-out transaction in the form of a tender offer followed by a short-form merger. The court further clarified this exemption of the entire fairness review under three conditions in *In re Pure Resources Litigation.*[783] Namely, a transaction is deemed as non-coercive as long as it fulfills the requirement of the majority approval of minority shareholders, followed by a short-form merger with the same price and no retributive threat. Hence, a non-coercive tender offer route freeze-out transaction is entitled to the business judgment rule, according to the court.

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781 777 A.2d. 242 (Del. Supr. 2001).

782 *Glassman* also confirmed the appraisal as the exclusive remedy for minority shareholders in a short-form merger unless fraud or illegality has been shown. Under these conditions, minority shareholders have no other choice but either receive the merger consideration or exercise the appraisal right. Accordingly, the court highly underlined the importance of full disclosure duty in a short-form merger in order to make sure minority shareholders' choices represent their true wills.

783 808 A.2d 421, 445 (Del. Ch. 2002).

Up to this point, the discrepancy in judicial review standards has been demonstrated. On the one hand, the court insisted on applying the entire fairness standard to a merger route freeze-out transaction. On the other hand, the court rejected the entire fairness standard under the tender offer route. In reality, both the merger route and the tender offer route intend to achieve the same result of squeezing out minority shareholders, but obviously, the tender offer route is much more beneficial for controlling shareholders, since it can escape the most stringent judicial scrutiny of entire fairness. Judging from the increasing amount of tender-offer route freeze-out transactions and the lower prices paid to minority shareholders, research has shown that after *Siliconix* and *Glassman* in 2001, more businessmen took advantage of this judicial contour, to avoid the entire fairness review.[784]

To put an end to the above inconsistency, the Delaware court established a unified approach in *In re COX Communications, Inc. Shareholders Litigation* (*hereinafter "COX"*)[785] for freeze-out transactions, regardless of the specific transaction form. In this case, the court advocated a uniform standard for freeze-out transactions through either the merger or the tender offer route. This standard consists of two elements, namely the approval of a special negotiating committee, consisting of independent directors, and the approval of a majority of minority shareholders. Moreover, the court emphasised the complementary relationship between these two elements. The special negotiating committee serves as an independent bargaining agent in the interests of minority shareholders in the first step. The second step shields minority shareholders from disloyal agents by granting them the right to vote against the proposed transaction. Consequently, the court believed that these two procedural protections were sufficient to reflect an at-arm's-length transaction, and thus they were capable of providing minority shareholders with effective protection and should consistently apply to guide both forms of freeze-out transaction.

Subsequently, the *COX* standard has been adopted in both merger route and tender offer route freeze-out transactions. In *In re CNX Gas Corporation Shareholders Litigation,*[786] the court followed the *COX* unified standard and

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[784] Fernán Restrepo and Guhan Subramanian, 'The Effect of Delaware Doctrine on Freezeout Structure & Outcomes: Evidence on the Unified Approach', 5 (2015) *Harvard Business Law Review*, pp. 205-236.
[785] 879 A.2d 604, 624 (2005).
[786] 4 A.3d 397 (Del. Ch. 2010).

ruled that the business judgment rule applies to a tender offer route freeze-out transaction, if both the approval of a special negotiating committee and the approval of a majority of minority shareholders are achieved. However, if these two conditions fail to be accomplished completely, or if the plaintiff has demonstrated the ineffectiveness of any or both of the devices, then it will trigger the entire fairness standard. Likewise, in the merger route freeze-out case *In re MFW Shareholders Litigation,*[787] the court confirmed the application of the business judgment rule, if the approval of a special independent committee and of a majority of minority shareholders is achieved. In addition, Delaware courts also clarified why the unified standard may be the optimal structure for minority shareholder protection. First, in exchange for a defendant-friendly judicial review, the unified standard motivates the controlling shareholder to adopt the double-approval structure in the interests of minority shareholders. Second, by requiring also the approval of a majority of minorities, the unified standard may provide the special committee with more incentives to conduct better independent bargaining so that the result of its negotiation will not be voted down by minority shareholders at a later stage. Last but not least, if minority shareholders are not satisfied with the work of the independent committee, they can always reject it by voting.

Appraisal remedy

To safeguard dissenting minority shareholders in takeover transactions, *DGCL* §262 provides a legal remedy to ensure they will receive a fair price established by the court. The exercise of this appraisal right should follow certain conditions. First, its scope covers mergers and consolidations.[788] Second, only shareholders who continuously hold shares of the corporation through the date of the merger or consolidation and up to the date of making the demand, and neither voted yes nor expressed written consent for the merger or consolidation, can submit written demands to the Court of Chancery for the implementation of the appraisal right.[789] Besides the above

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[787] C.A. No. 6566-CS, 2013 WL 2436341 (Del. Ch. May 29, 2013).

[788] It has been argued that by disguising the transaction in a different form rather than as a merger, i.e. transfer of assets, amendment of charters or the dissolution of the company, it can deprive minority shareholders of the appraisal remedy. See: Kimble C. Cannon and Patrick J. Tangney, 'Protection of Minority Shareholder Rights Under Delaware Law: Reinforcing Shareholders as Residual Claimants and Maximizing Long-Term Share Value by Restricting Directorial Discretion', (1995) *Columbia Business Law Review*, pp. 725-784.

[789] The fact that shareholders are not entitled to a class appraisal action according to Delaware law may significantly lessen the protection provided to minority shareholders by the appraisal remedy. See: Ronald J.

requirements, the 2016 amendment of the *DGCL*, which came into effect on 1st August 2016, added a shareholding or value threshold to the appraisal right. Pursuant to the revised *DGCL* §262(g), for shareholders of listed companies, only shareholders who own more than 1% of the target company's shares, or the considerations that these shares received in the merger or consolidation are worth more than $1 million, or shareholders in a short-form merger as prescribed in §253 or §267, are capable of bringing a qualified appraisal proceeding in the court. Besides, the 2018 amendment of *DGCL* §262 confirmed that the appraisal right is available to both long-form mergers and medium-form mergers in the same conditions. Namely, after the 2018 amendment, dissenting minority shareholders in a long-form merger, a medium-form merger or a short-form merger are now entitled to the protection of appraisal right, if relevant conditions are met.

Meanwhile, the "market-out exception" under *DGCL* §262(b)(1) determines that minority shareholders are deprived of the appraisal right if the corporation is listed on a national exchange or has more than 2000 shareholders, or if the corporation is the surviving firm after a merger and this merger does not require shareholder voting of the surviving corporation. However, the *DGCL* also prescribes the "exception to the exception" in section §262(b)(2),[790] namely that this deprivation of the appraisal right is restored if considerations for the shares are paid in any form except stocks (cash for fractional shares).[791]

Before the 2016 and 2018 amendments of the appraisal right, Delaware courts had established a "quasi-appraisal" remedy. Starting with the *Weinberger* case*,* Delaware courts provided minority shareholders with the "quasi-appraisal" remedy if the controlling shareholder breached the full disclosure duty in a

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Gilson and Jeffrey N. Gordon, 'Controlling Controlling Shareholders', 2 (2003) *University of Pennsylvania Law Review*, pp. 785-843.

[790] According to *DGCL* §262 (b)(3), shareholders in a two-step stock-for-stock merger, as prescribed in §251 (h), are still entitled to appraisal rights unless the offerer owns 100% of the target's shares after the first step. Meanwhile, shareholders in a one-step stock-for-stock merger are not entitled to appraisal rights, due to "market-out" exception in § 262 (b)(1) and (2). To remove this inconsistency between one-step and two-step mergers, the 2018 proposed amendment of the *DGCL* suggested amending §262 (b)(3) so that two-step mergers would be subjected to the same treatment as one-step mergers.

[791] In comparison, the scope of appraisal right is broader in the *MBCA*. Its §13.02 (a) lists eight situations, covering mergers, share exchange, disposition of assets, amendment of articles of incorporation, domestication, conversion of the corporation, where the appraisal right is available if related conditions are fulfilled.

short-form merger.[792] Subsequently, the *Glassman* case affirmatively confirmed the appraisal right as the exclusive remedy of minority shareholders in a short-form merger, with the notable exceptions of fraud and illegality.[793] In *Berger v. Pubco Corp*.,[794] Delaware courts clarified the procedural aspects of such a quasi-appraisal remedy by affirming *Nebe*[795] and rejecting *Gilliland*,[796] asserting that the quasi-appraisal should follow the opt-out approach and no escrow demand.[797]

4.4.3 Analysis

In viewing the fiduciary duties of directors, normally the business judgment rule will apply if the decision was made independently with full disclosure, in good faith and serves the interests of the company. The predominance of the business judgment rule can be roughly explained from two aspects. First, the court is not necessarily a better business decision-maker than directors. Judges, though equipped with many years of sophisticated legal training, do not maintain the same degree of commercial expertise and thus lack firm-specific knowledge in most cases.[798] Moreover, the hindsight bias is a problematic issue in judicial reviews.[799] In a probabilistic world, directors inevitably face uncertainty at the time of decision-making. On the contrary, judges retrospectively examine what went wrong in a business decision after its failure. Unsurprisingly, it is easier to conclude that the risk of the transaction in dispute outweighs its benefits, since it has been proven as a mistake in practice.[800] Second, a director-friendly liability default rule may be more

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792 *Weinberger v. UOP, Inc*., 457 A.2d 701 (Del. 1983), at 715. However, the Weinberger listed limitations of the quasi-appraisal remedies.

793 Nicholas Carroll, 'A Win For the Little Guys? Appraising Minority Shareholder Rights Under the Delaware Short-Form Merger Statute After Berger v. Pubco Corp.', 59 (2014) *Villanova Law Review*, pp. 243-268.

794 976 A.2d 132 (Del. 2009).

795 *Nebel v. Southwest Bancorp. Inc.* Civ. A. No. 13618, 1995 WL 405750 (Del. Ch. July 5, 1995).

796 *Gilliland v. Motorola, Inc.* 873 A.2d 305 (Del. Ch. 2005).

797 Research claims that the court of Chancery extends the quasi-appraisal remedy beyond squeeze-out and to broadly cover other situations as a post-closing remedy for breach of disclosure duties. See: Robert B. Schumer, Stephen P. Lamb, Justin G. Hamil, and Joseph L. Christensen, 'Quasi-Appraisal: The Unexplored Frontier of Stockholder Litigation', 12 (2012) *The M&A Journal*, pp. 1-6, available at https://www.paulweiss.com/media/103314/7719347_1.pdf. Last visited February 2019.

798 Supra. 574, p. 115-121.

799 Ibid.

800 Christine Jolls, Cass R. Sunstein and Richard H. Thaler, 'A Behavioral Approach to Law and Economics', 50 (1998) *Stanford Law Review*, pp. 1471-1550.

beneficial to shareholders.[801] Ex-post, directors are held accountable for an erroneous investment under the fiduciary duty. An overly strict director liability rule may deprive the company of many profitable investments, due to risk-averse directors. To resolve the conflict between risk-tolerant shareholders and risk-averse directors, the business judgment rule, based on the presumption of goodwill directors, may turn out to be a more favourable approach for shareholders.[802]

However, due to the conflicts of interest and the risk of minority expropriations in takeovers, Delaware courts will apply stringent review standards, i.e. enhanced scrutiny or entire fairness, to guide different transactions. Elaborations in previous sections have shown that minority shareholder protection mainly relies on judicial review standards and the appraisal right.

Considering the inherent conflicts of interest between shareholders and the board in takeover transactions, defensive measures are examined under the enhanced scrutiny standard, which imposes a two-pronged test of reasonability and proportionality. In special situations, such as an inevitable or imminent sale of control, or the break-up of a company, an obligation to maximise the share price is imposed on the board, to protect shareholders' economic returns. Meanwhile, the court resists unnecessary second-guessing of board decisions by granting shareholder approval the cleansing effect, namely for a transaction which is not subjected to the entire fairness review, fully informed and uncoerced approval of a majority of disinterested shareholders generates the application of the business judgment rule, in both one-step transactions and two-step transactions structured as a tender offer plus a medium-form merger under *DGCL* §251(h).

In freeze-out transactions, the controlling shareholder owes a fiduciary duty to minority shareholders who face the danger of being forced out of the company. The fairness of such a transaction is seriously in question, due to the self-dealing of the controlling shareholder. Accordingly, the most stringent judicial review standard of the entire fairness standard is imposed to ensure a fair deal and a fair price. Meanwhile, Delaware case law also demonstrates deference to justifiable controller "self-dealing" transactions. Namely, if

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[801] Supra. 574, p. 115-121.
[802] Ibid.

procedural protection of the approval of a special independent committee and the approval of a majority of minority shareholders is provided, the judicial review standard shifts from the entire fairness to the business judgment in both merger route and tender offer route freeze-out transactions.

In respect of dissenting minority shareholders, the appraisal right will ensure a fair exit price in different forms of mergers, varying from long-form mergers and medium-form mergers, to short-form mergers.

In Delaware, courts pursue the dual goals of shareholder protection and directorial authority as well as minority shareholder protection and controller authority in takeover transactions. For (minority) shareholder protection, the court holds the expropriator, either directors or the controlling shareholder, liable for any breach of fiduciary duty. To reach this goal, the court has established a well-built system of judicial review standards, i.e. the business judgment rule, the enhanced scrutiny standard and the entire fairness standard, which progressively become more burdensome for the defendant according to the risk of minority exploitation. For directorial authority, the court affirms the cleasing effect of shareholder approval. For controller authority, the court contents that if proper procedural protection has been provided to achieve an at-arm's-length transaction, such a transation should be respected, based on the business judgment rule. Besides, it is interesting to see that legal instruments such as "disclosure" and "independent directors" may play two roles, i.e. they may monitor the self-dealing transaction in the interests of minority shareholders, and they may serve as a shield to discharge controlling shareholder's fiduciary duty, thanks to the business judgment rule.

In sum, Delaware courts play a significant role in safeguarding minority interests in takeover transactions. By applying various judicial review standards, the courts intend to reach a balance between director primacy and shareholder protection, a balance between the review standard and the burden of proof and a balance between minority shareholders and the controlling shareholder. Consequently, the US system underlines the role of the court, highlights justice based on a case-by-case analysis and prioritises flexibility over rigidity to achieve the final goal of an advanced system of "enabling and evolving law".

4.5 Conclusion

Based on the analysis above, this research has found that minority shareholder protection in the US is not a separate task involving one or two rules that are specially designed for minority shareholders. Instead, it is a collective effort of the corporate law system as a whole.

To understand US corporate law, the dispersed ownership structure is the starting point. Within this structure, the primary conflicts of interest arise between shareholders and management. State corporate laws regulate respective powers of shareholders and boards of directors. The *DGCL* depicts a board of directors as the governing body of a company. Comparatively, shareholders as a class are limited to basic rights, such as the appointment right, the approval right and the right to sue. Additional minority protection is left to the free choice of the company.

With the growth of shareholder activism, a call to curb unsatisfactory director behaviours has been raised at the federal level. Federal securities regulations and listing rules used by stock exchanges provide comprehensive provisions to regulate disclosure and independent directors. Guided by statutory laws, US courts further develop and elaborate the substance of the two monitoring mechanisms through case-by-case analysis. Moreover, a mature securities market and effective enforcement provide inalienable support for the law to function in practice. For instance, the assistance of effective intermediary agencies, such as accounting firms, auditing firms and law firms, substantially improves the transparency of the market. The SEC consistently supervises the stability and legality of the securities market. In addition, a sensitive securities market, on which the share price reflects the ups and downs of the company, as well as an active "market of corporate control", essentially contribute to the external supervision of listed companies.

Addressing the general shareholder-management conflict, the US system restrains broad directorial powers through fiduciary duties, shareholder model, disclosure and independent directors. For the controlling shareholder-minority shareholder conflict, the US system attentively underlines minority shareholder protection in takeover transactions through its courts that implement the fiduciary duty of a controlling shareholder, disclosure, independent directors and appraisal rights. First, the judicial remedy system has provided enough support for minority shareholders to actively exercise their right to bring an action. For example, to encourage minority shareholders to bring fiduciary duty litigation, the law affirms the "company pay" rule. Furthermore, the law equips minority shareholders with the tool of "class action", and the "contingent fee" generates attorney activism. Second, the strong case law tradition provides a sophisticated judicial review system to confront minority shareholder oppression. In general, the court applies the medium "enhanced scrutiny" standard to guide a sale of control transaction. If the element of "self-dealing" is involved, the most stringent "entire fairness" standard is imposed on freeze-out transactions. For transactions supposedly under the enhanced scrutiny review, courts respect managerial authority by shifting the review standard back to the business judgment rule, if the decision was approved by shareholders under certain conditions. Courts also intend to safeguard minority interests in freeze-outs by modelling an at-arm's-length transaction via procedural protection, including transparency and approval of both an independent committee and minority shareholders. If an at-arm's-length transaction is actioned, a court shows deference to the transaction by shifting the judicial review standard to the business judgment rule. In other words, courts ultimately strike a balance by employing monitoring mechanisms, either to regulate the directors/ controllers or to shield them from liability. Last, for dissenting minority shareholders, the appraisal right facilitates them exit the company with a fair price.

Briefly, US corporate law stresses the interplay between federal securities regulations and state corporate laws, and between statutory law and case law. It presents such a system which consistently pursues a balance between the two core values of shareholder protection and board primacy. Particularly, US courts serve as the last guardian of a listed company's "checks and balances". Naturally, a listed company with well-functioning corporate governance also benefits its minority shareholders. For potential threats, such as takeovers, the system protects minority shareholders through timely disclosure, through a fair exit price and through at-arm's-length transactions supervised by the court. Therefore, minority shareholder protection is a joint effort of the entire legal system, which shapes balanced corporate governance and grants circumstance-specific attention to minority shareholders, when necessary.

Chapter 5 Minority Shareholder Protection in the Netherlands

5.1 Introduction

With the harmonisation of corporate law in Europe, and under the influence of foreign investors, the legal framework of corporate governance in the Netherlands has undergone important adjustments over the past decade, especially in areas such as transparency, independence, shareholder rights and board structures. Besides, the "flexibility" of Dutch corporate law has turned the Netherlands into an attractive market for foreign companies.[803]

Dutch listed companies are mainly traded on the Euronext Stock Exchange Amsterdam, which has three indices for three different trading volumes, namely AEX (Amsterdam Exchange Index), AMX (Amsterdam Midcap Index) and AScX (Amsterdam Smallcap Index). In the Netherlands, not only shares, but also depository receipts can be listed on the stock exchange. According to the latter mechanism, shares are deposited in a trust office, and for each deposited share, a depositary receipt is listed on the exchange. In addition, a "structure regime" applies to Dutch "large companies", which will be discussed at length later in this chapter. Generally, in the Dutch framework, large companies should have a supervisory board, to which certain powers of the general meeting are transferred. Since 2013, large stock companies governed by such a structure regime and other stock companies can also opt for the one-tier board structure.

[803] Some foreign companies, such as Fiat, Mylan and Altice, have moved to the Netherlands due to the flexibility of the Dutch legislation. See: "Flexible Corporate Law As Selling Point", available at https://cismanagement.nl/news/flexible-corporate-law-as-selling-point/. Last visited February 2019.

Despite the recent development of a more concentrated ownership,[804] Dutch listed companies are traditionally identified with the dispersed ownership structure, the main agency cost for which lies between management and shareholders. This chapter will examine how shareholder protection is pursued in the Dutch corporate governance system, with a focus on minority shareholder protection in takeover transactions. Based on legal sources such as EU Directives, the *Dutch Civil Code*, the *Dutch Corporate Governance Code*, the *Dutch Financial Supervision Act* and Dutch case law, this chapter will be divided into three main parts. The first will examine the protection of shareholder rights at both the EU and the Dutch law levels. The second part will first elaborate on relevant EU legislation and then discuss how shareholders can benefit from the transparency and the internal supervision of Dutch listed companies. The third part will investigate Dutch courts' role in redressing minority shareholder oppression in takeovers.

5.2 Minority shareholder protection through shareholder rights in the EU and the Netherlands

The harmonisation of company law in European member states underlines shareholders' significant role in promoting better corporate governance. Especially, *Directive 2017/828 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement*[805] highly emphasises the need for "effective and sustainable shareholder engagement" as well as internal "checks and balances" within a listed company. Another important reference is the *Takeover Bid Directive*, which aims at safeguarding particularly minority shareholders' interests by stipulating a "mandatory bid rule"[806] and a "sell-out right".[807] These principles, set by EU rules, have been or will be incorporated into Dutch corporate law, as we shall see in more detail in this

[804] Eumedion, "Position of Minority Shareholders in Companies with A Controlling Shareholder", available at http://www.eumedion.nl/en/public/knowledgenetwork/position-papers/2016-06-position-paper-minority-shareholders-final-version.pdf. Last visited February 2019.
[805] *Directive No. 2017/828*, O.J.EUR.COMM.(No. L132) 1 (2017).
[806] The mandatory bid rule demands the acquirer issues a public offer to all shareholders, to acquire all of the remaining shares when a certain threshold has been reached.
[807] The sell-out right enables remaining minority shareholders to require the acquirer to purchase their shares when the acquirer has reached a certain threshold after the offer.

first part, which consists of three sections. The first section will give a brief introduction to shareholder rights in EU Directives. The second section will elaborate on shareholder rights from the domestic law level, mainly based on the *Dutch Civil Code*. Based on the overview of legislation provided by the first two sections, the third section will analyse and discuss shareholder protection in the Dutch context.

5.2.1 Shareholder rights in EU directives

According to Article 26 of the *Treaty on the Functioning of the European Union* (hereinafter *"TFEU"*), it is within the power of the Union to remove obstacles for the free movement of goods, capital, services and persons. *TFEU* Article 49 and 50 also confirm the freedom of establishment. To achieve these goals, the Union has progressively established thirteen *Directives*, to harmonise corporate law at the EU level. In June 2017, several of these corporate law directives (*Directive 1, 2, 3, 6, 10* and *11*) were merged into *Directive 2017/1132*, which mainly regulates the establishment, the functioning and mergers and divisions of limited liability companies.[808]

More specifically, the *First Corporate Directive*[809] regulated the disclosure of a company's basic documents, representations and the safeguarding of third parties' interests. The *Second Corporate Directive*[810] clarified the formation, the maintenance and capital alteration of public limited liability companies for the protection of shareholders and creditors. Related to shareholder rights, the *Second Directive* pinpointed shareholders' right to demand an independent evaluation of company assets,[811] separate voting for relevant classes of shareholders,[812] preemptive rights[813] and the equal treatment of shareholders.[814] The *Third Corporate Directive*[815] targeted public limited liability company mergers. It prescribed various shareholder rights, such as the

808 Directive No. 2017/1132, O.J.EUR.COMM. (No.169) 46 (2017). For clarification, the discussion below still refer to the original *Directives* before they were incorporated into *Directive 2017/1132.*
809 Directive No. 2009/101, O.J.EUR.COMM. (No.L258) 11 (2009), repealed by *Directive 2017/1132*.
810 Directive No. 2012/30.O.J.EUR.COMM. (No.L315) 4 (2012), repealed by *Directive 2017/1132*..
811 Article 11.2, *The Second Corporate Directive*.
812 Article 29.3, *The Second Corporate Directive*.
813 Article 33, *The Second Corporate Directive*.
814 Article 46, *The Second Corporate Directive*.
815 Repealed by *Directive No. 2011/35*, O.J.EUR.COMM. (No.L110) 1 (2011).

right to be adequately informed,[816] the separate voting of affected classes of shareholders,[817] the right to approve a merger and the right to convene a general meeting on special occasions,[818] the right to an independent expert report,[819] an inspection right[820] and the sell-out right.[821] In addition, the *Third Corporate Directive* straightforwardly confirmed administrative or management bodies' civil liabilities in terms of shareholders,[822] as well as independent experts' civil liabilities in the same regard.[823] Both the *Fourth Corporate Directive* and the *Seventh Corporate Directive* were repealedby *Directive 2013/34*,[824] which stipulated financial statements and reports and provides detailed guidance on the preparation of various financial documents. It also granted member states the discretion to hold administrative, management and supervision bodies directly liable to shareholders for financial disclosure.[825]

The *Sixth Corporate Directive*[826] set down rules governing the division of public limited liability companies. To protect shareholder interests in a division, the *Directive* specified that shareholders are entitled to the right to be sufficiently informed,[827] the right to separate voting,[828] the inspection right,[829] the right to approve the division and the right to convene a general meeting on special occasions,[830] the right to an independent expert report[831] and minority

816 Preamble (5), *The Third Corporate Directive*.
817 Article 7.2, *The Third Corporate Directive*.
818 Generally speaking, the general meeting has the right to approve a merger resolution. If the acquiring company is exempted from the approval of the general meeting, various conditions must be fulfilled. Particularly, shareholders of the acquiring company who pass the threshold are entitled to the right to call for a general meeting for the approval of the merger, and the threshold should not be more than 5%. See: Article 8, *The Third Directive*.
819 Article 10, *The Third Corporate Directive*.
820 Article 11, *The Third Corporate Directive*.
821 In a parent-subsidiary merger, minority shareholders of the target company have the right to request the acquiring company to acquire their shares at a reasonable price, if the acquiring company owns 90% or more of the target company's shares. See: Article 28(a), *The Third Directive*.
822 Article 20, *The Third Corporate Directive*.
823 Article21, *The Third Corporate Directive*.
824 *Directive No. 2013/34,* O.J.EUR.COMM. (No.L182) 19 (2013).
825 Preamble (40), *Directive 2013/34*.
826 *Sixth Council Directive No.82/891*, O.J.EUR.COMM. (No. L378) 47 (1982), amended by *Directive No. 2014/59*, O.J.EUR.COMM. (No. L173) 190 (2014).
827 Preamble, *The Sixth Council Directive*.
828 Article 5.1, *The Sixth Council Directive*.
829 Article 9, *The Sixth Council Directive*.
830 Generally speaking, the general meeting has the right to approve the division resolution. If the recipient company is exempted from approving the general meeting, various conditions must be fulfilled. Particularly, shareholders who pass the threshold are entitled to the right to call up a general meeting for the approval of

shareholders' right to request to purchase their shares.[832] The *Eighth Corporate Directive*[833] elaborated on statutory audits and affirms that shareholders' right to appoint auditors or audit firms should not be restricted.[834] For public interest entities, shareholders with 5% or more of capital or voting rights are entitled to request the court to dismiss the auditors or the audit firm.[835] Besides, the *Directive* allowed member states to decide freely on shareholders' annual election of the chairman of the audit committee.[836] The *Tenth Corporate Directive*[837] lowered barriers for cross-border mergers of limited liability companies. Moreover, member states are free to take appropriate measures to protect dissenting minority shareholders.[838] In order to protect shareholders and third parties' interests, the *Eleventh Corporate Directive*[839] stipulated the disclosure of branches of companies. The *Twelfth Corporate Directive*[840] set out to lay down the foundations for the legal recognition of single-member private limited liability companies. The *Thirteenth Corporate Directive* (*hereinafter "Takeover Directive"*)[841] focused on takeover bids and entails principles such as the equal treatment of shareholders and the protection of non-controlling shareholders.[842] Particularly, the *Directive* prescribed the mandatory bid rule[843] and the sell-out right[844] to protect minority interests in takeovers. In addition, the *Proposal for the Fifth Directive* attempted to regulate the

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the division, and the threshold should not be more than 5%. See: Article 6 (c), *Sixth Council Directive No.82/891*, O.J.EUR.COMM. (No. L378) 47 (1982).

831 Article 8, S*ixth Council Directive No.82/891*, O.J.EUR.COMM. (No. L378) 47 (1982).

832 If shares of the recipient company are used as compensation, and these shares are not in proportion to the divided company's shareholders' capital, then minority shareholders of the divided company may have the right to request the recipient company to purchase their shares. See: Article 5.2, *Sixth Council Directive No.82/891*, O.J.EUR.COMM. (No. L378) 47 (1982).

833 *Directive No. 2006/43*, O.J.EUR.COMM. (No.L157) 87 (2006), amended by *Directive No. 2014/56*, O.J.EUR.COMM. (No.L158) 196 (2014).

834 Article37, *The Eighth Corporate Directive*.

835 Article 38.3 (a), *The Eighth Corporate Directive*.

836 Article 39, *The Eighth Corporate Directive*.

837 *Directive No. 2005/56*, O.J. EUR.COMM. (No.L310) 1 (2005), repealed by *Directive 2017/1132*. In 2019, *Directive 2019/2121* was adopted amending *Directive 2017/1132* on cross-border conversions, mergers, and divisions.

838 Article 4.2, *The Tenth Directive*.

839 *Eleventh Council Directive No.89/666*, O.J.EUR.COMM. (No.L395) 36 (1989), amended by *Directive No. 2012/17*, O.J.EUR.COMM. (L156)1 (2012).

840 Repealed by *Directive No. 2009/102*, O.J. EUR. COMM. (No. L258) 20 (2009).

841 *Directive No. 2004/25*, O.J.EUR.COMM. (No. L142)12(2004), amended by *Directive No. 2014/59*. O.J.EUR.COMM. (No. L173) 190 (2014).

842 Article 3, *The Thirteenth Corporate Directive*.

843 Article 5, *The Thirteenth Corporate Directive*.

844 Article 16, *The Thirteenth Corporate Directive*.

structure and powers of public company organs. The *Proposal for the Ninth Directive* prescribed company groups. However, both documents so far only remain draft proposals, due to opposition put forth by member states. Hence, the discussion herein will not cover these two proposals.

An important foundation of the EU framework on shareholders' rights is the *Directive on the exercise of certain rights of shareholders in listed companies* (hereinafter "*Shareholder Rights Directive*").[845] In the Preamble to this directive, the legislator remarkably recognises that effective shareholder control is a precondition of good corporate governance. It further prescribes the strengthening of shareholder rights by way of increased transparency, proxy voting, electronic participation and cross-border voting. The directive also affirms the equal treatment of shareholders[846] and aims at improving transparency through disclosure of information,[847] the publication of voting results[848] and granting shareholders the right to ask questions.[849] The directive regulates proxy voting in Article 10 and clarifies the formalities in Article 11. Last but not least, it enhances shareholders' participation and voting rights by giving them the right to put items on the agenda and to table draft resolutions,[850] by elaborating requirements related to the exercising of participation and voting rights,[851] by allowing shareholders to participate via electronic means or correspondence[852] and also by removing obstacles of shareholder voting.[853]

In 2014, the European Commission issued a proposal to amend the *Shareholder Rights Directive*, in order to address two significant problems, respectively, "insufficient shareholder engagement" and the "lack of adequate transparency".[854] Insufficient shareholder engagement is one of the reasons

[845] *Directive No. 2007/36*, O.J.EUR.COMM. (No. L184) 17 (2007), amended by *Directive 2017/828.*
[846] Article 4, *Shareholder Rights Directive*.
[847] Article 5, *Shareholder Rights Directive*.
[848] Article 14, *Shareholder Rights Directive*.
[849] Article 9, *Shareholder Rights Directive*.
[850] Article 6, *Shareholder Rights Directive*.
[851] Article 7, *Shareholder Rights Directive*.
[852] Article 8 and 12, *Shareholder Rights Directive*.
[853] Article 13, *Shareholder Rights Directive*.
[854] Proposal for a Directive of the European Parliament and of the Council Amending *Directive 2007/36/EC* as regards the encouragement of long-term shareholder engagement and *Directive 2013/34/EU* as regards certain elements of the corporate governance statement /COM/2014/0213 final, available at https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52014PC0213, adopted by *Directive 2017/828*. Last visited February 2019.

behind the short-termism of listed companies.[855] Specifically, the proposal suggests three solutions: increase transparency, establish shareholder oversight on related-party transactions and allow shareholders to vote on remuneration issues.[856] In 2017, *Directive 2017/82*8, amending *Shareholder Rights Directive*, as regards the encouragement of long-term shareholder engagement[857] was adopted. In line with the 2014 proposal, the *2017 Shareholder Rights Directive* highlights the core value of "effective and sustainable shareholder engagement" that relies on "checks and balances", and it pursues the two main goals of "long-term shareholder engagement" and "enhanced transparency between the company and the investors". The amendment covers various areas, such as the "identification of shareholders", "transmission of information", "remuneration policy and report" and "material related party transactions". In respect of material related-party transactions, the *Directive* demands a public announcement and an independent assessment report, to demonstrate the fairness and reasonableness of the transaction from a minority shareholder's perspective. Such transactions also require shareholder approval or administrative/supervisory body approval with sufficient procedural protection for minority shareholders. Furthermore, member states can freely adopt stricter rules for the purposes of protecting minority shareholders, helping exercise shareholder rights and promoting shareholder engagement.

5.2.2 Shareholder rights in the Netherlands

In compliance with the aforementioned EU directives, the *Dutch Civil Code* (hereinafter "*DCC*")[858] affirmatively prescribes various shareholder rights. The main reference for this is its Book 2 on Legal Persons, which is also a fundamental source of Dutch corporate law. Article 2:107 *DCC* states that shareholders of public companies are entitled to residual powers. Namely, any

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[855] Ibid.

[856] The proposal also prescribes exemptions to the above obligations. See: *Directive No.2014/59*, O.J.EUR.COMM. (No. L173) 190 (2014).

[857] *Directive No. 2017/828*, O.J.EUR.COMM.(No. L132) 1 (2017).

[858] Provisions of the Dutch Civil Code mentioned hereinafter will be based on an unofficial translation provided by the Dutch Civil Law website. See: http://www.dutchcivillaw.com/civilcodegeneral.htm. Last visited December 2017.

power that has not been designated to the board of directors or other corporate organs should be reserved for the general meeting.[859]

Powers of the general meeting

According to the *DCC*, the general meeting has the right to appoint and dismiss the board of directors[860] and the supervisory board.[861] Besides appointing directors and supervisors, the general meeting has a say in major decisions which may change the identity or character of the company. Article 2:107a *DCC* specifically demands shareholder approval for any resolution in the following instances: a transfer of the enterprise, or in fact the entire enterprise, the start or termination of a fundamental alliance or partnership and the acquisition or disposal of one-third or more of the company's assets. Article 2:317 and Article 2:334m prescribe that a merger or a division of a company requires the approval of the general meeting.[862] In addition, the general meeting has the power to amend the articles of association,[863] to issue new shares,[864] to pass a conversion[865] as well as to adopt the annual account,[866] which is related to the distribution of dividends.[867]

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[859] The second paragraph of Article 2:107, *DCC* also prescribes that the board of directors and the supervisory board are obliged to provide all requested information to the general meeting of shareholders. However, Dutch case law, such as the ASMI case, affirms the autonomy of the board by emphasising that it has the power to decide on corporate strategies and the involvement of shareholders. The court also intends to curtail the impact of shareholder activists.

[860] Article 2:132, *DCC* prescribes that except for the first generation of the board of directors affirmed in the notarial deed of incorporation, the general meeting is eligible to appoint the board of directors in normal circumstances.

[861] Article 2:142, *DCC* states that except for those designated by the notarial deed of incorporation, the general meeting has the power to appoint company supervisors. The provision also grants the articles of incorporation the discretion to set down supervisors' qualifications. However, the general meeting can rebut these limitations through a two-thirds resolution.

[862] In the ABN case, the court confirms that shareholders' approval power should be limited within Article 2:107 (a). Based on the stakeholder model, the court supports the board of directors' decision. For more details, see section 5.4.2.

[863] Article 2:121, *DCC*.

[864] Article 2:96, *DCC*.

[865] Article 2:18, *DCC*

[866] Article 2:101 (3), *DCC*.

[867] Article 2:105, *DCC*. According to Article 2:105 of the *DCC,* shareholders are entitled to the right to a dividend. Article 2:216 of the DCC prescribes that in a closed company, the general meeting has the power to allocate and distribute dividends. In the KLM case, after Air France became the controlling shareholder with a 96.3% shareholding, KLM was delisted. Concerning the dividend resolution, minority shareholders of KLM argued that the resolution to reserve instead of to distribute the dividends went against the reasonableness and fairness principle. However, the court respected the discretionary authority of the general meeting and held a "no interference" attitude in the *KLM* ruling, which sets a high standard for minority shareholders to challenge the dividend policy. See: Floor Veltman, Can KLM's Decision to Reserve Profits Be Upheld in View of the Interests of the Minority Shareholders? available at

Nevertheless, powers of the general meeting may be subjected to limitations when it comes to the "structure regime" under Dutch corporate law. Article 2:153(2) *DCC* sets the criteria of a "large" company, namely a public company: a) with at least € 16,000,000 of issued capital, b) is obliged to set up a work council according to law and c) jointly employs at least 100 employees in the Netherlands. If the company has continuously fulfilled the above criteria for three years, the structure regime applies.[868] Under the structure regime, the works council can recommend one-third of the supervisory board.[869] Pursuant to Article 2:154 *DCC*, the "structure regime" requires a mandatory supervisory board. Moreover, certain shareholder powers in this circumstance are transferred to the supervisory board; for example, the supervisory board replaces the general meeting to appoint the board of directors or executive directors,[870] to adopt the annual account and to approve certain resolutions.[871] Historically speaking, Dutch corporate law follows a two-tier board structure. Since 1st January 2013, a one-tier board structure has become possible, according to Article 2:129a *DCC*. The structure regime also applies to one-tier board companies.[872] Be that as it may, due to the exemptions provided by Article 2:153 (3), as well as the partial exemptions in Article 2:155

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https://kvdl.com/news/can-klms-decision-to-reserve-profits-be-upheld-in-view-of-the-interests-of-the-minority-shareholders/. Last visited February 2019.
Onno Boerstra, When Can Minority Shareholders Demand Dividend? Available at https://www.vandoorne.com/en/knowledge-sharing/blog/when-can-minority-shareholders-demand-dividend/. Last visited February 2019.

868 Article 2:154, *DCC*.

869 Article 2:158 (6), *DCC*. The creation of the structure regime was a byproduct of the stakeholder model, which stresses the interests of other stakeholders alongside shareholders. Its design, which grants the works council the right to nominate one-third of the supervisory board or non-executive directors, reveals the intention behind increasing employee influence in large listed companies while decreasing the power of shareholders. See: Jaron van Bekkum, Steven Hijink, Michael C. Schouten and Jaap W. Winter, 'Corporate Governance in the Netherlands', 14 (2010), *Electronic Journal of Comparative Law*, pp. 1-35.
And Maarten Muller (ed.), *Corporate Law in the Netherlands* (The Netherlands: Kluwer Law International, 2013), p. 111.

870 Article 2:162, *DCC*. However, the general meeting of shareholders still has the power to appoint the supervisory board, but this appointment shall be based on the nomination of the supervisory board according to Article 2:158 (3), *DCC*.

871 Resolutions which require supervisory approval prescribed in Article 2:164 *DCC* cover the issuance and acquisition of shares, the issuance of depository receipts, the listing or withdrawal of shares or depository receipts, the start or termination of a fundamental alliance or partnership, the acquisition of at least on-quarter of the company's share capital, investments amounting to at least one-quarter of share capital, an amendment of the articles of association, the dissolution of the company, bankruptcy or an official moratorium, termination of the employment of a substantial amount of employees, a significant change in employment conditions for a substantial amount of employees and a reduction in issued capital.

872 Article2:164a, *DCC*.

and 2:155a *DCC*,[873] the majority of large listed companies are exempted from the abovementioned structure regime.[874] It may be interesting to note that the exemption rate from this regime has grown from 40% in 1996 to 70% in 2010.[875]

Fiduciary duties and the right of inquiry

By and large, directors' fiduciary duties consist of the duty of care and the duty of loyalty. The *DCC* does not directly incorporate these two concepts. Instead, it provides two Dutch substitutes.[876] The Dutch version of the "duty of loyalty" is reflected through the "reasonableness and fairness" standard, one of the most fundamental principles of Dutch corporate law, mandated by Article 2:8 *DCC*. Moreover, the Dutch "stakeholder" model, which requires both the managing and monitoring directors to be guided by the interests of the company and its undertaking,[877] has been interpreted as an implicit declaration of the "duty of loyalty", namely, directors' personal interests ought not to prevail over the interests of the company.[878] In addition, the "duty of a proper performance", as the Dutch alternative to the "duty of care", can be found in Article 2:9 *DCC*, which states that every director owes the company the duty to properly perform his or her tasks, and he or she should be held liable for the entire results caused by poor performance, unless there is neither "serious personal blame" nor "negligence".[879] However, the fiduciary duty is

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[873] Article 2:153 (3), *DCC* clarifies exemptions to the statutory regime, e.g. if the company is merely a managing or financing company, and the majority of its employees are not resident in the Netherlands, Articles 2:155 and 2:155a prescribe partial exemptions to the statutory supervisory board requirement, e.g. if more than 50% capital of a company is held by a legal person, and the majority of this legal person's employees are not resident in the Netherlands, Article 2:156, *DCC* endows the Minister of Justice with the dispensation power of the statutory two-tier structure under the request of the company, and Article 2:157, *DCC* provides companies the opportunity to opt-in voluntarily into the statutory two-tier structure.

[874] Jaron van Bekkum, Steven Hijink, Michael C. Schouten and Jaap W. Winter, 'Corporate Governance in the Netherlands', 14 (2010) *Electronic Journal of Comparative Law*, pp. 1-35.

[875] Richard G. J. Nowak, 'Corporate Boards in the Netherlands', in Paul Davies, Klaus J. Hopt, Richard Nowak and Gerard van Solinge (eds.), *Corporate Boards in Law and Practice: A Comparative Analysis in Europe* (Great Britain: Oxford University Press, 2013), pp. 429-509.

[876] Maarten Muller (ed.), *Corporate Law in the Netherlands* (The Netherlands: Kluwer Law International, 2013), p. 95.

[877] Article 2:129 (5) and 2:140 (2), *DCC*. Principle 1.1 of the *DCGC* stipulates that the board concentrates on creating long-term value for the company and its undertakings.

[878] Supra. 874.

[879] Article 2:138 *DCC* prescribes the joint and several liabilities of directors in a bankruptcy, if improper performance is the predominant cause of the bankruptcy of a listed company.
Article 2:149 *DCC* confirms that the liability of an improper performance also applies to supervisory directors.

considered as the duty towards the company, which is the only eligible applicant that can bring a breach of fiduciary duty lawsuit.[880]

To enforce fiduciary duties, Dutch law accords as a judicial remedy a right of inquiry, which allows shareholder(s)[881] to file a mismanagement claim at the Enterprise Chamber of the Amsterdam Appeal Court. The inquiry proceedings are specified in Section 2.8.2 (Articles 2:344-359) of the *DCC*. According to Article 2:346 *DCC*, for companies with a nominal share value of less than €22.5 million, shareholder(s)[882] who individually or collectively hold(s) a shareholding of at least 10% or a nominal share value of €225,000,[883] and companies with a nominal share value of more than €22.5 million, shareholder(s)[884] who individually or collectively hold(s) a shareholding of at least 1% or a market share value of €20 million,[885] is/are entitled to file a written request to the Enterprise Chamber for an inquiry proceeding, to review the policy and the state of affairs[886] of the company.[887] However, it should be noted that this right to request an inquiry proceeding is under the precondition of the "exhaustion of existing internal remedies", i.e. the request should first be submitted to the board of directors and the supervisory board, and a reasonable period should have passed without any effective correction.[888]

After the request has been filed, the Enterprise Chamber can award an inquiry proceeding, but only if there are "well-founded reasons" to believe the policy

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880 In the case of bankruptcy, Article 2:138, *DCC* confirms the liquidator's capability to bring an action based on the breach of fiduciary duty of a director.

881 Based on Article 2:346 and Article 2:347, *DCC,* the company itself, any other person to whom the articles of association grants this right and also the labour union may enjoy the right to inquiry, if relevant conditions are fulfilled.

882 The term "shareholder" mentioned in this section also includes holders of depositary receipts. Likewise, the term "share" in this section also covers depositary receipts. See: Article 2:346, *DCC*.

883 A lower amount is also possible if specified in the articles of incorporation of the company. See: Article 2:346, *DCC*.

884 The term "shareholder" mentioned in this section also includes holders of depositary receipts. Likewise, the term "share" in this section also covers depositary receipts. See: Article 2:346, *DCC*.

885 A lower amount is also possible if specified in the articles of incorporation of the company. See: Article 2:346, *DCC*.

886 Article 2:345, *DCC* stipulates the scope of the inquiry proceeding is to review "the policy and the state of affairs".

887 Based on Article 346:1(d), legal persons as identified in Article 344 have the right to request an inquiry proceeding. Article 2:345, *DCC* prescribes that the Advocate General of the Amsterdam Court of Appeal can also request an inquiry proceeding based on public interest. Pursuant to Article2:344, *DCC*, the inquiry proceeding covers not only listed companies, but also other legal entities, such as closed companies, mutual insurance societies, cooperatives, foundations and associations.

888 According to Article 2:349, *DCC*, if the request of an inquiry proceeding is made by the labour union, then this request shall be submitted to the Works Council first, so it can express its opinion on the discussed issue.

or state of affairs of the listed company is improper.[889] If the inquiry proceeding is awarded, the Enterprise Chamber must announce the maximum costs for such an inquiry, and these will be borne by the listed company.[890] On the contrary, if the request is rejected by the Enterprise Chamber, the listed company may file a claim against the applicant for compensation.[891]

The Enterprise Chamber does not conduct the investigation itself in the first stage.[892] After the request is accepted, the Enterprise Chamber appoints investigators and a commissioner-judge.[893] These investigators have the power to inspect the "books, records and other data" of the company, while the board of directors and the supervisory board are obliged to provide all necessary information to the investigators upon their request.[894] When it is necessary, the Enterprise Chamber may extend this inspection right to cover also subsidiaries of the company, upon request of the investigators.[895] To ensure the enforcement of this inspection power, the investigators may request the commissioner-judge issues orders that instruct the police to assist in obtaining the information.[896] The investigators also have the right to request the Enterprise Chamber facilitates a witness hearing.[897] After the investigation, investigators should draft a report and submit it to the Amsterdam Court of Appeal,[898] and a copy of this report should then be sent to the Advocate-General, the company and the applicant. The Enterprise Chamber may also decide to make this report public.[899] Besides, upon request, the Enterprise Chamber may take provisional measures at any stage of the proceeding, when it is required by the company's state of affairs or in the interests of the investigation. The Enterprise Chamber has broad discretion to take any necessary provisional measure that may last, at the most, for the duration of the proceeding.[900]

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[889] Article 2:350 (1), *DCC*.
[890] Article 2:350 (3), *DCC*.
[891] Article 2:350 (2), *DCC*. This provision may prevent the "abuse of the right of inquiry" on the one hand, but it may deter minority shareholders from exercising their right to request an inquiry proceeding on the other.
[892] Pursuant to Article 2: 349a, *DCC*, upon the request of the applicant, the Enterprise Chamber is entitled to take provisional measures throughout the entire proceeding.
[893] Article 2:350 (4), *DCC*.
[894] Article 2:351 (1), *DCC*.
[895] Article 2:351 (2), *DCC*.
[896] Article 2:352, *DCC.*
[897] Article 2:352a, *DCC*.
[898] Article 2:353 (1), *DCC*.
[899] Article 2:353 (2), *DCC.*
[900] Article 2:349a, *DCC*.

The second stage of the inquiry proceeding is also initiated by the applicant. If the investigation report confirms the existence of mismanagement, shareholders, within 2 months after depositing the investigation report at the Registry of the Amsterdam Court of Appeal,[901] may request the Enterprise Chamber to order appropriate measures for corrections,[902] namely: to suspend or nullify a resolution, to suspend or dismiss director(s) or supervisor(s), to temporarily appoint director(s) or supervisor(s), to temporarily derogate provisions of the articles of association, to temporarily transfer shares for administrative reasons and to dissolve the company.[903] The company has the appeal right in cassation against the above orders.[904] In spite of the above discretions, the Enterprise Chamber neither touches upon the director's liability issue nor awards damages in the inquiry proceeding. Instead, shareholders should refer these issues to the general District Court, in which the Enterprise Chamber's judgment, though not binding, may serve great value in the court proceeding.

From 1971 to 2001, there were about 260 inquiry proceeding requests, and 205 of these were accepted by the Enterprise Chamber based on "sound-grounded reasons". From 1997 to 2001, 60 cases were awarded with provisional measures by the Enterprise Chamber.[905] Furthermore, between 2000 and 2007, there were 23 proceedings regarding listed companies, and more significantly, 19 of these were filed by minority shareholders.[906] From 2013 to 2016, the rate of provisional measures awarded increased from 52% to 64%.[907] The popularity of the inquiry proceeding has turned it into a helpful

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[901] Article 2:355 (2), *DCC.*

[902] Article 2:355 (1), *DCC.* Alternatively, according to paragraph 5 of the same Article, the Enterprise Chamber may suspend its order if the company promises to take measures to amend mismanagement.

[903] Article 2:356, *DCC.*

[904] Article 2:359, *DCC.*

[905] Levinus Timmerman and Alexander Doorman, 'Rights of Minority Shareholders in the Netherlands', 6 (2002), *Electronic Journal of Comparative Law*, pp.1-100. Available at http://www.ejcl.org/64/art64-12.html. Last visited February 2019. See also C. Cools, P.G.F.A. Geerts, M.J. Kroeze, and A. C. W. Pijls, '*Het recht van enquete: Een empirisch ondersoek*', Deventer: Kluwer 2009.

[906] Institutional investors and the Dutch Investors' Association played a big role in minority shareholder-initiated proceedings. Furthermore, it has been claimed that despite the high 10% shareholding threshold, the inquiry proceeding did not lose its popularity, and it may even have prevented the abuse of the right of inquiry. See: Martin Gelter, 'Why do Shareholder Derivative Suits Remain Rare in Continental Europe?', 37 (2012) *Brooklyn Journal of International Law*, pp. 842-892.

[907] A.J.F. Lafarre, B.C.J. Schippers, S.F.W. van den Bosch, C.F. Van der Elst and G.J.H. van der Sangen '. Doelbereiking en effectiviteit van de wet aanpassing enquêterecht in de praktijk', (2018) *WODC-rapport 2791*, p. 136.

information channel[908] which grants minority shareholders access to inside information with regards to the policies and the state of affairs of a company. Moreover, the inquiry proceeding provides minority shareholders the chance to influence company policies. By invoking external supervision through the Enterprise Chamber, minority shareholders manage to compensate for their weak position within the company. Decisively, minority shareholders are allowed to request the Enterprise Chamber to take provisional measures, which normally calls for adjustments to the company.[909]

Finally, shareholders are not entitled to bring a derivative action on behalf of a company in the Netherlands.[910] The Dutch context is further characterised by the absence of a "class action".[911] In the Dutch context, class action is addressed once again with a Dutch substitute, which can be found in Article 3:305a *DCC*. Accordingly, minority shareholders may establish a foundation or an association[912] with full legal capacity, to bring a claim against the company in the court for their collective interests. However, this collective claim cannot be made to request compensatory damages,[913] so after obtaining the declaratory judgment from the court, a minority shareholder can file another individual proceeding for compensation based on the judgment. As an alternative, minority shareholders can authorise the foundation or association to negotiate a fair settlement, which can later be declared by the court to be binding for the entire "class".[914]

Other shareholder rights

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[908] Generally speaking, the minority shareholders' information right mainly relies on three mechanisms, namely mandatory disclosure, the right to ask questions at the general meeting and the inquiry proceeding. See: supra. 874.

[909] Levinus Timmerman and Alexander Doorman, 'Rights of Minority Shareholders in the Netherlands', 6(2002), *Electronic Journal of Comparative Law*, pp.1-100. Available at http://www.ejcl.org/64/art64-12.html. Last visited February 2019.

[910] A shareholder has the right to file an action against a director if the director breaches his or her duty and this directly affects the shareholder. For example, pursuant to Article 2: 139 *DCC*, shareholders can bring a lawsuit against directors for any damage caused as a result of misleading information in annual accounts, interim reports or annual reports. However, case law is rarely found in this regard. See: supra. 874.

[911] See, for a proposal from the European Commission for a harmonised class action in member states, COM(2018) 184 def.

[912] This foundation or association whose articles of association have the objective of protecting similar interests of other persons. See: Article 3: 305a (1), *DCC*.

[913] On 1 April 2019 a law (the 'Wet afwikkeling massaschade in collectieve actie (WAMCA)' which makes this possible as from 1 January 2020, has been published in the Official Gazette. See for the proposal nr. 34608.

[914] Article 7:907, *DCC.* See also: supra. 874.

In addition to the rights described above, the Dutch legislative framework comprises other additional shareholder protection measures. Article 2:92 *DCC* prescribes the "equal treatment" of shareholders/holders of depository receipts. Moreover, every shareholder has the right to vote.[915] Dutch corporate law facilitates shareholder participation by recognising the right to attend, to address and to vote (including proxy voting) at the general meeting.[916] Additionally, to reduce the cost of being present at the meeting, Article 2:117a *DCC* provides shareholders with the possibility to attend the general meeting through electronic means. However, Article 2:118 *DCC* allows deviations to "one share, one vote". Various legal devices are available for such a deviation, for example "dual-class shares",[917] "loyalty shares",[918] "depositary receipts",[919] "priority shares"[920] and "preference shares".[921] In the case of capital increases, a shareholder is entitled to the "pre-emption right" to subscribe to newly issued shares in proportion to the amount of shares he or she owns.[922]

Furthermore, Dutch corporate law gives shareholders who pass certain thresholds the chance to influence the direction of the company. In general,

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[915] Article 2:118, *DCC* stipulates shareholders' right to vote at the general meeting, and Article 2:118a, *DCC* further clarifies holders of depository receipts are also entitled to vote at the general meeting. However, Article 2:118 also allows deviation from "one share, one vote", such as "dual-class shares" or "loyalty shares", which may be damaging to minority shareholder protection.

[916] Article 2:117 (1)(7) and 2:119, *DCC*.

[917] The dual-class shares may consist of two A and B classes, and normally one class is issued to public shareholders, while the other is issued to founders and executives. The prior has limited voting rights and the latter ensures the control of founders and executives by granting more voting power.

[918] Loyalty shares reward long-term shareholders, who consistently hold their shares for a certain period, with extra voting rights. In the Netherlands, the DSM case focused on the dispute over whether a loyalty dividend breached the equality of shareholders. The Enterprise Chamber adhered to the equal treatment of shareholders. However, the Supreme Court overruled this view and held that a loyalty dividend is permissible as long as conditions are satisfied to guarantee the equal treatment of shareholders who are in the same position. Finally, the DSM did not follow up on its loyalty dividends in practice. See: Alessio Pacces, Loyalty shares in the Netherlands, report by Tom Vos at the ECGI Roundtable, available at https://ecgi.global/sites/default/files/events/ecgi_roundtable_report_on_loyalty_shares_by_tom_vos_0.pdf. Last visited February 2019.

[919] The depositary receipt is a mechanism whereby the company automatically deposits the voting rights of shares in a trust office. Corresponding to each deposited shares, a depository receipt will be issued on the exchange market. Hence, a depositary receipt holder loses his or her voting right, which will be exercised by the trust office, but still enjoys the right to a dividend. Nevertheless, a depository receipt holder may regain his or her voting right under conditions based on Article2: 118a, *DCC*.

[920] The priority share is a device which grants special voting privileges to management-friendly foundations in major decision-making, as well as in nominating or dismissing managing and monitoring directors.

[921] The preference share, which has the same voting right as the common share, can be sold to a friendly trust office or outside shareholders at a lower cost.

[922] Article 2:96a (1), *DCC*.

the right to convene a general meeting lies with the board of directors and the supervisory board.[923] Nevertheless, a shareholder, or several shareholders who solely or jointly hold at least one-tenth of the issued share capital, may be authorised by the provisional relief judge of the District Court to convene a general meeting.[924] Yet, if requirements of Article 2:108 or 2:108a are not met, namely at least one general meeting once a year or when a dramatic decrease in equity happens, then any shareholder may be authorised by the District Court to convene a meeting.[925] Besides, shareholder(s) who individually or collectively hold(s) at least 3% of the issued share capital is/are entitled to the right to put items on the agenda.[926] For a voidable resolution, a shareholder can submit a request to the District Court for its nullification.[927]

Last but not least, in takeovers, special attention has been paid to minority shareholders in several aspects, such as the mandatory bid rule and the sell-out right. More elaboration on this issue will be found in 5.4 of this chapter.

5.2.3 Analysis

The Dutch corporate governance system is built on the “stakeholder model”. Different from the shareholder model, in the stakeholder model the board of directors and the supervisory board are guided by the interests of the company and its undertaking.[928] In the same vein, shareholder interest is not the exclusive goal; instead, other stakeholders’ interests should also be deemed valuable. Distinctively, Dutch corporate law underscores employees’ interests.[929] These structural designs, to a certain extent, increase the impact of other stakeholders on Dutch listed companies.

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923 Article 2:109, *DCC*.

924 However, the application will be rejected by the relief judge if the applicant does not request the board of directors or the supervisory board in writing first. See: Article 2: 110, *DCC*.

925 Article 2:112, *DCC*.

926 Article 2:114a, *DCC*. In the *Boskalis* case, the disputed issue concerned a corporate strategy which should be decided by the board of directors. Thus, the court rejected the applicant’s claim based on the right to put an item on the company agenda. Exercising this right to put an item to vote, the item must fall within the discretion of the general meeting. For more discussion, see section 5.4.2

927 Article 2:15 (3)(a), *DCC*.

928 Articles 2:129 (5) and 2:140 (2), *DCC*. Principles 1.1 and 2.4 of the *DCGC* require that the board of directors and the supervisory board should make decisions based on long-term value, and also take into account the interests of stakeholders.

929 Article 2:144a (1) and 2:158 (6), *DCC*.

With the internationalisation of share ownership, increasing demand for strengthened shareholder powers emerged in the Netherlands. After the introduction of the euro in 1999, Dutch listed companies witnessed enormous growth in foreign shareholders. The proportion of foreign shareholders, the majority of which were US and UK investors, grew from 37% in 1995, to 75% in 2005,[930] to 70% in 2007,[931] to 72% in 2009,[932] to 76% (AEX companies) in 2010[933] and to 80% in 2016.[934] Responding to the pressure caused by foreign shareholders and directors, the *Tabaksblat Code* and the *Act on the change of the Structure Regime* granted more powers to shareholders in 2004, including but not limited to: the right to appoint and dismiss supervisors of companies under the structure regime, the right to put an item on the agenda (1% shareholding or more than EUR 50 million),[935] the veto right on major decisions and a simplified procedure surrounding the right to inquiry. In addition, the *Tabaksblat Code* restricted the use of takeover defences.[936]

This "shareholder-in-favour" direction did not last long, due to another prominent characteristic of the Dutch securities market, namely its dispersed ownership structure.[937] In 2009, the Netherlands was identified as the least concentrated country in Europe when it comes to ownership structure. Averagely, shareholders with 5% or more than 5% shareholdings collectively held 20.8% of the market capital in comparison with the European average of 35%.[938] This dispersed ownership, plus the prevalence of foreign shareholders,

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930 Supra. 619.
931 Richard G. J. Nowak, 'Corporate Boards in the Netherlands', in Paul Davies, Klaus J. Hopt, Richard Nowak and Gerard van Solinge (eds), *Corporate Boards in Law and Practice: A Comparative Analysis in Europe* (Great Britain: Oxford University Press, 2013), pp. 429-509.
932 Supra. 619, p. 281.
933 Supra. 619.
(the number of foreign directors in the biggest Dutch companies expanded to more than one-third in the same period. See: supra. 619, p. 281.
934 Eumedion's 2016 position paper has recorded that, averagely speaking, foreign investors hold more than 80% of shares of a Dutch listed company. See: Eumedion, "Position of Minority Shareholders in Companies with A Controlling Shareholder", available at http://www.eumedion.nl/en/public/knowledgenetwork/position-papers/2016-06-position-paper-minority-shareholders-final-version.pdf. Last visited February 2019.
935 This threshold had been amended in 2008.
936 Supra. 619, p.281.
937 However, it is important to be aware that, according to the 2016 Eumedion Position Paper, an increasing trend in concentrated ownership structures has been observed on the Dutch market in recent years. See: Eumedion, "Position of Minority Shareholders in Companies with A Controlling Shareholder", available at http://www.eumedion.nl/en/public/knowledgenetwork/position-papers/2016-06-position-paper-minority-shareholders-final-version.pdf. Last visited February 2019.
938 Supra. 874.

inevitably made Dutch listed companies more vulnerable to shareholder activism.[939] Companies such as Stork, ASMI and ABN AMRO[940] were a few examples of this aggressive shareholder "revolution", and so proactive proposals were announced in 2008 to restrain activist shareholders. Measures taken included but were not limited to: a reduction in the threshold of ownership disclosure from 5% to 3%, an increase in the threshold for the right to put an item on the agenda (from 1% to 3%) and relief from restrictions on takeover defences.[941]

Nevertheless, the latest change to the ownership structure of Dutch listed companies may create the possibility for more intensive shareholder engagement in the future. According to recent data, an ownership concentration trend has been established: until 27 June 2016, 29% Dutch AEX companies had a controlling shareholder with more than a 30% shareholding.[942] This appearance of stronger shareholders may align with the recent amendments made to both the *Shareholder Rights Directive* and the *Dutch Corporate Governance Code*. In order to strengthen "checks and balances" within a company, the former underlines "long-term shareholder engagement" and the latter calls for "fully-fledged shareholder participation".[943] Moreover, under the influence of EU Directives, numerous minority shareholder protection measures, especially in takeovers, have been incorporated into Dutch corporate law. To name a few, the *DCC* confirms the equal treatment of shareholders, the pre-emptive right, the right to put items on the agenda, the mandatory bid rule and the sell-out right. Considering the transformation from dispersed to relatively concentrated ownership structure, Dutch listed companies may provide an opportunity in the future to test whether or not shareholder engagement is positively related to corporate governance and minority shareholder protection.

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939 Supra. 874.

940 Companies such as Stork, ASMI and ABN AMRO were subjected to the hedge fund activism. See: supra. 874.

941 In implementing the *Thirteenth Directive*, the Netherlands made numerous reservations on provisions which would restrict the use of anti-takeover measures. See: supra. 619.

942 For more details, see: Eumedion, "Position of Minority Shareholders in Companies with a Controlling Shareholder", available at http://www.eumedion.nl/en/public/knowledgenetwork/position-papers/2016-06-position-paper-minority-shareholders-final-version.pdf. Last visited February 2019.

943 Principle 4.1, *DCGC*, version 8th December 2016.

Another distinctive characteristic is that shareholders are not entitled to the legal remedy of derivative actions in the Netherlands. Generally speaking, directors' fiduciary duty is considered a duty towards the company, and the company is the only claimant qualified to bring an action. Alternatively, Dutch law grants shareholders the right to request the Enterprise Chamber for an inquiry proceeding. If mismanagement has been confirmed, the Enterprise Chamber will make a declaratory judgment, which leaves the issue of damages and director liability to the District Court.[944]

In brief, despite the recent concentration trend, the Dutch securities market is traditionally a dispersed one. As far as the conflict between shareholders and management is concerned, a Dutch listed company's general meeting has less governing powers in comparison with the powers of its board. Moreover, Dutch corporate law allows legal instruments to deviate the one share, one vote rule. These instruments may encourage shareholder engagement under a dispersed ownership structure, but they may also raise the risk of minority shareholder expropriation, if abused. An inquiry proceeding is another weapon for shareholders to redress their agents' misbehaviours. However, if the Dutch market transforms into a concentrated one in the future, the existing conditions to exercise the right of inquiry may in many cases be too high for minority shareholders.

5.3 Minority shareholder protection through monitoring mechanisms in the Netherlands

The elaboration above has depicted a general picture of shareholder rights in the Netherlands. However, prescribing the rights of shareholders in legislation does not necessarily mean that these rights will receive full respect in practice. In fact, monitoring mechanisms have a high value in implementing such protection. Accordingly, this part will focus on two pillars, respectively, disclosure and supervision, and will illustrate how the law is prescribed in the Netherlands and what Dutch characteristics apply.

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[944] For more details, refer to 5.4 of this chapter.

5.3.1 Disclosure

Below, the discussion on disclosure rules will follow three steps: the first step will examine EU Directives and Regulations, the second step will focus on the *Dutch Financial Supervision Act* and the final step will illustrate the main characteristics of disclosure rules in the Netherlands.

5.3.1.1 Disclosure in EU Directives and Regulations

After the creation of the euro, the *IAS-regulation*[945] was promulgated by the European Union to govern the financial statements of listed companies alongside the International Financial Reporting Standards (hereinafter "IFRS").[946] The notion of disclosure can improve shareholder protection, increase shareholder confidence and ultimately achieve an effective securities market.[947] Such a notion has been affirmed on the EU level by a number of directives. To safeguard the right to information,[948] *Directive 2001/34*[949] demands sufficient and objective disclosure on entering the stock exchange[950] and a regular information flow for the full listing period.[951] Furthermore, disclosed documents should be sent to the competent authorities before publication.[952]

The *Prospectus Regulation*[953] pursues shareholder protection and market efficiency.[954] Based on the belief that information is the key factor for shareholder protection,[955] the *Directive* demands that the prospectus should be sufficient for shareholders to make informed assessments and full-knowledge decisions,[956] and the prospectus should cover essential

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945 Available at http://ec.europa.eu/finance/company-reporting/ias-regulation/index_en.htm. Last visited February 2019.
946 The Annual Accounts in the Netherlands: A Guide to Title 9 of the Netherlands Civil Code, available at http://www.iasplus.com/en/publications/netherlands/annual-accounts-2014. Last visited February 2019.
947 Recital (31), *Directive No. 2005/1*.
948 Recital (21), *Directive No. 2005/1*.
949 *Directive No. 2001/34*, O.J.EUR.COMM. (No.L184) 1 (2001), amended by *Directive No. 2005/1*, O.J.EUR.COMM. (No. L79) 9 (2005).
950 Recital (9), *Directive No. 2005/1*.
951 Recital (25), *Directive No. 2005/1*.
952 Recital (24), *Directive No. 2005/1*.
953 *Prospectus Regulation 2017/1129, repealing Directive No. 2003/71*, O.J.EUR.COMM. (No.L345) 64 (2003).
954 Recital (7), *Prospectus Regulation.*
955 Recital (3), *Prospectus Regulation*.
956 Recital (54), *Prospectus Regulation*.

characteristics and risks to issuers and the securities.[957] The prospectus should be published in "an easily analysable, concise and comprehensive form".[958] To assure this easy access, the prospectus' summary should use non-technical language and be limited to a certain length.[959] Moreover, competent authorities have the power to demand supplementary information and the disclosure of all material information, when it is essential to shareholders' interests.[960]

In addition, the *Transparency Directive*[961] calls for "accurate, comprehensive and timely" disclosure of information,[962] and it stresses particularly the periodical and ongoing disclosure of listed companies.[963] Specifically, the *Directive* demands the "annual financial report",[964] the "half-yearly financial report"[965] and the notification of major changes to shareholdings or voting rights.[966] The notification should include voting rights, controlled undertakings, shareholder identities as well as dates.[967] For minority shareholder protection, the *Directive* clarifies that the issuer is obliged to ensure the equal treatment of shareholders. To facilitate minority shareholders in the exercise of their rights, the issuer should disclose all relevant information regarding the shareholder meeting, proxy voting, dividends and the issuance of new shares.

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957 Recital (28) and Article 6, *Prospectus Regulation*.
958 Recital (27) and Article 6, *Prospectus Regulation*.
959 Recital (30) and Article 7, *Prospectus Regulation 2017/1129*, the maximum length of the summary is seven A4 pages and should be fewer than 15 risk factors.
960 Article 32, *Prospectus Regulation*.
961 *Directive No. 2004/109*, O.J.EUR.COMM. (No.L390) 38 (2004), amended by *Directive No. 2013/50*, O.J.EUR.COMM. (No.L294) 13 (2013).
962 Recital (1), *Transparency Directive*.
963 Article 1, *Transparency Directive*.
964 Article 4 of the *Transparency Directive* requires the publication of the annual financial report to be no later than four months after the end of the financial year. Moreover, the public shall have access to the annual report for at least 10 years. The annual financial report shall include audited financial statements, the management report and statements concerning the truthfulness and fairness of the financial statements and the management report.
965 Article 5 of the *Transparency Directive* requires the publication of the half-yearly financial report to be no later than three months after the end of the first six months of the financial year. And it shall be available for at least 10 years. The half-yearly financial report shall cover the condensed set of financial statements, an interim management report and statements concerning the truthfulness and fairness of the financial statements and the management report. In addition, Article 8 prescribes exemptions to Articles 4 and 5.
966 Articles 9 and 10 *Transparency Directive*, according to which thresholds such as 5%, 10%, 15%, 20%, 25%, 30%,50% and 75% will trigger the notification obligation.
967 Article 12 *Transparency Directive*, which also prescribes that the notification shall be conducted promptly, at latest within four trading days.

Moreover, disclosure through electronic means is highly recommended for a the better delivery of information to shareholders.[968]

Based on the above *Directives*, the EU legislator further promulgated the *Prospectus Regulation 2004*[969] with 19 Annexes, to provide more detailed guidance on the disclosure of the prospectus. The *Regulation* covers subjects such as format,[970] minimum information requirement,[971] incorporation by reference,[972] publication methods and the dissemination of advertisements.[973]

Last but not least, the *Directive No.2017/828,*[974] which amended the *Shareholder Rights Directive*, strongly highlights transparency as one of the two core solutions for better corporate governance. It underlines various issues, including but not limited to: heightened transparency of related-party transactions, disclosure of the remuneration matter, disclosure of the proxy advisor's voting and the transparency of institutional investors and asset managers.

5.3.1.2 Disclosure in the Netherlands

On the domestic law level, the majority of disclosure rules prescribed in the EU Directives have been implemented in the *Dutch Financial Supervision Act* (hereinafter "*FSA*", *Wet op het financieel toezicht*).[975] Section 5:2 of the *FSA* specifies that the publication of the prospectus is the precondition for a company to issue or trade shares on an exchange market.[976] This prospectus should include all necessary information, depending on the nature of the issuer and the issued securities, so that shareholders can make informed assessments.

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[968] Article 17, *Transparency Directive*.
[969] *Regulation No. 809/2004*,O.J.EUR.COMM. (No.L149) 3 (2004), amended by *Regulation No.759/2013*, O.J.EUR.COMM. (No.L213) 1 (2013).
[970] Article 25, *Prospectus Regulation*.
[971] Article 3, *Prospectus Regulation*.
[972] Article 28, *Prospectus Regulation*. The main advantage of the "incorporation by reference" mechanism is that it can lower the cost of the prospectus. In the meantime, the provision also makes suggestions on the protection of shareholders' information right. Article 28 (5) specifically clarifies that the application of the mechanism shall not degrade the comprehensibility and accessibility of the prospectus to shareholders.
[973] Article 1, *Prospectus Regulation*.
[974] *Directive No. 2017/828*, O.J.EUR.COMM.(No. L132) 1 (2017).
[975] The cited English version of the *Wet op het financieel toezicht* here refers to Warendorf Legislation Chapter 5.3 FSA, available at https://www.navigator.nl/document/id59f5ecc848fff312db7621678b5161a2?ctx=WKNL_CSL_1754. Last visited February 2019.
[976] Section 5:3 and 5:4 stipulate exemptions of Section 5:2, *FSA*.

Besides, the prospectus should be formulated in such a format that is comprehensible to a reasonable and diligent person.[977] In addition to the prospectus, the *FSA* requires the publication of annual financial reports[978] and semi-annual financial reports.[979] The annual financial report, which consists of the annual account, management report and a truth and fairness certificate, plays a vital role in updating shareholders on a regular basis. Moreover, the adoption of the annual account does not necessarily discharge directors or supervisory directors from their liabilities.[980] In other words, the general meeting can choose to adopt the annual account but reserve the ability to hold directors or supervisors liable at a later stage. Moreover, the *FSA* consistently updates shareholders through the notification obligation, if there is a change in voting rights, capital and major shareholdings, etc.[981]

To implement the *Transparency Directive*'s 2013 amendment, which attempts to lower the burden and to facilitate the disclosure of small and medium listed companies, the Dutch *FSA* has correspondingly gone through several changes. These changes include but are not limited to: the abolishment of the quarterly financial report requirement, the availability of both annual and semi-annual financial reports being prolonged from 5 to 10 years, the publication time limit for the semi-annual financial report extended to three months, changes to shareholdings or voting rights which have reached or crossed the thresholds of 3%, 5%, 10%, 15%, 20%, 25%, 30%, 40%, 50%, 60%, 75% or 95% having to be notified to the Dutch Authority for the Financial Markets (hereinafter "AFM") within four trading days and abolishing the notification obligation of an intended amendment to articles of association.[982]

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[977] Section 5:13, *FSA*.
[978] Section 5:25c, *FSA*.
[979] Section 5:25d, *FSA*.
[980] Article 2:101, *DCC*.
[981] Section 5:34, *FSA* an issuer's obligation to notify changes of capital, Section 5:35 an issuer's obligation to notify changes of voting rights, section 5:38 shareholders' obligation to notify changes in major holdings whenever a threshold is reached, section 5:48 a director or supervisor's obligation to notify changes to his or her shareholdings of the company.
[982] See: Amendments to the Transparency Directive implemented in the Netherlands, available at http://www.elexica.com/en/legal-topics/corporate-governance-and-compliance/30-amendments-to-the-transparency-directive-implemented-in-the-netherlands. Last visited February 2019.

5.3.1.3 Analysis

Disclosure rules in the Netherlands, to a large extent, are shaped by EU Directives, in particular the aforementioned *Prospectus Directive* and the *Transparency Directive*. Historically speaking, the issue of Dutch listed company disclosure was not in a leading position when compared with its European counterparts. Research has shown, for instance, that disclosure in the UK was more comprehensive than in the Netherlands, and this difference was notable.[983] The reasons behind this can be ascribed to the following. First, a permissive financial reporting framework which grants extensive freedom of accounting choices in the Netherlands.[984] Second, the prevalence of anti-takeover measures constrains the growth of the corporate control market in the Netherlands. As a matter of fact, it has been shown that an effective takeover market provides incentives for broader disclosure so that the market price can properly reflect the company value.[985] Without sufficient external supervision of the market, "private access" unsurprisingly becomes the main channel of information flow.[986]

However, thanks to the harmonisation of disclosure rules at the EU level, and the establishment of the official AFM supervision organ, disclosure in Dutch listed companies has been improved.[987] Before the establishment of the AFM in 2006, the supervision of financial reports was conducted by the Enterprise Chamber. Nevertheless, the Enterprise Chamber did not have the power to actively dig into a company's disclosure but could only base its investigation on the complaint of a party whose interest was related to the disclosure.[988]

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[983] Kees Camfferman and Terence E. Cooke, 'An Analysis of Disclosure in the Annual Reports of UK and Dutch Companies', 1 (2002) *Journal of International Accounting Research*, pp. 3-30.
Another research study found that Swedish listed companies had higher compliance levels with disclosure requirements than Dutch companies. However, the research's data also demonstrated that there was no significance difference in accounting compliance between the Netherlands and Sweden in 2008. See: Fredrik Hartwig, 'Swedish and Dutch Listed Companies' Compliance with IAS 36 paragraph 134', 12 (2015) *International Journal of Disclosure and Governance*, pp. 78-105.

[984] Ibid.

[985] This capital market difference has been regarded as one of the reasons why disclosure is better in the UK than in the Netherlands. See: Kees Camfferman and Terence E. Cooke, 'An Analysis of Disclosure in the Annual Reports of UK and Dutch Companies', 1 (2002) *Journal of International Accounting Research*, pp. 3-30.

[986] Ibid.

[987] Fredrik Hartwig, 'Swedish and Dutch Listed Companies' Compliance with IAS 36 paragraph 134', 12 (2015) *International Journal of Disclosure and Governance*, pp. 78-105.

[988] Different from the Netherlands, an active review system of financial reports was adopted in Sweden, consisting of several layers from the Monitoring Panel, the Stockholm Stock Exchange and ultimately the

Since 2006, the AFM has become the foremost supervision organ of the financial market. For example, in 2015, the AFM announced 52 formal enforcements and 575 informal enforcements.[989] More specifically, it is entitled to take diverse measures, varying from warnings, incremental penalty payments, administrative fines, the withdrawal or limitation of licences and referrals to the public prosecution service.[990] When looking at the prospectus liability, for example, the AFM plays a role in its public enforcement, namely by approving the prospectus before they can be published or distributed.[991] The AFM also has the power to impose a fine regarding any breach of prospectus obligations.[992] In addition to public enforcement, the private enforcement is also available in the Netherlands. Dutch law bases the prospectus liability on tort law[993] or unfair commercial practices[994] so that investors are entitled to bring a claim on the spreading of misleading information.[995]

5.3.2 Supervision

Supervision has traditionally taken place in the Netherlands through a two-tier board structure. It was not until 2013 that the *Dutch Civil Code* officially integrated the one-tier board structure. Within the concept of supervision, independence is deemed the key element for internal "checks and balances" and has a fundamental impact on shareholder protection. Focusing on the above issues, the analysis below will examine EU legislation as the first layer,

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Swedish Financial Supervisory Authority. This difference is considered one of the reasons why Swedish listed companies were more compliant than Dutch companies. However, the compliance levels of the Swedish and Dutch listed companies were found to be indistinguishable in 2008, which demonstrated convergence and learning. See: supra. 983.

989 The total amount of the 17 fine decisions was €9,616,250 in 2015. In 2014, the amount of 31 fine decisions was €7,327,287, and there were 106 formal enforcements and 417 informal enforcements. See: AFM Annual Report 2015, available at: https://www.afm.nl/~/profmedia/files/afm/jaarverslag/2015/samenvatting-jaarverslag-engelstalig.ashx. Last visited February 2019.

990 Other measures that can be taken by the AFM also cover instructive conversations, public warnings, notices and disciplinary complaints., available at: https://www.afm.nl/en/over-afm/werkzaamheden/maatregelen. Last visited February 2019.

991 Tomas Matthieu Christiaan Arons, *Cross-border Enforcement of Listed Companies' Duties to Inform* (The Netherlands: Kluwer Deventer, 2012), p.50.

992 Article 1:80, *FSA*.

993 Article 6:162, *DCC*.

994 Section6:3.3A, *DCC*.

995 Pursuant to Article 3:305a *DCC*, shareholders are able to bring a collective action. And after the declaratory judgment of the collective action, investors shall refer to individual proceedings for compensation. For more details, see 5.3.3 of this chapter.

and the *Dutch Corporate Governance Code* and the *Dutch Civil Code* as the second layer, and it will end with an analysis and evaluation of the issue of supervision in the Dutch context.

5.3.2.1 Supervision in EU recommendations

The monitoring mechanism of independent directors, as identified by the *Commission Recommendation on the Role of Non-Executive or Supervisory Directors of Listed Companies and on the Committees of the* (*Supervisory*) *Board* (hereinafter "*Recommendation 2005/162*"),[996] is seen as a key vehicle for the protection of shareholders and other stakeholders' interests.[997] Independent directors in dispersed and concentrated listed companies face different challenges.[998] In the case of dispersed companies, the issue is mainly about the accountability of management to shareholders. In the case of concentrated companies, the main issue is the protection of minority interests. Responding to these challenges, *Recommendation 2005/162* underlines two vital responsibilities of the supervisory board, namely to ensure the accurate disclosure of information and to evaluate and manage risks.[999] In particular, the *Recommendation* emphasises the importance of non-executive directors or supervisors in the daily monitoring of management and resolving conflicts of interest.[1000] Three areas have been marked as the highest potential conflicts of interest: nomination, remuneration and auditing.[1001] Correspondingly, three special committees have been established for enhanced supervision.[1002] These special committees are not exclusively composed of independent directors; instead they consist of a majority of independent non-executive directors or supervisors (with extra expertise requirements for the audit committee[1003]).[1004]

Likewise, there is no rigid proportion requirement of independent directors on the supervisory board, as long as this amount is sufficient.[1005] Concerning

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[996] *Recommendation No. 2005/162*,O.J.EUR.COMM. (No.L52) 51 (2005).
[997] Preamble (7), *Recommendation 2005/162*.
[998] Preamble (7), *Recommendation 2005/162*.
[999] Preamble (14), *Recommendation 2005/162*.
[1000] Preamble (3), *Recommendation 2005/162*.
[1001] Preamble (9), *Recommendation 2005/162*.
[1002] Article 5, *Recommendation 2005/162*.
[1003] Preamble (16), *Recommendation 2005/162*.
[1004] Annex I, Article 2.1 (2), 3.1 (2), and 4.1, *Recommendation 2005/162*.
[1005] Preamble (8) and Article 4, *Recommendation 2005/162*. However, Preamble (18) asserted that member states generally require a significant proportion of independent directors in their corporate governance codes.

“independence”, Article 13.1 precludes any relationship that may cause a conflict of interest, such as a connection with the company, the controlling shareholder or management. Additionally, Annex II provides detailed independence criteria.[1006] Even if all of these criteria are fulfilled on paper, the supervisory board should still have a final say on the independence issue, i.e. it has the power to reject a director based purely on substance.[1007] This provision reveals that more attention should be given to the essence instead of the form.[1008] Furthermore, *Recommendation 2005/162* discourages CEO duality unless safeguards have been prepared.[1009] The supervisory board is obliged to conduct an annual self-evaluation at both the macro level of the board and the micro level of board members and committees.[1010] Last but not least, member states are encouraged to implement the *Recommendation* through either “comply or explain” or domestic legislation.[1011]

In addition to *Recommendation 2005/162*, the Commission issued *Recommendation as Regards the Regime for the Remuneration of Directors of Listed Companies* (hereinafter “*Recommendation 2009/385*”)[1012] in 2009. To address problems such as the prioritisation of short-term interests and excessive remuneration,[1013] *Recommendation 2009/385* underlines long-term sustainability and performance-based remuneration policy.[1014] Specifically, share options are forbidden as remuneration for non-executive directors or supervisors, due to the consideration of independence.[1015] The remuneration

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[1006] Namely, a non-executive director or supervisor shall not have been an executive or managing director of the company in the previous five years, shall not have been an employee of the company in the previous three years, shall not have received an excessive amount of additional remuneration from the company, shall not be related to the controlling shareholder, shall not have had a material business relationship with the company in the previous year, shall not have been related to the current or former external auditor within the past three years, shall not be linked to executive directors or supervisors, due to his or her participation in another company, shall not be employed as a non-executive director or a supervisor by the company for more than three terms, shall not have a close family relationship with an executive or managing director.

[1007] Article 13.2, *Recommendation 2005/162*.

[1008] Annex II.1, *Recommendation 2005/162*.

[1009] The CEO and the chairman of the supervisory board or the one-tier board are encouraged to be separated, or the conflicts of interest has been cleared following a certain amount of time. See: Article 3.2, *Recommendation 2005/162*.

[1010] Article 8, *Recommendation 2005/162*.

[1011] Preamble (4) and Article 1.1, *Recommendation 2005/162*. Article 1.2 further commands that “comply or explain” be conducted annually.

[1012] *Recommendation No. 2009/385*,O.J.EUR.COMM. (No. L120) 28 (2009).

[1013] Preamble (2), *Recommendation 2009/385*.

[1014] Preamble (6), *Recommendation 2009/385*.

[1015] Article 4.4, *Recommendation 2009/385*.

committee should have at least one expert in remuneration policy,[1016] should conduct a regular review of executive or managing directors' remuneration based on the proportionality[1017] standard,[1018] should report its performance and be present at the annual shareholder meeting.[1019] Particularly, institutional investors are encouraged to actively hold the board accountable to shareholders regarding remuneration issues.[1020]

5.3.2.2 Supervision in the Netherlands

Historically speaking, Dutch listed companies have followed the two-tier board structure. However, since 2013, the one-tier board structure has also become possible in the Netherlands.[1021] The *DCC* provides various provisions to regulate the supervisory board, clarifying that supervision and advice are its two main responsibilities.[1022] For certain resolutions made by the board of directors in a structure regime, the *DCC* requires the approval of the supervisory board.[1023] The *DCC* also clarifies that a person who serves as a supervisor or non-executive director for five or more than five legal persons is regarded as unqualified for a supervisory position in a non-small or medium listed company.[1024] Furthermore, the *DCC* affirms the role of the works council. Generally speaking, the proposal to appoint, suspend or dismiss a supervisor or non-executive director should first be submitted to the works council. After the works council gives its opinion, the proposal, together with the viewpoint of the works council, can be presented to the general meeting for a decision.[1025]

1016 Preamble (11) and Article 7.1, *Recommendation 2009/385*.
1017 Article 9.3, *Recommendation 2009/385*.
1018 Article 8.1, *Recommendation 2009/385*.
1019 Article 9.4, *Recommendation 2009/385*.
1020 Preamble (10), *Recommendation 2009/385*.
1021 Corresponding to this change, supervision in Dutch listed companies can be divided into four categories, namely supervisors on two-tier boards, supervisors on two-tier boards under the structure regime, non-executive directors on a one-tier board and non-executive directors on a one-tier board under the structure regime. Articles 2:129a and 2:164a, *DCC* and Principle 5.1, *DCGC*.
1022 Article 2:140 (2), *DCC*.
1023 Article 2:164 of the *DCC* specifies 12 different resolutions covering issues such as the issuance and acquisition of shares or debentures; collaboration regarding the issuance of depository receipts; admissions of shares, debentures, depository receipts to a regulated market, the start or termination of a long-lasting alliance, the acquisition of a participating interest (no less than one-quarter of the nominal value of the share capital and reserves), and investment of no less than one-quarter of the nominal amount of share capital and reserves, amendments to articles of association, dissolution of the company, bankruptcy, termination of the contracts of a substantial amount of employees, a significant change in employment conditions that involves a substantial amount of employees and a decrease in share capital.
1024 Article 2:142a, *DCC.*
1025 Article 2:144a (1), *DCC*.

For a company under the structure regime, the works council enjoys the extra power to recommend one-third of the supervisory board.[1026] A supervisor or non-executive director of a company under the structure regime should not have an employment relationship with the company or its dependent company, and he or she should not be a director or employee of the labour union constantly involved in the employment of the company or its dependent company.[1027]

In addition to the *DCC*, the *Dutch Corporate Governance Code* (hereinafter "*DCGC*") is another important piece of legislation regulating internal supervision in Dutch listed companies.[1028] In 1996, the first corporate governance committee, the Peters Committee, was established in the Netherlands. In order to tackle issues such as transparency, accountability and shareholder control, the Peters Committee issued 40 Recommendations in 1997, which can be considered as the antecedent of the *DCGC*.[1029] In 2003, the Tabaksblat Committee published the first official *DCGC*, which was revised by the Frijns Committee in 2008.[1030] The latest amendment of the *DCGC* was published in December 2016.[1031] The *DCGC* focuses on coordinating the relationship between the board of directors, the supervisory board and shareholders.[1032] It provides detailed board standards and elaborates on independence issues.[1033] The *DCGC* implements the "comply or explain" approach prescribed in the *EU Recommendations* by demanding a listed company explains any non-compliance to the *DCGC*, either in a separate chapter of its management report or on its website.[1034] The board of directors and the supervisory board are held accountable to shareholders concerning

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[1026] Article 2:158 (6), *DCC*.
[1027] Article 2:160, *DCC*
[1028] The *Dutch Corporate Governance Code* mentioned in this chapter is based on the latest 2016 amendment, available at http://www.mccg.nl/?page=4738. Last visited February 2019.
[1029] More information available at http://www.commissiecorporategovernance.nl/commissie-peters. Last visited February 2019.
[1030] More information available at http://www.commissiecorporategovernance.nl/dutch-corporate-governance-code. Last visited February 2019.
[1031] The revised *Dutch Corporate Governance Code* 2016, available at http://www.commissiecorporategovernance.nl/download/?id=3367. Last visited February 2019.
[1032] Preamble: contents of the code, *DCGC*.
[1033] Stefan C. Peij, Pieter-Jan Bezemer and Gregory F. Maassen, 'The Effectiveness of Supervisory Boards: An Exploratory Study of Challenges in Dutch Boardroom', 7 (2012) *International Journal of Business Governance and Ethics*, pp. 191-208.
[1034] Preamble: compliance with the code, *DCGC*.

the compliance of the *DCGC*, and they are required to support any deviation from the Code with a “substantive and transparent” explanation.[1035]

In the Netherlands, independence is determined through the exclusion of dependence. The section on Best Practice Provisions 2.1.8 *DCGC* lists seven “dependence criteria”: a supervisor or non-executive director[1036] i) who has had an employment relationship with the company in the past five years; ii) who receives additional “out-of-business” compensation from the company;[1037] iii) who had a substantial business relationship with the company in the previous year; iv) who has a conflict of interest, due to cross-board membership in another company; v) who has played a temporary management role in the company in the past 12 months; vi) who has at least a 10% shareholding in the company and vii) who has board service or a representation relationship with another legal entity which has at least a 10% shareholding in the company.

In addition, Best Practice Provisions 2.1.7 *DCGC* states that the supervisory board can have a maximum one non-independent director, as prescribed in i) to v) of 2.1.8; the number of non-independent directors as prescribed in 2.1.8 should be less than half and each shareholder or shareholders who directly or indirectly own(s) a shareholding of more than 10% can have a maximum one non-independent director as prescribed in vi) to vii) of 2.1.8 to represent his/her or their interests. This provision also applies to non-executive directors in one-tier board structures.

Moreover, shares or rights to shares may not be used as a form of remuneration for supervisors or non-executive directors in the Netherlands.[1038] A Dutch company in general is not allowed to provide any personal loans, guarantees or anything similar to its supervisors or non-executive directors.[1039] For a supervisory board which has more than four members, three special

[1035] The explanation should include: details on the departure, reasons for the departure, intention to comply in the future and alternative measures taken. See: Preamble: compliance with the code, *DCGC*.
[1036] Including his or her wife/ husband, registered partner, other companion, foster child, relative by blood or marriage up to the second degree.
[1037] The “company” mentioned in this section includes its associated companies.
[1038] Best Practice Provisions 3.3.2, *DCGC*.
[1039] Best Practice Provisions 2.7.6, *DCGC*. The exception of this article requires two preconditions, namely under normal business and with the approval of the supervisory board.

committees[1040] (the audit committee,[1041] the remuneration committee and the selection and appointment committee) should be established.[1042] The diversity of the board, such as gender and age, is another element to be considered in the Netherlands.[1043]

Lastly, the supervisory board can decide how to resolve a conflict of interest transaction between the company and its directors, supervisors or major shareholders.[1044] *DCC* Art. 2:129 states that a director should not participate in the deliberation and decision-making if such a director has conflicts of interest with the company and its connected business; if a management decision can not be made due to this reason, then the supervisory board will make such a decision.[1045] The *DCGC* also confirms the supervisory boards' role in resolving conflicts of interest transactions. For a transaction which causes a (potential) conflict of interest[1046] between the company and a supervisor or director, the supervisor or director is obliged to make an immediate report,[1047] and the resolution to enter the transaction should be approved by the supervisory board[1048] (the supervisor who has a direct or indirect interest should be excluded from the decision-making).[1049] Likewise, for a material conflict of interest transaction between the company and a major shareholder who owns at least 10% of the shares, the approval of the supervisory board is necessary.[1050]

[1040] Best Practice Provisions 2.3.4, *DCGC* prescribes that independent directors should account for more than half of the committee. Furthermore, the chairman of the supervisory board or a former director of the board of directors should not chair the remuneration or audit committee

[1041] Best Practice Provisions 2.1.4, *DCGC* requires the audit committee has at least one financial expert.

[1042] Principle 2.3.2, *DCGC*.

[1043] Principle 2.1.5, *DCGC*.

[1044] Principle 2.7, *DCGC*. *DCC* Article 2:129 (6) also prescribed that the supervisory board has the power to pass a resolution which involves any conflict of interest between a director and the company.

[1045] In the absence of the supervisory board, the general meeting will make the decision unless the articles of association prescribe otherwise.

[1046] According to Best Practice Provisions 2.7.3, *DCGC*, it refers to a transaction between the company and a legal entity in which a supervisor or director owns a substantial financial interest, a director or supervisor who has a family relationship with a supervisor or a director of the company.

[1047] Best Practice Provisions 2.7.3, *DCGC*.

[1048] Best Practice Provisions 2.7.4, *DCGC*, according to which such a transaction should be disclosed in the management report.

[1049] Article 2:140 (5), *DCC*.

[1050] Best Practice Provisions 2.7.5, *DCGC.*

5.3.2.3 Analysis

According to Dutch law, supervisors and non-executive directors should be independent from directors and executive directors.[1051] Moreover, the supervision body is designed to consider genuinely the interests of all stakeholders, without being too vulnerable to the general meeting.[1052] Representatives of shareholders who individually or jointly own(s) more than 10% shares is/are considered “non-independent” according to 2.1.8 *DCGC*. However, shareholder representatives are not strictly forbidden based on 2.1.7 *DCGC*. Shares or rights to shares may not be awarded as remuneration for supervisors or non-executive directors pursuant to 3.3.2 *DCGC*, but 3.3.3 *DCGC* permits supervisors or non-executive directors to hold shares of the company as long as they are long-term shareholders. All of these provisions converge into a “Dutch” definition of independence as independence from major shareholders. Meanwhile, in order to encourage shareholder engagement, the *DCGC* allows non-independent shareholder representatives on the supervisory board or the one-tier board, if other conditions are satisfied. Accordingly, it could be argued that the concept of independence in the Netherlands implies independence from management and semi-independence from major shareholders.

Scholars have examined the differences between one-tier and two-tier board models in the Netherlands. One big division concerns differences between non-executive directors and supervisors. The core of the division between the one-tier and two-tier models can be summarised by the following question: is it good practice to allow monitors to be involved in decision-making?[1053] In other words, the biggest difference between non-executive directors and supervisors is that on the one-tier board, non-executive directors play the double role of managing directors and monitoring directors, while on the two-tier board, supervisors play a solo monitoring role.[1054] Another main difference relates to access to information, which concerns both content and timing. Non-executive directors, as part of the managing board, are able to

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[1051] Best Practice Provisions 2.1.8, *DCGC.*

[1052] Nicolaas Johannes Mattheus van Zijl, *The Importance of Board Independence-A Multidisciplinary Approach* (The Netherlands: Kluwer Deventer, 2012), p. 239.

[1053] Pieter-Jan Bezemer, Stefan Peij, Laura de Kruijs and Gregory Maassen, ‘How Two-Tier Boards Can Be More Effective’, 14 (2014) *Corporate Governance: The International Journal of Business In Society*, pp. 15-31.

[1054] Supra. 619.

access insider information and obtain information faster than their counterparts in the two-tier system. In contrast, supervisors' information right, in most circumstances, passively relies on the disclosure of the board of directors.[1055] Furthermore, regarding issues that require the supervision body's approval, the two-tier board merely asks for a simple majority of its supervisory board to accept or reject the management board's resolution. In the meantime, non-executive directors' opinions only count if they can outweigh executive directors by voting.[1056] Grounded on distinctions between the two board structures, some scholars have posited that non-executive directors are burdened with more liability than supervisors,[1057] and supervisors on a two-tier board are more independent than non-executive directors on a one-tier board.[1058]

Despite the differences between these two board models, some research has shown that there is no substantial distinction between one-tier and two-tier boards in practice.[1059] As a matter of fact, the newly imported one-tier board

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[1055] Supra. 619, p. 371.

[1056] Supra. 619, p. 338.

In addition, a more detailed discussion demonstrated that differences between supervisors and non-executive directors can be found in areas: involvement in decisions, veto on major decisions, giving instructions to executive directors, extra powers, co-management, chairman, more information and at an early stage, representing the company, knowledge attribution, representation in case of a conflicting interest, legal person as a director, calling meetings, appointments, remuneration, structure regime and committee membership. See: supra 619, pp. 338-342.

[1057] On the one hand, it has been claimed that non-executive directors are facing increased liability, due to their extra role as managing directors and the joint and several liabilities rule. See: supra. 626, pp. 310 and 404. See also: Maarten Muller (ed.), *Corporate Law in the Netherlands* (The Netherlands: Kluwer Law International, 2013), p. 153. On the other hand, the opposite opinion argued that case law has demonstrated that the adoption of the one-tier board does not increase non-executive directors' liability: a director is held liable only in the case of serious personal blame, and the liability is found on the case-by-case analysis; there is clearly a distinction between non-executive and executive directors in the legislation and in situations where directors have been found accountable, more than often, supervisors are also responsible for failing in their monitoring role. See: supra. 619, pp. 404-405.

[1058] Supra. 619, p. 371.

[1059] Dirk Jan Zom's article, published in 2017, pointed out that the differences between the one-tier and two-tier boards are getting smaller in practice. See: Dirk Jan Zom, One-tier model niet populair: 'Onbekend maarkt onbemind', available at: https://cfo.nl/artikel/onetier-board-niet-populair-onbekend-maakt-onbemind Last visited February 2019.

The 2010 data on average numbers of board meetings in AEX and AMX Dutch listed companies showed: on average, 10.7 supervisory board meetings (8.8 with the board of directors) for the two-tier board, and 10.6 board meetings on average (8.6 with executive directors) for the one-tier board. See: Nicolaas Johannes Mattheus van Zijl, *The Importance of Board Independence-A Multidisciplinary Approach* (The Netherlands: Kluwer Deventer, 2012), p. 218.

See also: supra. 874.

may not solve problems that have been faced by the two-tier board.[1060] Regardless of the board model, the issue of Dutch company supervision still faces diverse challenges, such as information asymmetry,[1061] dominant CEOs and ineffective board interactions.[1062] As a result, scholars have pointed out that boardroom problems go beyond the simple one-tier or two-tier alternatives.[1063] The current legal and economic regulatory approach attempts to improve board efficiency through reforms, such as increasing the independence of monitoring directors, rejecting CEO duality and creating special committees.[1064] However, the *DCGC*, as an example, has been criticised for its "checking-the-box" proposition in assessing independence, which lists seven specific dependent relationships, without giving the supervisory board the power to make a substantial judgment.[1065] This exclusive focus on technical requirements would deny the essence of the board as a social and organisational entity, in which the interaction of members plays a big role in its success.[1066] Consequently, academics have called for more "internally-driven initiatives"[1067] as a supplement to "externally-driven measures".[1068] The regular board evaluation has been individuated by some as another useful tool that should be encouraged.[1069]

[1060] In total, 78.7% of the non-executive director interviewees had doubts about the argument that a one-tier board can solve existing problems. See: Pieter-Jan Bezemer, Stefan Peij, Laura de Kruijs and Gregory Maassen, 'How Two-Tier Boards Can Be More Effective', 14 (2014) *Corporate Governance: The International Journal of Business in Society*, pp. 15-31.
[1061] Information asymmetry between managing directors and monitoring directors is apparent in two ways: one is the lack of substantial information, and the other is overloading of useless information. This information deficiency has negatively influenced monitoring directors' ability to ask compelling questions of management. See: ibid.
[1062] The relationship between monitoring directors and managing directors is vital to communication, decision-making and group interactions. See: ibid.
[1063] Ibid.
[1064] Ibid.
[1065] Nicolaas Johannes Mattheus van Zijl, *The Importance of Board Independence-A Multidisciplinary Approach* (The Netherlands: Kluwer Deventer, 2012), p. 235.
[1066] Jaap Winter and Erik van de Loo, 'Board on Task Towards a Comprehensive Understanding of Board Performance', in Massimo Belcredi and Guido Ferrarini (eds.), *Boards and Shareholders in European Listed Companies* (Cambridge: Cambridge University Press, 2013), pp. 225-250.
[1067] For example, the role of the chairman was highlighted in facilitating communication with the CEO, lowering the cost of task processing within or outside the boardroom as well as problem-solving. See: supra. 1060.
[1068] Ibid.
[1069] Supra. 1066, pp. 225-250. And supra. 1060.

5.4 Minority shareholder protection in takeovers: especially by courts

This final part of this chapter will examine the issue of minority protection by Dutch courts in takeovers. It will review what special takeover protection has been granted to minority shareholders by Dutch legislation, and it will discuss how the Dutch judiciary adjudicates in these transactions.

5.4.1 Special protection for minority shareholders in takeovers

Merger resolutions

In order to protect minority shareholders in legal mergers, a supermajority rule has been set in Dutch law. Article 2:330 *DCC* prescribes that a two-thirds supermajority is required for the general meeting to pass a merger resolution, if shareholders who are present at the meeting represent less than half of the issued capital. Pursuant to Article 2:331 *DCC*, the board of directors of the acquiring company can decide on a merger. The precondition for such a resolution is that the company has disclosed the issue in the inspection announcement of the merger proposal. However, within one month after the board of directors' announcement of a legal merger resolution, shareholder(s) who individually or collectively hold at least one-twentieth of the issued share capital may request the board to convene a general meeting, to decide on the issue. In addition, according to article 2:325 *DCC*, a cash-out merger is not possible.[1070]

Mandatory bid rule

To protect better minority shareholders' interests in takeovers, a "mandatory bid rule" has been implemented in the Netherlands. Such a rule imposes the obligation to issue a public bid for all remaining shares of the target company at a fair price, once the acquirer, individually or jointly, has acquired 30% of voting rights in a Dutch listed company.[1071] Moreover, the Enterprise Chamber

[1070] Article 2:325, *DCC* limits the amount of shares that can be traded on a cash basis in a merger, namely the total joint amount should not be more than one-tenth of the nominal amount of shares.
[1071] Article 5:70, *Financial Supervision Act*.

has the authority to enforce such an obligation based on the request of the target company.[1072]

Sell-out right

Article 2:359d *DCC* grants minority shareholders the “sell-out right” to sell all remaining shares at a fair price fixed by the court, if the acquirer possesses at least 95% of the issued share capital and voting rights of the target company after the public bid.[1073]

Squeeze-out

Two statutory squeeze-out proceedings exist in the Netherlands: one is the general squeeze-out proceeding and the other is the special squeeze-out proceeding following a public offer.[1074] Both proceedings share the same threshold of 95%, but the general squeeze-out may be denied by the court in three specific circumstances,[1075] while the special squeeze-out must be enforced within three months after the termination of the tender offer.[1076] Moreover, the Enterprise Chamber will rule on the claim and determine a fair price in cash for the squeeze-out. However, in practice, a lower threshold of 80% is common through a pre-wired freeze-out.[1077]

[1072] For more details, see: https://www.afm.nl/en/professionals/doelgroepen/effectenuitgevende-ondernemingen/openbare-biedingen/proces. Last visited February 2019.

[1073] Corresponding to minority shareholders’ “sell-out right”, the acquirer also enjoys the “squeeze-out right” in Article 2:359c, *DCC*, according to which an acquirer who obtains at least 95% share capital and voting rights of the target company is entitled to request a forced transfer of shares to squeeze out all remaining minority shareholders at a fair price fixed by the court. In addition, both the squeeze-out right and the sell-out right shall be exercised within three months following the public bid.

[1074] Duco de Boer, The Netherlands Squeeze-out Guide IBA Corporate and M&A Law Committee 2014, available at https://www.ibanet.org/Document/Default.aspx?DocumentUid=46B885F0-82CC-43AE-BCE1-779CF5F62535. Last visited February 2019.

[1075] Article 2:92a, *DCC* prescribes the buy-out of minority shareholders, i.e. a shareholder who owns at least 95% of the share capital may file a claim to demand other shareholders transfer their shares at a fair price confirmed by the court. However, the court will reject such a claim if it causes tremendous loss for a shareholder, or if it damages a shareholder’s control privilege granted by the preferred shares or if the plaintiff has previously waived the right to file such a claim against one of the shareholders.

[1076] Article 2:359c, *DCC* prescribes that the acquirer who owns at least 95% of the issued capital and at least 95% of the voting rights of the target company after a public bid has the right to file a legal claim within three months, to squeeze out the remaining shareholders.

[1077] A pre-wired freeze-out refers to a transaction in which the bidder intends to circumvent additional procedural requirements by negotiating beforehand with the board of directors of the target company about the post-acquisition freeze-out. Furthermore, this post-acquisition freeze-out will be submitted to the general meeting for approval, before the takeover ends. See: Tom Vos, ‘Baby, it’s Cold Outside-A Comparative and

Appraisal right

Article 330a of the *DCC* prescribes that if the acquiring company is not a private company, dissenting holders of non-profit shares or holders of non-voting shares may submit a written request to the company for compensation. This compensation will be determined by one or more independent experts, unless the articles of association prescribe otherwise. Meanwhile, Article 330a does not apply in a cross-border merger. According to Article 333h, dissant shareholders or holders of non-voting shares of the disappearing company in a cross-border merger may request for compensation within one month after the merger decision.

5.4.2 Judicial protection in takeovers

Mergers and acquisitions in the Netherlands are normally conducted through legal mergers or public offers.[1078] Judging from the steps in a transaction, they can be categorised as one-step mergers or two-step mergers.[1079]

In the *Versatel* case,[1080] Tele 2 announced in its offer document that should the takeover bid fail to reach the 95% threshold, it would conduct a triangular merger as a freeze-out method, in order to thin out the remaining minority shareholders. The Enterprise Chamber affirmed the legislative purpose of the squeeze-out provision prescribed in Art. 2:92a *DCC*, which serves the interests of the majority shareholder. The Supreme Court confirmed the ruling of the Enterprise Chamber by acknowledging that a triangular merger, if properly used, could in fact serve as a means to squeeze out minority shareholders. However, the Supreme Court also clarified that if a merger is used for no other reason but to freeze out minority shareholders, it may violate the reasonableness and fairness standard. In *Shell*,[1081] another relevant case, the

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Economic Analysis of Freeze-outs of Minority Shareholders', 15 (2018) *European Company and Financial Law Review*, pp. 148-196.

[1078] Public offers can be full offers (100%), partial offers (<30%) or tender offers (<30%, considerations individually determined). See: https://content.next.westlaw.com/Document/I2ef128e71ed511e38578f7ccc38dcbee/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&bhcp=1. Last visited February 2019. Full offers are more common than partial and tender offers in the Dutch practice. See: https://gettingthedealthrough.com/area/112/jurisdiction/17/public-m-a-netherlands/. Last visited February 2019.

[1079] Two-step mergers are normally structured as a public offer followed by a merger.

[1080] Supreme Court 14 September 2007, ECLI:NL:HR:2007:BA4117, *JOR* 2007/237,*Centaurus/Versatel I*).

[1081] Enterprise Chamber 20 December 2007, ECLI:NL:GHAMS:2007:BC0800, *JOR* 2008/36 (*Trafalgar/Shell*).

dispute concerned a legal merger which forced minority shareholders of the target company to exit with only payment in cash. Based on Article 2:8 *DCC*, the Enterprise Chamber held the opinion that such a legal merger, designed for the exclusive purpose of squeezing out minority shareholders by cash and circumventing the statutory squeeze-out procedure as prescribed in Article 2:92a *DCC*, constituted misuse and breached the reasonableness and fairness standard. These two rulings imply a "purpose" test adopted by the Dutch judiciary, namely that a merger should not solely pursue the purpose of squeezing out minority shareholders; otherwise, it may be found in violation of Article 2:8 *DCC*.[1082]

The intention to protect minority shareholders' interests is also illustrated by other *Versatel* decisions made by the Enterprise Chamber. In the case,[1083] after a successful public offer, Tele 2 became the controlling shareholder of Versatel. In a subsequent merger, Tele 2 intended to squeeze out minority shareholders of Versatel. To achieve this goal, Tele 2 attempted to use its controlling position to replace three out of four members of Versatel's supervisory board with its own executive directors. It also planned to pass a corporate policy that would allow "interested" supervisors to vote on the squeeze-out merger. The Enterprise Chamber believed that such a non-independent supervisory board, which was dominated by the controlling shareholder, would greatly harm minority shareholders' interests. To correct the conflicts of interest, the Enterprise Chamber took a provisional measure to appoint three independent supervisors with full authority over the squeeze-out merger.[1084] Subsequently, Tele 2 and Versatel considered speeding up the squeeze-out merger by proposing a share structure plan, which, it was claimed, would protect minority shareholders after the merger. The supervisory board passed this proposal. Thus, Versatel's minority shareholders brought a claim requesting the Enterprise Chamber to reject the merger. The Enterprise Chamber ruled that there was no sufficient justification for the share structure proposed by Tele 2 and Versatel. Furthermore, a general description of the merger conditions should have been provided to

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[1082] Tom Vos, 'Baby, it's Cold Outside – A Comparative and Economic Analysis of Freeze-outs of Minority Shareholders', 15 (2018) *European Company and Financial Law Review*, pp. 148-196.
[1083] Enterprise Chamber 14 December 2005, ECLI:NL:GHAMS:2005:AU8151, *JOR* 2006.
[1084] Maarten J. Kroeze, 'The Companies and Business Court as a Specialized Court,' available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=976277. Last visited February 2019.
And supra. 874.

minority shareholders before the completion of the merger. In the case at hand, the controlling shareholder's behaviour, in squeezing out minority shareholders without proper information, had breached the "reasonableness and fairness" requirement in Article 2:8 *DCC*.[1085] Accordingly, besides the purpose test, the Dutch court intends to safeguard minority interests in mergers by emphasising elements such as independence and transparency.

In addition, the Dutch court has demonstrated a lenient attitude towards takeover defences and often deferred to board authority. In *RNA v. Westfield*, for instance, after obtaining 23.9% of RNA's shares, Westfield attempted to interfere with the composition of RNA's board of directors. As a response, RNA adopted several defensive measures. In reviewing the case, the Dutch Supreme Court justified defensive measures through three conditions: first, that the measures were taken to create a certain space for further consultation, second, that the temporary measures were necessary to sustain the status quo of the company, and to shield the continuity of the company from substantial changes before deliberation, and finally, that the measures were adequate and proportional to the impending threat.[1086]

In the *Boskalis* case, Boskalis held more than 20% of shares in Fugro NV, a Dutch listed company. Fugro adopted three takeover defences: the first was conducted through the device of depository receipts, and the other two were in the form of preference shares. In response, Boskalis particularly considered the defence device, which enabled two subsidiaries of Fugro to issue preference shares, as disproportionate. On 18th February 2015, Boskalis exercised the right to put items on the agenda so that Fugro must incorporate the decommissioning of the "subsidiaries" defence into the next general meeting. However, this request was rejected by Fugro. Subsequently, Boskalis brought a claim to The Hague district court to request a provisional measure to force Fugro to include the "subsidiaries" defence in the agenda. The court ruled against the claim of Boskalis based on the opinion that the right to put an item on the agenda prescribed in Article 2:114a *DCC* does not cover a corporate strategy issue that exclusively belongs to the discretion of the board

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[1085] Maarten J. Kroeze, 'The Companies and Business Court as a Specialized Court', available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=976277. Last visited February 2019.
[1086] For more details, see: https://www.studytubelaw.nl/nl/arresten/788-rna-westfield. Last visited February 2019.
Marcel C. A. Nieuwenhuijzen (ed.), *Financial Law in the Netherlands* (The Netherlands: Kluwer Law International, 2010), p. 215.

of directors.[1087] The Court of Appeal and the Dutch Supreme Court upheld the decision of the court.[1088]

In another case, ABN AMRO was negotiating a merger proposal with Barclays. Meanwhile, the RBS Consortium expressed its willingness to takeover LaSalle, which was a valuable division of ABN AMRO on the US market. Subsequently, the VEB[1089] communicated its opinion to the board that the RBS Consortium offer was better than that of Barclays. Consequently, ABN AMRO agreed to enter into negotiation with the RBS Consortium during an exclusionary period. Surprisingly, ABN AMRO sold LaSalle to Bank of America, before the end of the exclusionary period set up with the RBS Consortium. This decision to sell LaSalle without the approval of the general meeting of ABN AMRO profoundly offended shareholders. The VEB filed an inquiry proceeding request to the Enterprise Chamber, claiming that the sale of LaSalle had constituted a crown jewel defence, which aimed to hinder the takeover bid made by the RBS Consortium. Hence, it requested the Enterprise Chamber take provisional measures to stop the sale of LaSalle unless shareholders' voting rights were being respected. The Enterprise Chamber held that the sale of LaSalle was connected to the merger between ABN AMRO and Barclays, and thus it supported the claim of prior shareholder approval and asserted that the board was obliged to maximise shareholder returns if the company was "up for sale".[1090] The case was subsequently submitted to the Dutch Supreme Court. Referring to Dutch legislation and the articles of incorporation, the Supreme Court held that the board was not obliged to seek shareholders' approval; rather, the board should be guided by the interests of the whole company instead of those of shareholders alone. In addition, the Supreme Court emphasised the concept of "legal certainty" and the authenticity of written law. Specifically, expanding the power of shareholders as claimed by the applicant goes against the consistency of Article 2:107 (a) *DCC*, which lists issues that require shareholder approval. In the end, the Supreme Court rejected the

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[1087] Case C/09/484302/KG ZA 15-310, March 17, 2015. See: Cees de Groot, Shareholders' Rights to Have an Item Put on the Agenda of the General Meeting, available at http://leidenlawblog.nl/articles/shareholders-rights-to-have-an-item-put-on-the-agenda-of-the-general-meetin. Last visited February 2019.

[1088] Supreme Court 20 April 2018, ECLI:NL:HR:2018:652.

[1089] VEB is the Dutch Shareholders' Association, which serves as a main information source for shareholders and also represents those seeking to pursue collective redress by filing VEB actions. More details see: https://www.veb.net/over-de-veb-menu/about-the-veb. Last visited February 2019.

[1090] Danielle Quinn, 'Dutch Treat: Netherlands Judiciary Only Goes Halfway Towards Adopting Delaware Trilogy in Takeover Context', 41 (2008) *Vanderbilt Journal of Transnational Law*, pp. 1211-1249.

judgment of the Enterprise Chamber and ruled in favour of the board instead. It has been claimed that this judgment, again, affirmed the Dutch "stakeholder model" and unveiled the Supreme Court's unwillingness to expand shareholder power at the expense of other stakeholders.[1091]

Following the ABN case, minority (activist) shareholders of ASMI Company filed an inquiry proceeding request before the Enterprise Chamber concerning company strategy. The Enterprise Chamber ruled in favour of the shareholders on grounds that the board of directors excluded minority shareholders from participating in setting company strategy, and the supervisory board failed the duty to mediate. Subsequently, the Dutch Supreme Court rejected this ruling. Instead, the Supreme Court affirmed that the strategy of the company lies within the authority of the board of directors. It is the board's discretion to decide to involve shareholders or not, as well as to decide the degree of shareholder involvement. Moreover, the court clarified that there is no active mediation duty for the supervisory board to resolve conflicts between management and shareholders.[1092] The decision seems to imply that the Supreme Court intends to constrain the influence of activist shareholders and to underline the long-term interests of the company.[1093]

This deference to board authority was again confirmed in a recent case, *AkzoNobel v. Elliott*, whereby Akzo Nobel received three unsolicited takeover offers from PPG. After both boards of Akzo Nobel rejected these offers, shareholder Elliott brought an inquiry proceeding request before the Enterprise Chamber. The Enterprise Chamber stated that the strategic response to an unsolicited takeover offer is within the authority of the board as long as it is monitored by the supervisory board. The stakeholder model applies in takeovers that the board of directors should be guided by the company and its stakeholders' interests.[1094] In other words, the board may reject an unsolicited bid even if (a majority of) shareholders support such a bid,

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1091 Ibid.

1092 Harm-Jan de Kluiver, Martin van Olffen, Bernard Roelvink and Berto Winters, Dutch Supreme Court ruling in ASMI: no duty to mediate for supervisory boards, available at http://www.lexology.com/library/detail.aspx?g=597b5e5c-c6cd-4749-a2f5-3c0e5cfa3162. Last visited February 2019.

1093 Louis Bouchez and Bart-Adriaan de Ruijter, Order in ASMI case: Corporate Governance put on edge with respect to activist shareholders, available at https://kvdl.com/news/order-in-asmi-case-corporate-governance-put-on-edge-with-respect-to-activist-shareholders/. Last visited February 2019.

1094 Francis J Aquila (ed), *Shareholder Rights and Activism Review* (United Kingdom: Law Business Research, 2017), p70.

or even if the acceptance of such a bid would bring more shareholder value than rejection.[1095] The boards have no active obligation to consult shareholders in relation to decision-making. However, both the board of directors and the supervisory board are responsible to shareholders for company decisions, and the shareholders should be fully informed. In order to ensure that the board decision can reflect the long-term interests of the company, the Enterprise Chamber further provided guidance to determine whether the decision-making of the board is diligent, as well as whether negotiation with the bidder is necessary.[1096]

Last but not least, a prominent freeze-out transaction is exemplified in the EVC case.[1097] Specifically, Ineos was the controlling shareholder of EVC with a shareholding of 86.4%. After a takeover bid, Ineos successfully held 92.8% of EVC's shares. Ineos then continued with an asset sale at the same price, to squeeze out minority EVC shareholders. Subsequently, Trafulgar filed a request before the Enterprise Chamber for an inquiry proceeding. The Enterprise Chamber claimed that despite the majority of supervisors not being independent from the controlling shareholder, this mere fact was insufficient to rebut the company's decision, since the transaction was approved by EVC's independent director with a veto right and supported by the fairness report provided by Ernst & Young. As a result, the Enterprise Chamber rejected the plaintiff's request.

5.4.3 Analysis

To squeeze out minority shareholders, Dutch law has established a threshold of 95%. In practice, if the acquirer fails to reach the 95% threshold after the offer, the transaction normally will be followed by a merger or asset sale, to squeeze out the remaining shareholders.

Besides statutes, Dutch courts play a vital role in regulating takeover transactions. The court justified in the *Shell* and the *Versatel* rulings that it is legitimate to use a merger to squeeze-out minority shareholders, if the

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[1095] ECLI: NL: GHAMS: 2017: 1965, para. 3.34.

[1096] De Brauw Blackstone Westbroek, AkzoNobel v. Elliott: landmark case on board conduct in takeover situations, available at http://www.debrauw.com/alert/akzonobel-v-elliott-landmark-case-board-conduct-takeover-situations/#. Last visited February 2019.

[1097] Enterprise Chamber 21 December 2005, ECLI:NL:GHAMS:2005:AV1585, ARO 2006, 6 (Trafalgar/EVC).

transaction also serves "other business purposes". In another *Versatel* decision, the court further affirmed that minority shareholders should be informed of merger conditions, and the participation of independent directors should be emphasised. Based on Dutch case law, research has summarised the conditions that can justify an alternative freeze-out measure, such as a merger. The conditions include: the transaction should also serve other business purposes, the transaction should involve the participation of independent directors, the freeze-out intention should be revealed in the offer documents beforehand, the post-acquisition freeze-out price should be (or almost) equal to the bid price, the investment bank should issue an opinion on the fair price to the minority shareholders, and for a pre-wired freeze-out, a threshold, normally 80%, should have been agreed beforehand, in order to trigger the agreed legal merger or asset sale after the offer.[1098]

Concerning takeover defences, various mechanisms, such as depositary receipts,[1099] priority shares,[1100] preference shares[1101] and the option for a third party to buy new shares, are widely available in the Netherlands. In particular, the depositary receipt, i.e. the act of transferring the shares to a trust office, is a common practice in the country. The negative view claims that the trust office normally holds a management-friendly view at voting,[1102] and that the holders of depository receipts may not have a significant say at the general meeting. Moreover, defence devices, such as the depositary receipt, may limit shareholders' rights – even without the threat of a hostile takeover.[1103] In contrast, the positive view argues that the depositary receipt is not a takeover defence; rather, it can be used to protect minority interests by preventing a majority shareholder from dominating the voting by taking advantage of absenteeism.[1104]

[1098] Tom Vos, 'Baby, it's Cold Outside – A Comparative and Economic Analysis of Freeze-outs of Minority Shareholders', 15(2018) *European Company and Financial Law Review*, pp. 148-196.

[1099] See section 5.2.2.

[1100] The priority share is a device which grants special voting privileges to management-friendly foundations in major decision-making, as well as in nominating or dismissing managing and monitoring directors.

[1101] The preference share, which has the same voting right as the common share, can be sold to a friendly trust office or outside shareholders at a lower cost.

[1102] Abe de Jong, Gerard Mertens and Peter Roosenboom, 'Shareholders' Voting at General Meetings', 10 (2006) *Journal of Management & Governance*, pp. 353-380.

[1103] For the above reason, the Netherlands can also be held as an example of weak shareholder protection in continental European countries. See: ibid.

[1104] Principle 4.4, *DCGC*, version 8 December 2016.

Academics have also noted that the lenient Dutch attitude towards takeover defences has already been demonstrated in the implementation of the *Takeover Directive*. As a matter of fact, the Netherlands opted out of many provisions which limit the application of defence measures.[1105] For example, it opted out of Article 9 of the *Directive*, which imposes shareholder approval as a precondition for boards to adopt defence measures. Alternatively, instead of a mandatory status, it followed an "opt-in" approach in Article 2:359 b *DCC* by giving the company the freedom to execute the "shareholder approval" precondition in articles of incorporation.[1106]

Dutch case law seems to confirm such a friendly attitude towards takeover defences. As seen previously, in the *RNA* case, the court justified the adoption of defence measures in three situations. Or again, in the *ABN* case, the court rejected the claim of a shareholder approval to sustain the legal certainty of the written law. Moreover, the court applied the stakeholder model and held that the board of directors was not obliged to seek the highest price. Instead, the board's decision-making had to pursue the company and its stakeholders' interests. In the *Boskalis*, the *ASMI* and the *AkzoNobel* cases, the court has similarly shown deference to board authority and rejected activist shareholders' claims.

There are various motivations behind the Dutch "free" spirit in takeover defences, such as maintaining the attractiveness of the Dutch market in line with its US counterpart, and preventing shareholder activism.[1107] On the one hand, this pro-defence and pro-board attitude could be beneficial to minority shareholders, since it may allow directors to focus on the long-term interests of the company without worrying about hostile takeovers, or directors may use the defence device as a bargain chip in exchange for a higher premium in the tender offer.[1108] On the other hand, it may restrict the development of the corporate control market and reduce the external supervision of Dutch listed companies.

Last but not least, the *EVC* case seems to demonstrate that independent director approval and the fairness opinion of a third party have a cleasing

[1105] Supra. 619, p.282
[1106] Danielle Quinn, 'Dutch Treat: Netherlands Judiciary Only Goes Halfway Towards Adopting Delaware Trilogy in Takeover Context', 41 (2008) *Vanderbilt Journal of Transnational Law*, pp. 1211-1249.
[1107] Supra. 619, p. 282.
[1108] Rezaul Kabir, Dolph Cantrijn and Andreas Jeunink, 'Takeover Defenses, Ownership Structure and Stock Returns in the Netherlands: An Empirical Analysis', 18 (1997) *Strategic Management Journal*, pp. 97-109.

effect on “self-dealing” between the company and its controlling shareholder. Nevertheless, according to some dissenting scholars, the *EVC* ruling fails to mirror an at-arm’s-length transaction to protect minority shareholders.[1109]

5.5 Conclusion

Based on the analysis above, this chapter has made the following findings. First, Dutch corporate law follows the stakeholder model, which guides board decisions in line with the interests of the company and its stakeholders, rather than the shareholders alone, and nurtures ideas of co-determination and structure regime. The general meeting is entitled to a number of fundamental rights, such as the appointment right, the approval right on major decisions and the right to adopt annual accounts. However, some of these rights may be constrained by the structure regime and co-determination. Dutch corporate law affirms the equal treatment of shareholders, but it also allows various mechanisms that deviate from the one share, one vote rule. In addition, special legislative protection is provided to minority shareholders, such as the right to convene a general meeting or the right to put items on the agenda, if the respective threshold is reached, as well as the mandatory bid rule and the sell-out right in takeovers.

Second, Dutch listed company disclosure has not had a good record in the past. Reasons behind this underperformance may be ascribed to too much discretion in accounting options, the underdeveloped market of corporate control and the lack of an institutional supervisory body. However, disclosure in the Netherlands has been improved in recent times thanks to the influence of EU disclosure rules and the establishment of the AFM.

Third, the Dutch statutory concept of “independence” refers to “independence” against management and “semi-independence” against major shareholders. The latter can evidently be seen in the latest revision of the *DCGC*, which labels representatives of major shareholders as “non-independent” but does not strictly forbid the participation of such non-independent directors. To encourage shareholder participation, Dutch legislation allows certain

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[1109] Tom Vos, ‘Baby, it’s Cold Outside – A Comparative and Economic Analysis of Freeze-outs of Minority Shareholders’, 15 (2018) *European Company and Financial Law Review*, pp148-196.

shareholder representatives to act as supervisors or non-executive directors, if other conditions prescribed in the law are fulfilled.

Fourth, the Enterprise Chamber plays an important role in regulating takeover transactions and protecting minority interests. In viewing takeovers, “reasonableness and fairness” and the “stakeholder model” are two main guiding principles. Companies usually refer to alternative squeeze-out methods if the 95% threshold is not reached. Dutch case law has established conditions to justify such methods. In terms of takeover defences, the Dutch court confirms the authority of the board of directors and also applies the stakeholder model to guide board decisions in line with the interests of the company and its stakeholders, rather than the shareholders alone. This lenient attitude towards takeover defences may implicitly reveal a certain level of “shareholder activism” suspicion in the Netherlands. In addition, the court seems to hold the opinion that the approval of independent directors and the fair opinion of a third party can clear the self-dealing element of a transaction.

In brief, minority shareholders, as one group of stakeholders, are protected by the “stakeholder” model. In line with this model, both Dutch legislation and case law support “director primacy”, which constrains the possibility of a super-powerful general meeting. Moreover, shareholder participation is encouraged by the latest revision of the *DCGC,* which calls for “fully-fledged” shareholder participation in regard to checks and balances within a company. Last but not least, through inquiry proceedings, the Enterprise Chamber effectively redresses minority oppressions in takeover transactions, mainly based on the “reasonableness and fairness” standard.

Chapter 6 Comparative Chapter

6.1 Introduction

Chinese listed companies are known for two prominent characteristics: their concentrated ownership structure and the state as the controlling shareholder. Under this structure, minority shareholders may face double threats from both the controlling shareholder and management, if balanced corporate governance fails to be achieved. In fact, minority shareholder protection has become a pressing issue for Chinese listed companies. In contrast, the US market is known for its dispersed ownership structure. Similarly, Dutch listed companies mostly have dispersed ownership structure. However, recent data reveal a concentration trend among Dutch listed companies.

To understand better and address how these three jurisdictions safeguard minority interests under different ownership structures and legal systems, this chapter will compare Chinese, US and Dutch corporate laws in three steps. The chapter will first examine minority shareholder protection through shareholder rights in legislation. Second, it will go into protection that minority shareholders can obtain from monitoring mechanisms, such as disclosure and independence. As a third and last step, it will focus on takeover transactions, particularly courts' role in guarding minority interests. This analysis reveals certain similarities and dissimilarities between minority shareholder protection in the three countries.

6.2 Comparison of minority shareholder protection through shareholder rights in the three countries

As mentioned in previous chapters,[1110] corporate law systems in China, the US and the Netherlands are based on different ownership structures. In the highly concentrated Chinese ownership structure controlling-minority conflicts are the main issue.[1111] In a dispersed ownership structure, one of the main issues is the potential conflicts of interest between the board of directors and shareholders.

Table 6.1 Main agency costs in China, the US and the Netherlands

Countries	Ownership structure	Types of companies	Conflicts of interest	Agency costs
China	Concentrated	State-owned	State vs. minority shareholders	Principal-principal
			Management vs. minority shareholders	Principal-agent
		Non-state-owned	Controlling shareholder vs. minority shareholders	Principal-principal
US & NL	Dispersed	Companies without a controlling shareholder	Management vs. shareholders	Principal-agent

Comparing China with the US and the Netherlands, this research has found that all three countries provide general shareholder rights and specific mechanisms to protect minority interests. Simply judging from legislation, it seems that China provides the most rights and instruments to shareholders, followed, respectively, by the Netherlands and then the US.[1112]

[1110] Chapter 1 section 1.1, chapter 3 section3.2.1, chapter 4 section 4.1 and chapter5 section 5.1.

[1111] Controlling-minority conflicts refer to both the principal-principal cost and the principal-agent cost. See Chapter 2.

[1112] It is summarised in this chapter that there are 20 shareholder rights and instruments in Chinese legislation, i.e. the right to vote, the right to a dividend, the appointment right, proxy voting, the right to transfer shares, the dissolution right, the supermajority rule, shareholder approval on certain issues, the right to propose a shareholder meeting, the remote participation of shareholders, group voting, cumulative voting, the

Table 6.2 Legislative shareholder rights in China, the US and the Netherlands

Shareholder rights	China	US (focus on Delaware)	The Netherlands
Right to appoint directors	Y	Y (may be limited by board nominations, plurality voting, proxy rules and staggered boards)	Y (transferred to the supervisory board under structure regime)
Right to vote	Y	Y (may be limited by dual-class shares)	Y (may be limited by loyalty shares, depositary receipts etc.)
Right to dividend	Y	Y (board decides)	Y
Right to inspect	Y	Y	Y
Right to dissolve the company	Y (both general meeting and shareholders with more than 10% shares)	Y (normally board decides)	Y
Shareholder approval	Y	Y	Y
Proxy voting	Y	Y	Y
Right to transfer	Y	Y	Y
Supermajority rule	Y	Y (articles of association)	Y
Remote participation	Y (only prescribed in regulatory documents)	Y	Y
Right to sue	Y (derivative action)	Y (derivative action)	Y (inquiry proceeding)
Group voting	Y (only prescribed in regulatory documents)	Y	N
Cumulative voting	Y	Y	N
Appraisal right	Y	Y	Y (only holders of non-voting shares or non-profit shares)
Right to put items on the agenda	Y	Y (but it is 17CFR§240.14a-8 that prescribes the right to proposal, not in *DGCL*)	Y
Right to call a	Y (10%)	Y (if it is prescribed by the articles of association	Y (if authorised by the articles of association or

inspection right, the right to suit, the appraisal right, the right to put items on the agenda, the right to nullify voidable resolutions, the mandatory bid, the pre-emption right and the sell-out right. There are 18 in Dutch legislation and 16 in Delaware (there is no group voting, cumulative voting and derivative action in the Netherlands, and there is no nullification of voidable resolutions, the mandatory bid rule, the pre-emptive right and the sell-out right in Delaware).

shareholder meeting		or bylaws)	the court)
Right to nullify voidable resolutions	Y	N	Y
Mandatory bid	Y	N	Y
Pre-emptive right	Y (only in closed companies, not in listed companies)	N	Y
Sell-out right	Y	N	Y

(Y=yes, N=no)

From the above table, it is evident that some similar shareholder rights are prescribed in China and the US, in China and the Netherlands and even in all three countries. However, shareholder rights prescribed in one country are not necessarily identical to their foreign counterparts. Legislative distinctions are typically reflected as follows.

Government interventions

The first major difference between China and the other two countries is that minority shareholder expropriations in China are tackled by not only legislative shareholder rights, but also political interventions. The party organisation is a governing body in Chinese listed companies, and recent developments have further strengthened the role of the party in corporate governance. For instance, the newly revised 2018 *Chinese Corporate Governance Code* added a provision to demand Chinese listed companies establish a party organisation, and state-owned listed companies should incorporate relevant policies and regulations of the party organisation into their articles of association.[1113] In 2016, 91% of SOEs and 68% of non-SOEs established party organisations, and up to mid-2017, 100 large SOEs were reported to have amended their articles of association to incorporate the party organisation.[1114] This change can certainly be viewed as a symbolic way of deepening party interference in Chinese listed companies, but it can also be viewed as providing more transparency to lift the mysterious veil of party organisations that have long existed in Chinese listed companies.[1115] Besides, several quasi-state

[1113] Article 5, revised 2018 *CCGC*.

[1114] Jamie Allen, Li Rui, Guo Peiyuan, Li Zhaowen, Zhang Zhengjun, and Zhou Chun, *Awakening governance: The Evolution of Corporate Governance in China*, Asian Corporate Governance Association China Corporate Governance Report 2018, available at https://www.acga-asia.org/specialist-research.php. Last visited February 2019.

[1115] Ibid.

institutions have been formed to assist and safeguard minority shareholders. Particularly, the Incestor Service Center is portrayed as representative of minority shareholders, to encourage their engagement. This political protection of minority shareholders shows that China has opted for a peculiar path of its own.

Powers of the general meeting

Based on the *Chinese Company Law,* the *Delaware General Corporate Law* and the *Dutch Civil Code*, one of the most prominent differences between China and the other two countries lies in the power disparities between the general meeting and the board of directors. In a Chinese listed company, the general meeting, according to the law, is significantly more powerful than the board of directors. The Chinese general meeting is the governing body and has powers to decide on operating guidelines and investment plans, which conversely are powers of the board of directors in the US and the Netherlands. Furthermore, the Chinese general meeting can appoint and remove directors and is in charge of their remuneration, whilst in the US, the removal right of the general meeting may be limited by the staggered board structure. For appointments, generally it is the current board that nominates candidates, and if the company does not adopt proxy access, shareholders may have to go through a much tougher proxy contest. In the Netherlands, the power to appoint directors may be transferred to the supervisory board, if the company falls into the structure regime. In addition, the Chinese general meeting has the authority to review and approve the distribution of dividends. Conversely, the *DGCL* endows the board of directors with the power to declare and distribute dividends rather than the general meeting.[1116] The Dutch general meeting has the power to adopt annual accounts, related to the distribution of dividends.

Right to sue

Shareholders in all three countries have the right to bring a direct claim to redress personal grievances; however, only shareholders in China and the US have the right to file a derivative action. Comparing derivative actions in these two countries, the Chinese threshold is higher than the US one. China imposes requirements in two respects, i.e. only shareholders who individually or jointly hold at least 1% shares for at least 180 consecutive days are entitled to file a

[1116] §170(a), *DGCL.*

derivative action. Softer than China, the US adopts the “continuous ownership” demand, i.e. a shareholder who is qualified to file a claim should be a shareholder of the company at the time of the transaction as well as at the time of filing the action. In addition to the threshold requirement, both China and the US impose a pre-suit demand that shareholders should request the board to bring a lawsuit before exercising their right to a derivative action. The exception is that Chinese shareholders can directly file a lawsuit if there is an emergency, and in the US, this pre-suit demand can be exempted if shareholders can prove the futility of such a demand. Different from China, US boards may designate a special litigation committee to investigate and recommend the court continues or dismisses the case. To balance minority interests, US courts do not necessarily grant business judgment protection to the recommendations of the special litigation committee but set up a two-step examination of the action’s dismissal.

In contrast, there is no derivative action in the Netherlands. Alternatively, the *DCC* provides shareholders with the right to file an inquiry proceeding in the Enterprise Chamber of the Amsterdam Court of Appeal. Shareholders face a shareholding or a capital requirement but with no demand to hold the shares consecutively for a certain period of time to exercise the right of inquiry. Upon the request, the Enterprise Chamber has the power to review the policy and the state of affairs of the company, and also to take provisional measures, but the inquiry proceeding does not rule on issues of damage and directors liability.

Additionally, neither China nor the Netherlands provides the same type of US class action. In China, class action has been clearly ruled out since 2002 for private securities litigation related to false statements. Instead, such litigation can be filed individually or jointly. Very recently, a trial to test the standard adjudication mechanism in solving mass securities litigation was started. The *CSL*, which was amended on 28th December 2019 and will come into force on 1st March 2020, added Article 95 in the same direction as argued by this research to authorize shareholders to appoint a representative to proceed a securities compensation action and the verdict or ruling of the court applies to registered shareholders. Hence, a Chinese “representative action” will be available in the very near future. In the Netherlands, a foundation or association may bring a collective action and subsequently reach a settlement with the defendant, if the action prevails, and apply to the court to declare this settlement to be binding on the "class", except for those who opted-out.

Appraisal right

Comparing appraisal rights in the three countries, the Dutch appraisal right has the narrowest scope, in that only dissenting holders of non-profit and non-voting shares may request compensation determined by independent experts. In China, the *CCL* prescribes that a shareholder is entitled to request the company acquires his or her shares, if he or she disagrees with a merger or division.[1117] Comparatively speaking, the *DGCL* attaches a shareholding or value threshold and further clarifies that the appraisal of the fair value of shares shall be conducted by the Court of Chancery.[1118] More discussion on this instrument, which sets out to protect minority shareholders in takeovers, can be found in 6.4 of this chapter.

Group voting

Despite both China and the US prescribing "group voting", various distinctions exist. First, the subject is different. Separate approval applies to all minority shareholders in China, and meanwhile, group voting only applies to a certain class or series of shareholders in the US. Second, the scope is different. In China, separate approval is required for major decisions that cause notable issues for minority shareholders. However, this group voting is prescribed only in regulatory documents, without being incorporated into the *CCL*. This non-mandatory status may substantially degrade its influence in practice. On the contrary, the *DGCL* stipulates that group voting applies to a proposed amendment of the amount, the par value, the powers, preferences or special rights that adversely affect the interests of a certain class or series of shareholders.

Cumulative voting

As an instrument which is peculiarly created to strengthen minority shareholders' representation on boards, cumulative voting is not a default rule in either China or the US. The *CCL* prescribes that it can be adopted by either the articles of association or the general meeting. The *CCGC* moves a step further by demanding Chinese listed companies to adopt cumulative voting if

[1117] Article 142(4), *CCL*.
[1118] §262, *DGCL*.

one of its shareholders and persons acting in concert have more than a 30% shareholding. Nevertheless, this provision is in conflict with Article 105 of the *CCL*. Consequently, the low legal effect of the *CCGC* casts doubt on the practical influence of cumulative voting in Chinese listed companies. In the US*,* cumulative voting must be stated in the articles of association.

The right to nullify a voidable resolution

Both China and the Netherlands bestow shareholders with the right to request a court to nullify a voidable resolution.[1119] The difference is that in China, shareholders have the right to request a court not only to nullify a flawed resolution, but also to confirm a resolution that has never been formed or is invalid.[1120] This right has to be exercised within 60 days following the adoption of the resolution. In the Netherlands, the right to request a court to nullify a voidable resolution exists for one year after the publication or awareness of the resolution.[1121]

Last but not least, both China and the Netherlands offer minority shareholders special protection through the "mandatory bid rule" and the "sell-out right" in mergers and acquisitions. More discussion can be found in 6.4 of this chapter.

6.3 Comparison of minority shareholder protection through monitoring mechanisms in the three countries

This part will examine two important monitoring mechanisms, disclosure and independence, in the three countries. Based on observations, the characteristics of each country will be revealed, and differences will be outlined.

[1119] Article 2:15(3)(a), *DCC* and Articlet 22, *CCL*.
[1120] Article 2, *CCL Provisions IV*.
[1121] Article 2:15(5), *DCC*.

6.3.1 Comparison of disclosure in the three countries

The previous chapters[1122] demonstrate that the three countries have respectively established their own comprehensive disclosure system. A noteworthy difference on the macro level is the disclosure regulatory regimes in the three countries. The US disclosure system stands out from China and the Netherlands, due to its peculiar "federal-state" regulatory structure. Disclosure in the US is mainly regulated by federal securities regulations and supplemented by state corporate laws. On the federal level, disclosure is identified by "rule-based" regulations and the "market-oriented" dimension. US federal disclosure rules are very detailed and technical, and they highlight values of shareholder protection and market transparency. On the state level, disclosure is defined by "principle-based" case law and the "business-oriented" dimension, which intensifies the supremacy and discretion of the board.[1123] In other words, disclosure presents the interplay between federal and state corporate laws. In the Netherlands, disclosure rules are highly influenced by EU *Directives* and are incorporated in the *Financial Supervision Act*. However, the relationship between EU *Directives* and Dutch disclosures rules is nothing like the US "federal-state" regime. Similarly, disclosure in China is regulated through one-dimention, namely Chinese disclosure legislation, for instance, the *Chinese Securities Law*.

In terms of specific rules, all three jurisdictions demand initial disclosure and a continous information flow. For periodical reports, the US law prescribes quarterly and annual reports, with a "rapid and current" disclosure of any material change. The Dutch law demands annual and semi-annual reports with notification obligation regarding any change in voting rights, capital and major shareholdings etc. The Chinese law requires interim, annual and provisional reports, which regulate disclosure of major events. On top of the similarities, the Dutch annual financial report, which consists of the annual account, management reports and the certificate of truth and fairness, is worthy of mention. Different from the US, the Dutch general meeting has the power to adopt the annual accounts. The adoption of the annual accounts does not

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[1122] Chaper 3, section 3.3.1, chapter 4, section 4.3.1 and chater 5, section 5.3.1.

[1123] Pieter A. Van der Schee, Regulation of issuers and investor protection in the US and EU: A Transatlantic Comparison of the Basics of Securities and Corporate Law, p. 230, available at: https://pure.uvt.nl/ws/files/1383065/Vanderschee_regulation_20-05-2011.pdf. Last visited February 2019.

discharge directors or supervisors from their liabilities by default. Similarly, the Chinese general meeting also has the power to approve the final accounts, but there is no such concept similar to the Dutch “discharge” in China. In other words, the Dutch general meeting can choose to adopt the annual accounts but reserve the chance to hold directors or supervisors liable if the disclosure is found to be unqualified at a later stage.[1124] Such provisions soften director primacy and may stimulate directors to draft annual accounts diligently, in order to avoid any future liability.

Another important distinction of the three jurisdictions is the shareholding thresholds that trigger disclosure. In the US, any person who directly or indirectly holds more than 5% shares is obliged to file a statement, including clarification on the transaction purpose[1125] (Chinese and Dutch legislations do not require this confession). If such a transaction concerns no sale of control, then a simplified statement is sufficient. In the Netherlands, the thresholds are specifically listed in the legislation, namely a lower minimum threshold of 3% has been adopted, supplemented by thresholds of 5%, 10%, 15%, 20%, 25%, 30%, 40%, 50%, 60%, 75%, and 95% to activate the notification obligation. In China, the 5% shareholding threshold leads to the obligation to submit a written report within three days. Different from the US and the Netherlands, this Chinese disclosure obligation also comes with the obligation to stop trading during the above period. After reaching the first 5%, every subsequent increase or decrease of 5% voting shares will also trigger the disclosure and non-trading obligations. The latest revision of 2020 *CSL* further added two requirements, one is that after reaching the initial 5%, every subsequent 1% increase or decrease in shareholding will trigger the obligation to inform the company and to make an announcement. The other is that shares bought breaching the first 5% and every subsequent 5% requiremrents, for the part that is beyond the prescribed proportion is not allowed to vote for 36 months since the purchase.

Moreover, to safeguard minority interests in going-private transactions, all three countries impose a disclosure obligation. The US federal regulations set a broad scope of disclosure. It is commanded to not only report the purpose of the transaction, but also to specify whether there is an alternative to fulfill the

[1124] There is also no such “discharge” in the US, so directors may seek shelter from the “business judgment rule”.

[1125] 17*CFR* 240.13d-1 (a).

transaction purpose, and if there is indeed one, why this alternative was ruled out, what are the reasons behind such a going-private transaction at such a moment, how this transaction will affect the target company, its subsidiaries and minority shareholders and also whether it is fair to unaffiliated shareholders.[1126] Comparatively, both China and the Netherlands require the disclosure of going-private transactions, but they do not set down such detailed explanations.

In addition to disclosure rules, a bigger gap probably lies at the implementation between China and the other two countries. On the one hand, China has a comprehensive disclosure regulatory system, which covers listing documents, annual, semi-annual and provisional reports, substantial shareholdings, remuneration, financial and accounting reports, corporate governance information, shareholder information and related-party transactions. On the other hand, the Chinese accounting practice is still rather immature, despite legislative attempts to converge with IFRS and ISA.[1127] Due to the immature accounting and the lack of auditor independence, the quality of Chinese annual accounts falls far behind the international standard.[1128] Besides, the conservative view that more disclosure equates to more risks still lingers among Chinese companies.[1129] Some companies disclosed only the "good" instead of the "bad".[1130] Accordingly, the implementation of disclosure rules still remains a challenging issue in the country.[1131]

1126 17*CFR* 240.13e-3.

1127 IFRS stands for "International Financial Reporting Standards" and ISA stands for "International Standards on Auditing". See: Jamie Allen, Li Rui, Guo Peiyuan, Li Zhaowen, Zhang Zhengjun, and Zhou Chun, *Awakening governance: The Evolution of Corporate Governance in China*, Asian Corporate Governance Association China Corporate Governance Report 2018, available at https://www.acga-asia.org/specialist-research.php. Last visited February 2019.
Empirical research has found that Chinese listed companis' disclosure remains insufficient even after the convergence of disclosure standards. On average, less than 50% of the listed companies disclosed sufficiently according to the standard. See: Li Yingqi, Chen Chunhua and Yu Junli, '我国上市公司内部控制评价信息披露 (Internal Control Evaluation Disclosure: Issues and Improvement-Evidence from 2011 Evaluation Reort on Internal Control of Chinese Listed Companies)', 8 (2013) *会计研究 (Accounting Research)*, pp. 63-68.

1128 Lin Z. Jun and Wang Liyan, 'Financial Disclosure and Accounting Harmonization: Cases of Three Listed Companies in China', 16 (2001) *Managerial Auditing Journal*, pp. 263-273.
Wang Zhen, 近 3 月中国 19 家在美上市公司遭停牌或摘牌 (New York Exchange sanctioned 19 Chinese Companies for Stock Suspension or Delisting in the Past 3 Months), available at http://finance.sina.com.cn/stock/usstock/c/20110608/12369958941.shtml. Last visited on February 2019.

1129 Supra. 1125.

1130 Li Fenglian, '美中两国上市公司自愿性信息披露的比较 (Comparison of Voluntary Disclosure of Listed Companies between China and the United States)', 12 (2011) *求索(Search)*, pp. 36-38.

1131 Li Jianwei and Li Jia qi, '中美股票市场比较分析与启示(The Comparative Analysis and its Enlightenment of China-US Stock Market)', 33 (2019) *湖南大学学报(Journal of Hunan University),* pp.37-51.

Generally speaking, disclosure rules are mainly implemented through public enforcement and supplemented by private enforcement. For public enforcement, institutional supervision bodies in these three countries are the SEC in the US, the AFM in the Netherlands and the CSRC in China. Specifically, SEC enforcement actions cover a wide spectrum,[1132] including the administrative aspect,[1133] the civil aspect[1134] and the criminal aspect.[1135] In addition, SEC sanctions may inflict extensive costs, i.e. monetary penalties, management job losses, economic and reputational damage to auditors and a decline in share prices.[1136] The AFM, as the Dutch supervision body, is entitled to take diverse measures, amongst which are warnings, incremental penalty payments, administrative fines, the withdrawal or limitation of licences and referral to the public prosecution service.[1137] In China, the CSRC has the enforcement power to impose administrative sanctions or to deprive a company of market entry.[1138] Comparing these three institutional supervision bodies, the CSRC case rate seems rather marginal. The *Annual Report* found that the CSRC had dealt with 199 cases, imposed "fines and disgorgements" for a total amount of RMB 7.479 billion and also made 44 "ban of market entry" in 2017.[1139] Meanwhile, the SEC reported 446 independent enforcement actions, 119 secondary proceedings, 112 delinquent filing proceedings, 309 trading suspensions, with 3.8 billion USD disgorgement and penalties in 2017.[1140] The AFM announced 81 formal measures and 450 informal measures in 2017.[1141]

[1132] See: https://www.sec.gov/litigation.shtml. Last visited February 2019.
[1133] The consent decree and disciplinary action.
[1134] The injunctive relief.
[1135] The SEC can refer criminal offences to the Department of Justice.
[1136] Rebecca Files, 'SEC Enforcement: Does Forthright Disclosure and Cooperation Really Matter?,' 53 (2012) *Journal of Accounting and Economics*, pp. 353-374.
[1137] Other measures that can be taken by the AFM also cover instructive conversations, public warnings, notices and disciplinary complaints. Available at: https://www.afm.nl/en/over-afm/werkzaamheden/maatregelen. Last visited February 2019.
[1138] See: http://www.csrc.gov.cn/pub/csrc_en/regulatory/BanMarketEntry/. Last visited February 2019.
[1139] See: 2017 CSRC Annual Report, available at: http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb/201809/P020180907609864959832.pdf. Last visited February 2019.
[1140] See: 2017 Agency Financial Report, available at: https://www.sec.gov/files/sec-2017-agency-financial-report.pdf#mission. Last visited February 2019.
[1141] Formal measures taken in 2017 also included 12 incremental penalty payments, 21 public warnigs, and assessed 104 prospectuses etc. Informal measures taken in 2017 included 345 instructive consultations or letters, and 105 warning letters or conversations. See: AFM Annual Report 2017, available at: https://www.afm.nl/en/verslaglegging/jaarverslag-archief. Last visited February 2019.

In addition, private enforcement is still largely restricted in China.[1142] This restriction not only increases the difficulty in shareholder supervision, but it also decreases the flexibility of law. Taking the disclosure standard as an example, Chinese legislation advocates the "truthfulness, accuracy and completeness" of information. Comparatively, the US refers to the concept of "materiality", and the Netherlands demands that disclosure is "comprehensible to a reasonable and diligent person". Though all three countries opt for a general description of the standard, the difference lies in the fact that both the US and the Dutch rules are regularly updated and substantiated by their courts. US courts have established a general "materiality" standard based on case-by-case analysis, diligently scrutinised the duty of disclosure to safeguard minority shareholders in takeovers and also recognised the procedural value of disclosure in avoiding unnecessary interference with board autonomy. Dutch courts are also active in the interpretation of a comprehensible third person standard. On the contrary, the courts' role in substantiating the legislation is still currently lacking in China.

6.3.2 Comparison of statutory independence in the three countries

The three countries have three different board structures. The US system settles on the one-tier board structure, which consists of inside and outside directors, the latter of which can be further divided into non-independent and independent directors. The Dutch system has traditionally followed the two-tier board but has also embraced the one-tier since 2013. Specifically, the Dutch one-tier board comprises non-executive directors and executive directors, and the two-tier covers the board of directors and the supervisory board. In China, the two-tier board has been prescribed in the *CCL*, namely in the guise of the board of directors and the supervisory board. Distinguished from the Dutch two-tier option, the Chinese board of directors consists of not

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[1142] In 2001, the Supreme Court issued a notice to temporarily stop accepting any civil securities compensation cases. See:*最高人民法院关于涉及证券民事赔偿案件暂不予受理的通知* (*Notice on Temporarily Stop Accepting Civil Securities Compensation Cases*), Supreme People's Court, date of issue 21st September 2001, invalid.
In 2003, the Supreme Court marginally loosened the above restriction by allowing civil compensation cases caused by false securities statements, but only to those that had previously been sanctioned by the CSRC or its agencies, or the Ministry of Finance or the Criminal Court. See: *最高人民法院关于审理证券市场因虚假陈述引发的民事赔偿案件的若干规定* (*Provisions on Adjudicating of Civil Compensation Cases based on Securities False Statement*), Supreme People's Court, date of issue 9th January 2003.

only directors, but also independent directors. In other words, China opts for a mixed system that incorporates both independent directors and the supervisory board. Under the influence of the stakeholder model, both the Netherlands and China intend to achieve a certain degree of co-determination in their supervision bodies. Dutch law prescribes that the proposal to appoint, suspend or dismiss supervisors or non-executive directors should be submitted to the works council first, and together with the opinion of the works council, the proposal is then submitted to the general meeting for a decision.[1143] For a company under the structure regime, the works council enjoys the extra power to recommend one-third of the supervisory board or non-executive directors.[1144] In China, the supervisory board is required to have employee representatives. The articles of association may freely decide the specific proportion, but employee representatives should not make up less than one-third of the supervisory board.[1145]

Besides board structure, the statutory definitions of independence are different in the three countries. In the US, for example, the *Sarbanes-Oxley Act* underlines the role of independent directors in corporate governance, particularly in shareholder protection. Listing rules for stock exchanges have specified requirements concerning majority independent boards and mandatory special committees. Specifically, the statutory definition of independence explicitly expels the "executive officer" and the "employee", but not "shareholders".[1146] US listed companies have to form nominating, compensation and audit committees,[1147] composed of only independent directors.[1148] However, controlled companies are exempted from majority

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[1143] Article 2:144a(1), *DCC*. It is to be clarified that many listed companies have works councils on the Dutch level but not on the global level.
[1144] Article 2:158 (6), *DCC*.
[1145] Article 117, *CCL.*
[1146] Share ownership is not considered an element which may disqualify a candidate from being found as independent. NASDAQ Rules IM-5605, see: http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?searched=1&selectednode=chp_1_1_4_3_8_5&CiRestriction=independent+director&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F. Last visited February 2019.
[1147] The *NYSE Manual* specifically demands three special committees: the "nominating/corporate governance committee", the "compensation committee" and the "audit committee". Meanwhile, the *NASDAQ Rule* does not strictly require a nomination committee.
[1148] §303A.04 *NYSE Manual*, the *NASDAQ Rule* does not straightforwardly call for a nominating committee but prescribes independent directors' oversight function on nomination in 5605(e) (1); §303A.05 (a) *NYSE Manual,* 5605 (d)(2)(B) *NASDAQ Rule* states that for "the best interests of the company and its shareholders", and under the "exceptional and limited circumstances", the board can approve the appointment of a non-independent director to a compensation committee. *NYSE Manual* §303A.06, *NASDAQ Rule*, 5605 (c)

independent board, nominating committee and compensation committee requirements. The rationale behind these exemptions can be attributed to the consideration that the controlling shareholder is able to secure his or her interest by dominating the board. The independent director mechanism loses its charm in a controlled company, though, due to the affiliation of the board and the controller.[1149] Furthermore, the *NASDAQ Rule* proposes that representatives of significant shareholders serve on the compensation committee as good practice.[1150] These provisions have shown that independent directors, to a large degree, can be considered shareholder representatives. In a nutshell, the US concept of independence in listing rules primarily focuses on being independent from management. Supplementary, state courts further define independence from controlling shareholders in going-private transactions based on case-specific facts. In Delaware, approval of an independent special committee may shift the burden of proof, or even the judicial review standard, if other conditions are also fulfilled, in a going-private transaction. Considering the conflicts of interest between the controlling shareholder and minority shareholders in such a transaction, clearly, members of the special committee are required to be independent from the controller.[1151]

Compared with the US, the Dutch independence definition in the *Dutch Cororate Governance Code* (comply or explain) excludes both management and major shareholders, but representatives of the latter are allowed under certain conditions. The Netherlands establishes the 10% threshold, in that whomever has at least a 10% shareholding of the company, or has board service or a representation relationship with another legal entity with at least 10% shareholding of the company, is viewed as non-independent. However, the *Dutch Cororate Governance Code* permits shareholders who directly or indirectly own more than a 10% shareholding to have a maximum one

demands the audit committee shall be composed of at least three independent directors, except under "exceptional and limited circumstances", as stated in 5605 (c)(2)(B).

[1149] Exemptions for controlled companies, to a certain extent, illustrate the notion that the independent director instrument is chiefly organised around the conflicts of interest of shareholders and management, without specifically addressing minority shareholders. Nevertheless, it does not mean minority interests are simply being ignored in the US. In fact, the case law system also makes a big contribution to defining and regulating the independent director mechanism, as well as correcting minority expropriations. For more discussion, see 6.4 of this chapter.

[1150] NASDAQ Rule IM-5605-6.

[1151] The *DGCL*§144 (a)(1) also affirms the procedural value of independent directors in related-party transactions.

representative on the board, in order to encourage shareholder participation. Also, the Netherlands prescribes that shares or rights to shares are not permissible as a form of remuneration for supervisors or non-executive directors, albeit supervisors or non-executive directors may hold shares as long as they are long-term shareholders. From these provisions, it is notable that the Dutch concept of independence generally demands independence from major shareholders, but it also compromises this standard in facilitating the goal of long-term shareholder participation. Moreover, three special committees – the selection and appointment committee, the remuneration committee and the audit committee – are required by the *Dutch Cororate Governance Code* for listed companies whose supervisory board has more than four members. Conversely to the US, Dutch special committees are not exclusively composed of independent members,[1152] and there is no exemption for controlled companies. Moreover, the supervisory board or non-executive directors play an important role in conflict of interest transactions. For a material conflict of interest transaction between the company and a major shareholder who owns at least 10% shares, the approval of the supervisory board or non-executive directors is necessary. Under the influence of the stakeholder model, Dutch independence is defined as being independent from both management and major shareholders.[1153] Nevertheless, to encourage shareholder participation, non-independent major shareholder representatives are allowed, as long as certain conditions are met.

In comparison, China seems to be the country that ties most closely the independent director mechanism with minority shareholder protection. Different from the majority independent board requirement, Chinese listed companies require only one-third of independent directors on the board.[1154] The Chinese definition of independence refers to independence from both management and major shareholders.[1155] Different from both the US and the Netherlands, Chinese independent directors are identified as the "guardians"

[1152] Best Practice Provision 2.3.4, *DCGC* prescribes that independent directors should account for more than half of the committee. Moreover, the chairman of the supervisory board or a former director of the board of directors should not chair the remuneration or audit committee.
[1153] *EU Recommendation 2005/162*, Article 13.1 explicitly states that the concept of independence shall preclude any connection with the controlling shareholder. In addition, its Annex II of the independence criteria also clarifies that a non-executive director or supervisor shall not be related to the controlling shareholder.
[1154] Article 1 (3), *Independent Director Opinion.* Both US and Dutch listed companies have the majority independent director requirement, but the US also prescribes the controlled company exemption.
[1155] Articles 34, 35 and 36, *CCGC*.

of minority shareholders.[1156] For minority infringements, independent directors are entitled to give their independent opinion to the board of directors or the general meeting.[1157] Qualified minority shareholder representation is also encouraged in China, i.e. shareholder(s) who either independently or jointly hold(s) more than 1% of the issued shares of a listed company have the right to nominate independent director candidates, but the final decision depends on the general meeting. In addition, despite Chinese legislation stipulating special committees, such as strategies, audit, nomination, remuneration and assessment committees, these special committees (except the audit committee)[1158] are not mandatory for Chinese listed companies.[1159] Different from the US, Chinese nomination, remuneration, audit and assessment committees merely demand a majority of independent directors, chaired by independent directors, and there is no exemption for controlled companies. In sum, the definition of independence in China covers not only independence from management and major shareholders, but also the representation of minority shareholders.

Comparing the statutory independence concepts in the three countries, the Chinese independence concept is congruent with the US and the Dutch experiences at first sight. In the US, independent directors are held accountable to the principal. Regarding the highly concentrated ownership structure in China, it seems reasonable that Chinese independent directors are portrayed as guardians of minority shareholders. The Netherlands highlights the importance of shareholder engagement by exceptionally allowing non-independent major shareholder representatives. Correspondingly, Chinese legislation endows qualified minority shareholders with the right to nominate independent directors. However, on the other side of the coin, the internal supervision of Chinese listed companies in practice is not as effective as those in the other two jurisdictions. Compared with the US and the Netherlands,

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[1156] Article 37 of the *CCGC* explicitly states that independent directors shall "focus on protection of the lawful rights and interests of small-and-medium shareholders". Besides, Articles 34 and 35 of the *CCGC* specify that a listed company shall be equipped with independent directors, which shall be independent of the company they work for, as well as the big shareholders of that company.

[1157] Besides, independent directors are granted a wide range of special powers, which cover issues of major related-party transactions, the employment of accounting firms, interim general meetings, meetings of the board of directors, the engagement of external auditing and consulting institutions and solicitation of proxy voting. See: Article 5, *Independent Director Opinion.*

[1158] The audit committee became mandatory for Chinese listed companies after the 2018 revision of the *CSRC* came into effect.

[1159] Instead, they are left to the resolution of the general meeting of listed companies.

independent directors have only limited influence within Chinese listed companies. Different from the mandatory special committee requirement, most special committees are optional in Chinese listed companies.[1160] Furthermore, proposals made by special committees should be submitted to the board of directors for a final decision.[1161] Conversely to their US and Dutch peers, Chinese independent directors merely have soft powers. US courts grant high value to the procedural protection of “approval of independent directors”. which may shift the burden of proof or even the judicial review standard under different circumstances. In the Netherlands, material conflict of interest transactions and self-dealing transactions involving major shareholders require the approval of a supervisory board or non-executive directors. In contrast, Chinese independent directors only have soft powers to acknowledge major conflict of interest transactions or to give an independent opinion on issues that are likely to infringe minority interests.

6.4 Comparison of minority shareholder protection in takeover transactions in the three countries, especially by courts

This part will compare minority shareholder protection in takeovers in two respects: legislative special protection and judicial remedy.

Legislative protection of minority shareholders in takeovers

Generally speaking, minority shareholders face a more severe risk of expropriation in takeover transactions, and legislation in the US, the Netherlands and China all demonstrate this consideration. In the US, for instance, the main legislative provision that relates to minorities in takeovers is the appraisal right, whilst the Netherlands prescribes the mandatory bid rule

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[1160] Article 38, *CCGC.* Special committees are mandatory for US listed companies and for Dutch listed companies whose board has more than four members.
[1161] Article 38, *CCGC.* Different from the US and the Netherlands, the audit committee is the only mandatory special committee for Chinese listed companies. Chinese audit committee’s proposals should be decided by the board of directors (special committees’ proposals also need to be submitted to the board of directors for decision in the Netherlands). Additionally, the audit committee can only propose to appoint or remove an external auditor. Meanwhile, the US audit committee is in charge of the appointment, compensation and oversight of external auditors.

and the sell-out right.[1162] Chinese legislation seems to combine both jurisdictions by stipulating the appraisal right, the mandatory bid rule and the sell-out right. However, it is necessary to clarify that these pro-minority instruments provided in China are not exactly the same as those found in the US and the Netherlands.

Specifically, the US appraisal right involves the court deciding on a fair share price. Case law confirms that if the controlling shareholder fails in his or her full disclosure duty in a short-form merger, minority shareholders are entitled to the "quasi-appraisal" remedy. Legislation affirms appraisal rights in both one-step and two-step transactions. In contrast, the Chinese "equivalent" is more like an "exit" right, which allows minority shareholders who disagree with the merger or division to request the company to buy back their shares, without appointing the court as the institution to ascertain a fair price.

As for the mandatory bid rule, the Chinese provision varies from the Dutch one in two ways, i.e. the Chinese mandatory bid allows the acquirer to issue part tender offers and can be exempted (exempt the obligation to issue a tender offer in China instead of exempt simply the mandatory bid) if the acquisition is conducted through negotiation,[1163] and the securities regulatory authority under the State Council decides so. Moreover, tender offers are not as popular as negotiated acquisitions in China, and even for takeovers that trigger the mandatory bid threshold, it is common practice that the obligation to issue a tender offer is exempted.[1164] In addition, the threshold of the sell-out right in China is different from the one in the Netherlands.[1165]

Last but not least, in the second phase of takeovers, a US controlling shareholder can freeze-out remaining minority shareholders of a target by cash, normally through a long-form merger or a tender offer plus a short form merger (90% threhold). The Netherlands prescribes both the general squeeze-out and the special squeeze-out following a public offer (within 3 months). Both proceedings follow the 95% threshold to invoke the right to file

[1162] The Dutch appraisal right only applies in very limited situations, as discussed in 6.2 of this chapter.
[1163] Or indirect takeovers as prescribed in Article 56 of the *Takeover Measures*.
[1164] See Chapter 3 section 3.4.3.
[1165] The Dutch threshold for the sell-out right is 95%. According to the 2014 *CSL*, when the acquirer possesses more than 75% shares of a Chinese listed company, or more than 90% shares of a Chinese listed company whose total share capital exceeds 400 million RMB, then the remaining shareholders of the target company are competent enough to exercise their sell-out rights. However, this provision was deleted in the revised 2020 *CSL*. After 1st March 2020, shareholders should refer to regulations of the stock exchange on which the company is listed for guidance.

a claim to squeeze out minority shareholders. Besides the threshold difference (90% v. 95%), eliminating minority shareholders by cash is more difficult in the Netherlands than in the US for the reason that Article 2:325 *DCC* limits the amount of shares that can be traded by cash in a merger, in that the total joint amount should not be more than one-tenth of the nominal amount of the shares. In China, the US style of short-form mergers are not permitted since the *CCL* specifically prescribes that shareholder approval is necessary for mergers (netheir the Dutch style squeeze out). A merger's consideration can be cash, securities or a combination of both in China.[1166] When an acquirer intends to delist the target through a full offer or fails to receive a CSRC exemption from the mandatory bid rule, then the consideration should be in cash or at least a cash option should be provided if the consideration is any tradable securities.[1167]

Judicial protection of minority shareholders in takeovers

Comparatively speaking, the American and the Dutch courts play a greater role in looking after minority interests in takeovers than the Chinese courts. To examine judicial influence, entry is the starting point. Comparing the three jurisdictions, minority shareholders in the US face the lowest "continuous ownership" entrance demands. Meanwhile, the Netherlands imposes a minimum shareholding or share value on the right of inquiry. In China, minority shareholders have to overcome both shareholding and timing obstacles to exercise the right to a derivative action. Statistics have shown that most shareholders on the Chinese securities market, especially individual minority shareholders, fail to overcome the 1% shareholding and 180-consecutive-day requirements.[1168]

To lower the cost of judicial remedy, both the US and the Netherlands have confirmed the "company pay" rule. In the US, class actions are very popular for shareholder litigation. Minority shareholders in the same "class" do not need to go through the turmoil of a trial personally, in order to make their voice heard; instead, they are entitled to the same protection, once their peers succeed in the legal proceeding. The "contingent fee" is another factor that

[1166] When the securities provided as consideration are unlisted, then a cash option should also be provided to the target's shareholders; when providing cash consideration, a deposit of at least 20% of the total price is required. See: Article 36, the *Takeover Measures*.
[1167] Article 27, *Takeover Measures*.
[1168] See Chapter 3 section 3.4.3

motivates US lawyers to pursue minority shareholder litigations. Though the Netherlands does not prescribe the class action, an alternative has been provided, i.e. a settlement agreement can be reached between a foundation or association and the company, and this agreement can be declared by the court to be binding for the entire class of minority shareholders. In China, *Litigation Costs Measures* stipulate that the loser takes on the burden of litigation costs, albeit the plaintiff has to pay his or her own lawyer's fee and the cost of court enforcement. The *CCL Provisions IV* in 2017 affirmed that if the court partly or fully supports the plaintiff's claims, the company should pay all reasonable costs of the derivative action. This provision does not change the fact, however, that shareholders still have to pay expenses first, in order to bring a derivative action. However, the country does innovatively assign a semi-governmental institution, the Investor Service Center, as the representative of minority shareholders, in order to exercise shareholder rights, including the right to bring a derivative action. The ISC is in charge of the lawyers' fees if it decides to bring an action on behalf of minority shareholders. After the revised 2020 *CSL* coming into force on 1st March 2020, the ISC, if it is a shareholder of the company, can directly bring a derivative action without restrictions of the 1% shareholding and the 180 consecutive days. Besides, for private securities litigation, with 50 or more shareholders' authorizations, the ISC can act as a litigation representative and the result will be valid for registered shareholders.

In addition to litigation cost, the Delaware Court of Chancery and the Dutch Enterprise Chamber are both highly specialised in commercial cases, and judges are well-known for their professional knowledge in resolving business and financial disputes. Relatively, the Chinese securities market is considered a newborn, and Chinese judges are also rather inexperienced when it comes to securities cases. In this regard, it is not a surprise that Chinese courts are still lagging behind their US and Dutch counterparts in resolving minority oppression in takeovers.

In the US, minority shareholder expropriations are regulated by the case law of fiduciary duties. US courts have established three judicial standards. Depending on the risk of minority expropriation, these three standards vary from being the least strict, medium, to the strictest. In specific, the business judgment rule, as a default rule, applies to a good faith, fully informed and independent board decision. The enhanced scrutiny standard targets at sale of control transactions in which the conflicts of interest may cause the board to take unnecessary defensive measures or accept a sub-optimal bid at the expenses of shareholders. This standard consists of a two-pronged test of "reasonability" and "proportionality", i.e. the board should prove that there is a reasonable ground to support the belief of an existing company threat and the board's reaction to this threat is reasonable and proportional.[1169] The board also has the obligation to negotiate the highest price available for shareholders in front of an inevitable or imminent sale or break-up of the company,[1170] or in other situations confirmed by courts.[1171] Meanwhile, US courts affirm that uncoerced, fully informed and independent shareholder approval has the cleansing effect in both one-step transactions and two-step *DGCL* §251(h) transactions to shift the review standard from the enhanced scrutiny to the business judgement rule. For freeze-out transactions with the controlling shareholder, US courts impose the strictest entire fairness standard to ensure minority shareholders are protected by fair dealing and fair price. Courts also confirm that if the transaction is approved by both a special independent committee and a majority of minority shareholders under full disclosure, then the business judgment rule applies no matter whether the transaction follows the merger or the tender offer route.

An overview of the US experience indicates that courts act as a pendulum which intends to achieve a balance between the "board primacy" and "shareholder protection" values. (also between "controller authority" and "minority shareholder protection" in freeze-out transactions). In general, board primacy is the norm, under which US corporate law builds on the assumption of "good faith" directors. Shareholders are well protected by shareholder rights, disclosure and independent directors. Consequently, the court prioritises shareholder interests over the discretion of the board when the transaction involves a conflict of interest. US case law is not a rigid and static system but an evolving and enabling one which continuously attempts to strike a balance between the two values. Namely, when procedural protection is sufficiently provided, the judicial review standard may shift from the strict standard to the lenient standard. It is evident that legal instruments such as disclosure and independent directors are portrayed as a "double-edged sword", in that they may monitor directors (or the controlling shareholder) in the

[1169] Unocal Corp. v. Mesa Petroleum Co., 493, A.2d 946 (Del.1985).
[1170] Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506A.2d 173(Del.1986), Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del.1989).
[1171] Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1993).

interests of shareholders (or minority shareholders) and may also serve as a shield to discharge directors (or the controlling shareholder) from strict review standards in certain conditions. In brief, US corporate law pursues a balanced system, in which the court functions as the mediator, by swinging various legal mechanisms to achieve equilibrium in board primacy (controller primacy) and shareholder protection (minority shareholder protection).

Comparing with the US, there is not a clear division of the duty of care and the duty of loyalty in the Netherlands. Alternatively, *DCC* Art.2:8 prescribes the "reasonableness and fairness" principle and Art.2:9 states the "duty of a proper performance". Moreover, the stakeholder model of the *DCC* guides both directors and controlling shareholders to take into account other stakeholders' interests, including minority shareholders.

When it comes to the judicial review standard, Dutch courts do not apply a beforehand protection of the business judgment rule as the US courts do. Instead, *DCC* Art.2:9 implies that director liability should be the general rule in front of mismanagement unless there is neither "serious personal blame" nor "negligence". The "serious personal culpability" and "reasonable and competent third person" standards have enabled Dutch courts to respect the board's discretion on the one hand and to incriminate director malfeasances on the other. In other words, the end result of the Dutch rule may not be substantially different from the "business judgment rule", but it does not assume "innocent" directors by default.

Taking a deeper dive into the Dutch case law, it has been found that the "reasonableness and fairness" principle plays a fundamental role in regulating takeovers. Targeting minority interests, Dutch courts established a "purpose" test, namely if a merger pursues no other purpose but squeezing out minority shareholders, this transaction may violate the reasonableness and fairness principle.[1172] Dutch courts further clarified two elements of the principle, i.e. "independence" and "transparency". In the *Versatel* case,[1173] the court emphasized that a non-independent supervisory board, which was dominated by the controlling shareholder, would greatly harm the minority interests. And

[1172] Supreme Court 14 September 2007, ECLI:NL:HR:2007:BA4117, *JOR*2007/237,(*Centaurus/Versatel I*), and Enterprise Chamber 20 December 2007, ECLI:NL:GHAMS:2007:BC0800, *JOR*2008/36(*Trafalgar/Shell*).
[1173] Enterprise Chamber 14 December 2005, ECLI:NL:GHAMS:2005:AU8151, *JOR*2006.

the controlling shareholder has the duty to properly inform minority shareholders of the merger agreement.

Under the stakeholder model, Dutch courts demonstrate a lenient attitude towards takeover defenses and deference to board authority. In the *RNA* case, the court justified defensive measures under three conditions, namely the measures are to create further consultation, necessary for the company's continuity before further deliberation, and adequate and proportional. The *Akzo Nobel* case stated that the strategic response to an unsolicited takeover offer is within the authority of the board, governed by the stakeholder model.[1174] The *Boskalis* case rejected the applicant's request to incorporate the disputed takeover defense into the agenda based on that the right to put items on the agenda does not include corporate strategies which exclusively belong to the board.[1175] Again, the *ASMI* case affirmed that company strategies are within the authority of the board and the board can freely decide to involve shareholders or not.[1176] In the *ABN* case, the Dutch Supreme Court rebutted the Enterprise Chamber's ruling, which claimed that shareholder approval was needed and the board was obliged to maximize the return of shareholders if the company was "up for sale".[1177] Instead, the Dutch Supreme Court held the opinion that the board should be guided by the interests of the whole company instead of shareholders alone.[1178] In addition, the Enterprise Chamber confirmed in the *EVC* case that certain procedural protection, i.e. the approval of independent directors with veto right and the fairness report of accounting firm, has a cleansing effect in freeze-out mergers.

The Dutch case law has shown that courts mainly rely on two powerful weapons to guard minority shareholders' interests in takeovers: the

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[1174] De Brauw Blackstone Westbroek, AkzoNobel v. Elliott: landmark case on board conduct in takeover situation, available at https://www.debrauw.com/alert/akzonobel-v-elliott-landmark-case-board-conduct-takeover-situations/. Last visited December 2017.

[1175] Cees de Groot, Shareholders' Rights to Have an Item Put on the Agenda of the General Meeting, available at http://leidenlawblog.nl/articles/shareholders-rights-to-have-an-item-put-on-the-agenda-of-the-general-meetin. Last visited December 2017.

[1176] Harm-Jan de Kluiver, Martin van Olffen, Bernard Roelvink and Berto Winters, Dutch Supreme Court Ruling in ASMI: no duty to mediate for supervisory boards, available at https://www.lexology.com/library/detail.aspx?g=597b5e5c-c6cd-4749-a2f5-3c0e5cfa3162. Last visited December 2017.

[1177] Danielle Quinn, 'Dutch Treat: Netherlands Judiciary Only Goes Halfway Towards Adopting Delaware Trilogy in Takeover Context', 41(2008), *Vanderbilt Journal of Transnational Law*, pp. 1211-1249.

[1178] Ibid.

“reasonableness and fairness” principle and the stakeholder model. Dutch corporate law has been known for its flexibility, and the reasonableness and fairness principle performs as a scale to ensure this flexibility is not abused and to maintain the balance of the entire system. To examine the reasonableness and fairness of a takeover transaction, minority shareholder oppression is one of the most influential elements in determining the final result. Moreover, Dutch corporate law was built on the stakeholder model. In takeovers, minority shareholders, as stakeholders who are under the most serious attack, should be offered the intensive care of law. It is evident that a qualified and capable court is indispensable for these two shelters to function in practice. The inquiry proceeding, under the authority of the Enterprise Chamber, has been considered a success for its efficiency, which, to a greater extent, can be attributed to the power to take broad “provisional measures”. Though the Dutch inquiry proceeding does not touch upon compensation and director liability, it still appreciably serves the interests of minority shareholders, or at least from two perspectives, i.e. acting as an information channel for minority shareholders and granting minorities the chance to have an impact on company policies. At the same time, Dutch courts also demonstrate deference to the board’s authority, as well as a lenient attitude towards takeover defences. On the one hand, this stance can be beneficial to minority shareholders if directors manage to use defence measures as a bargaining chip in exchange for a higher premium. On the other hand, it may damage minority interests if takeover defences block the monitoring of an active market of corporate control.

In comparison, Chinese minority shareholders’ rewards for bringing an action do not seem as prominent as in the US or the Netherlands. The most fundamental reason for this is that there is neither a case law tradition nor a strong judicial system in China. Due to this inexperience, Chinese courts are reluctant to accept securities cases, and Chinese minority shareholders therefore face unpredictable results. Accordingly, it is necessary to set a long-term goal to enhance the independence, professionalism and the experience of judges in China. Furthermore, the US and the Dutch experiences have shown that it is possible to take care of minority interests properly, if corporate law can maintain a balanced system. In the US takeover context, shareholder-driven litigation is a powerful weapon to redress any breach of fiduciary duties and to safeguard minority shareholders’ interests. The Netherlands relies on the inquiry proceeding and ex ante legislative protection, such as the mandatory bid rule and the exclusion of cash-out mergers. Referring to these two systems, it is rather impractical for China, at the current stage, to follow the US path and transform its system into a litigation-driven one. Rather, China may resemble the Netherlands by striking a balance between legislative protection and judicial protection.

Different from both the US and the Netherlands, takeover practice on the Chinese market has certain visible characteristics. Particularly, trading suspension as a defence measure is rather popular among Chinese listed companies, though it not only interrupts the stability of the securities market, but it also causes big losses for minority shareholders. It is thus necessary for legislation to regulate and clarify the scope and the procedure of trading suspensions. Moreover, government intervention as a byproduct of the Chinese political system should be limited in certain urgent circumstances, and an announcement should be made to explain why such government intervention is necessary.

Chapter 7 Conclusion and Recommendations for China

The relationship between a listed company and its minority shareholders presumably depicts a win-win situation in which, on the one hand, the company affords to expand its business and develop further by relying on funds raised through the exchange market, while, on the other hand, minority shareholders may receive economic returns by investing in the company. However, this theoretical idealism easily falls apart when minority shareholders' interests are ignored, and, more than often, minority shareholders are too weak to protect themselves. Thus, a country's corporate law system should sustain such equilibrium and prevent minority shareholder expropriations.

China has very distinctive corporate governance due to state ownership and government intervention. Guided by Chinese Communist Party policies, the Chinese socialist market economy is continuously dominated by state ownership, while different ownerships are allowed to develop side by side. Correspondingly, corporate governance with Chinese characteristics combines party leadership through state ownership of shares with the corporate governance of a modern company.[1179] In addition to legal protection, semi-governmental institutions, especially the Investor Service Center, were designed to safeguard investors' interests through the government's visible hand. According to the idiosyncratic vision theory, the peculiar Chinese ownership structure is not necessarily bad for minority shareholders, if the controlling shareholder can practice firm leadership, show effective supervision and continuously push the company forward. Meanwhile, a corporate governance structure based on an imbalance of power implies a big risk of minority shareholder expropriation. This research is conducted to answer one central research question, namely, how could minority shareholder protection in Chinese listed companies be improved in comparison to that in the US and the Dutch systems? To answer this central question, four sub-research questions were raised as follows. Based on the descriptive

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[1179] *《上市公司治理准则》（征求意见稿）修订说明* (*Revision Statement of the Consultation Draft of the Chinese Corporate Governance Code*), issued by the CSRC, date of issue 16th June 2018. Available at http://www.csrc.gov.cn/zjhpublic/zjh/201806/P020180615655618058597.pdf. Last visited October 2018.

comparison of the three jurisdictions in chapter 6, the discussion below will provide answers from a more analytical point of view, with a focus on China.

Sub-question 1: How are minority shareholders protected by shareholder rights according to the law in China, the US and the Netherlands?

This research has found that all three countries positively recognise fundamental shareholder rights, such as the appointment right, the dividend right and the exit right. In particular, the Chinese system has granted more statutory rights to shareholders than the Dutch and the US systems (20 in China, 18 in the Netherlands and 16 in the US). To better understand this difference, two major factors have been identified, namely the ownership structure and the principal-agent power equilibrium.

Ownership structure

This research has shown that the US and the Dutch corporate law systems are based on the dispersed ownership structure, which focuses on the main conflicts of interest between shareholders and directors. In a dispersed company, shareholders' interests normally are in alignment with one another. By protecting shareholders as a group, the US and the Dutch corporate laws also intend to protect each shareholder's interest. However, in special situations such as a freeze-out, minority shareholders' interests are in conflict with those of the controlling shareholder, i.e. the protection of shareholders as a group no longer equates to the protection of minority shareholders. Accordingly, both the US and the Dutch laws underline minority interests in these contexts. In contrast, Chinese listed companies are characterised by their highly concentrated ownership structure. This distinction gives rise to different agency problems. The concentrated ownership structure causes conflicts of interest between the controlling and minority shareholders. Moreover, the special nature of the state controller, which may cause the absence of owner and insider control problems, determines that the conflicts of interest may also exist between management and minority shareholders. These conflicts may be found not only in takeovers but also in normal corporate operations. Thus, when analysing Chinese corporate law, it is necessary to distinguish between the protection of shareholders as a whole and the protection of minority shareholders.

The principal-agent power equilibrium

In the US, the *Delaware General Corporate Law* depicts the board of directors as the governing body of a company and underlines the value of "managerial authority".

The board of directors is entitled to very broad discretion and power in a US-listed company. On the contrary, the *DGCL* does not grant much power to the general meeting of shareholders.[1180] To ensure balanced power between the principal and the agent, Delaware corporate law encourages shareholders to hold directors accountable through litigation and fiduciary duties; in other words, directors should fulfill their fiduciary duties and make the best decisions in the interests of shareholders.

In the Netherlands, the *Dutch Civil Code* accords the governing power to the board of directors while bestowing the general meeting with certain fundamental rights. In alignment with EU *Directives*, the *DCC* prescribes various rights with a threshold to broaden shareholder participation, as well as specific protection for minority shareholders in takeover transactions. Compared with the *DGCL*, the *DCC* stipulates more shareholder rights, whereby a Dutch listed company's general meeting has more powers than its counterpart in the US. To strike a balance, Dutch corporate law demands the board of directors consider the interests of the company as a whole, namely the interests of shareholders and other stakeholders. Guided by the stakeholder model and the equal treatment principle, the board of directors has the obligation to protect minority shareholders.

In China, the *Chinese Company Law* portrays the general meeting as a governing body with extensive powers. Opposite to the US and the Netherlands, the Chinese general meeting is more powerful than the board of directors, and in some circumstances, the "absence of owner" phenomenon turns a powerful general meeting into a powerful board, which exacerbates the "insider control" problem. In other circumstances, the board of directors functions as an extended hand of the controlling shareholder, who in turn dominates the general meeting. This affiliation further enlarges the power discrepancy between the company controller/management and minority shareholders in China.

[1180] Besides state corporate law, such as the *DGCL*, shareholder protection in the US is also achieved through federal securities regulations. For instance, the right to proposal is prescribed on the federal level, not in the *DGCL*.

To reduce this conflict, the *CCL* adopts the "stakeholder model", which guides the board to also consider other stakeholders' interests. Under the concentrated ownership structure, minority shareholders are considered one group of stakeholders. As such, the board of directors should also take care of minority interests; however, the stakeholder definition covers not only minority shareholders but also other stakeholders, such as employees. Namely, company decisions should go beyond commercial interests to look after employees, fulfill social responsibilities and so on. The stakeholder model may make sense for minority shareholder protection in non-state-owned listed companies, but it would probably lose its charm in state-owned listed companies. If the state misuses the company resources to raise employment rates, develop other industries or save other SOEs from bankruptcy, this pursuit of political interests, despite the risk to violating minority shareholders' economic interests, still find its justification under the stakeholder model. Therefore, there is little evidence to prove that the stakeholder model alone is the panacea for minority shareholder expropriations in China.

In addition to the stakeholder model, Chinese legislation attempts to compensate minority shareholders' fragile position with multiple shareholder rights. Besides the "shareholder primacy", this is another reason why Chinese legislation stipulates more shareholder rights than the *DGCL* and the *DCC*. However, it is still questionable whether these shareholder rights in the books add up to proper protection for minority shareholders in reality. This research has found that many of these legislative shareholder rights, (e.g., the right to dividend and the right to question management and supervisors) are exercised through the general meeting, which may serve the convenience of the controller rather than minority shareholders. Different from the general meeting, the powers of which are confirmed by the *CCL*, instruments designed to safeguard minority interests, such as online voting and the separate vote-counting rule, are either prescribed merely in lower regulatory documents or on a voluntary basis. For those minority rights that have been formally recognised in the *CCL*, problems still exist in that some provisions continue to be still controversial (e.g., high thresholds, partial mandatory bid and the guarantee precondition), and also the *CCL* does not take any further steps to supply relevant ancillaries for effective implementation, such as appointing the court to decide the appraisal price.

Sub-question 2: How are minority shareholders protected by monitoring mechanisms, focusing on disclosure and independence, in China, the US and the Netherlands?

Relating to the first sub-research question, examinations of the US and the Netherlands have demonstrated that disclosure and independence, as monitoring mechanisms, intend to balance the power between shareholders and management. The Chinese system also prescribes detailed disclosure rules as well as a supervisory board and independent directors, yet implementation still faces various challenges.

Disclosure

In the US, federal disclosure rules protect shareholders by imposing strict disclosure obligations in order to limit broad directorial powers granted by state corporate law. This disclosure equilibrium has also been found in the Netherlands, for example, the management board is the governing body that has the power to draft the annual accounts. Considering that the annual report is closely related to shareholders' interests, Dutch law restricts the directorial power in this case by giving adoption power to the general meeting and cancelling the automatic discharge of directors (also supervisors). Additionally, both the US and the Dutch regulatory authorities, respectively the U.S.Securities and Exchange Commission and the Dutch Authority for the Financial Markets, vigilantly govern the securities markets. The US and Dutch courts also play an important role in the clarification, interpretation and modernisation of disclosure rules.

Different (in principle) from the shareholder-management conflict in the US and the Netherlands, Chinese listed companies have to deal with controlling-minority conflicts. If the controlling shareholder attempts to withhold or misuse information, or if the controlling shareholder fails to monitor the board breaching the disclosure duty, in both situations minority shareholders will be the victims. Comparatively, the Chinese securities market and the court, currently, are rather immature and cannot afford minority shareholders the same level of protection as their US or Dutch counterparts.

To change this status quo, adding more disclosure rules may not solve the problem, and it may even worsen the "information overload" phenomenon, which has been reported in both China and the US. In this regard, efforts should concentrate on enhancing disclosure monitoring. The 2018 revision of the *Chinese Corporate Governance Code* underlined the importance of the audit committee by upgrading it to a mandatory requirement. Though the new provisions[1181] clarify its scope of obligations, the audit committee merely has the right to propose but not decide on the appointment and dismissal of external audit firms, and its proposals are submitted to the board of directors for decisions. Research has found that the more powerful management is, the less effective the audit committee is.[1182] The audit committee consists of a majority of independent directors, yet it remains unclear whether the existing legislative design is sufficient to ensure independence from management and the controlling shareholder. Besides, the accounting system should also be improved to achieve the unified implementation of accounting rules and to enhance the credibility of intermediate agencies, such as accounting firms and law firms.[1183]

In addition, the "secretary of the board of directors", as a special design to connect various company organs, communicate with diverse interest groups and have wide access to company information, may serve as a bridge to relieve the information asymmetry between the board and minority shareholders. Shareholders' right to know can be traced back to the first version of *Chinese Company Law* in 1993. But how to exercise this right to inspect company documents has been rather unclear in practice. The 2018 revision of the *CCGC* added Article 28 to specify the board secretary's obligations, which include the preparation and reservation of company documents and investor coordination. The 2017 *CCL Provisions IV* confirmed that shareholders have the right to seek compensation from responsible directors and senior management for the failure of the right to know.[1184] By making the secretary (also directors and managers)[1185] accountable to minority shareholders, the vulnerability of minorities in disclosure may be avoided to a certain extent. Last, the China Securities Regulatory Commission should play a more active role in the

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[1181] The revised 2018 *CCGC* emphasises the role of the audit committee through Articles 38 and 39.

[1182] Liu Yan and Yao Haixin, '高管权力，审计委员会专业性与内部控制缺陷(Chief Executive Power, Professional Competence of Audit Committee and Internal Control Weakness)', 17 (2014) *南开管理评论* (*Nankai Business Review)*, pp. 4-12.

[1183] The revised 2018 *CCGC* underlines the role of intermediate agencies through Article 81, which states that intermediate agencies should actively monitor the corporate governance of the company and promote better corporate governance.

[1184] Articles 7 and 12, *CCL Provisions IV*.

[1185] According to Article 12 of the *CCL Provisions IV*, directors or senior managers who fail their obligations to prepare or reserve documents prescribed in Article 33 and 97 and caused damages to shareholders, shareholders are entitled to bring an action against these directors or managers for compensation.

securities market through its rule-making and sanction powers. Taking into account the dominance of the state controller on the Chinese securities market, the CSRC should equally regulate state-owned and non-state-owned listed companies and be transparent about its decisions and the reasons behind them. The newly revised 2020 *CSL* added Article 199 to impose sanctions on illegal vote solicitations; raised the sanctions against controlling shareholders, directors, supervisors or managers for breach of disclosure duties in Article 197; and also affirmed sanctions against intermediate agents, such as auditing and law firms in Article 213. The CSRC should effectively enforce these provisions to have a deterrent effect on non-compliance, especially higher sanctions against individuals and intermediate agents.

Independence

In the US and the Netherlands, independent directors or supervisors, with the main task of monitoring management, are another mechanism to level the principal-agent power. The case law also affirms the value of independent approval.

In China, the mixed structure of independent directors and supervisors confuses their respective roles, represented by the overlapping[1186] vs. supplementary[1187] debate. Generally speaking, academic opinion on the coexistence of the supervisory board and the independent director system can be divided into the "opponent" and "proponent" groups.[1188] The opponent group asserts that the overlapping of supervisors and independent directors not only causes confusion and imposes an extra cost but also reduces monitoring effects. Moreover, in 2003, some scholars proposed abolishing the supervisory board or leaving it to company discretion.[1189] On the contrary, the proponent group claims that the supervisory board is necessary for Chinese

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[1186] Yan Xuefeng, '监事会制度生死之辩 (Dispute on the Dead or Alive of the Supervisory Board)', 11 (2012) *董事会* (*Directors& Boards*), pp. 52-55.

[1187] Shen Sibao and Jia Jing, 'Will the Independent Director Institution Work in China?', 27 (2005) *Loyola of Los Angeles International and Comparative Law Review*, pp. 223-248.

[1188] Xi Chao, 'In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China', 22 (2006) *Connecticut Journal of International Law*, pp. 1-46.

[1189] Supra. 1186.

The "rejection" opinion finds its support in the experience of Japan, which abolished its supervisory board system in the 2002 reform. For more details, please refer to Wang Peng, 'The Effectiveness and Independence of Supervisory Board: Evidence from China 2000-2009', available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2223990. Last visited February 2019.

listed companies,[1190] in that supervisors and independent directors supplement each other, and the only thing required is to further improve the system.[1191] Referring to the Dutch debate on the one-tier and two-tier structures, non-executive directors reportedly enjoy an informational advantage in terms of content and timing aspects, and they are directly involved in decision-making. Meanwhile, supervisors are more independent than non-executive directors. In other words, the Dutch experience illustrates that both structures (i.e., non-executive directors and supervisors) have their own advantages.

Recognising the above findings, the "supplementary" argument seems more reasonable. It is important to understand that the supervisory board and the independent director system, respectively, serve different functions within a Chinese listed company, and they can compensate for each other's weaknesses.[1192] In China, part of the independent directors' role is to act as minority shareholders' "guardian", and the independence standard clearly distances itself from the controlling shareholder.[1193] This is very different from the statutory definition of independent directors in the US, which largely targets management.[1194] To a certain extent, the focus of the US independent director system is comparable to that of the Chinese supervisory board, which seeks to oversee its executives. Meanwhile, one of the key rationales behind the Chinese independent director system emphasises the protection of minority shareholders.[1195] Accordingly, it is important for Chinese legislation to specify the division of tasks between the supervisory board and independent directors so that "overlapping" can be avoided and the "supplementary" relationship between supervisors and independent directors optimised.

[1190] Supra. 1186.
[1191] Supra. 1187.
[1192] It has been claimed that the supervisory board has a postmortem characteristic, in that supervision starts after actions have been finished. Meanwhile, independent directors' monitoring functions during the decision-making process. Furthermore, supervisors are external to company operators, namely directors and managers. While independent directors sit on the board, they are closer to insider information. For more details, please refer to Shen Sibao and Jia Jing, 'Will the Independent Director Institution Work in China?', 27 (2005) *Loyola of Los Angeles International and Comparative Law Review*, pp. 223-248.
[1193] See paragraph 3.3.2.1
[1194] Zhou Ling, 'The Independent Director System and its Legal Transplant into China', 6 (2011-2012) *Journal of Comparative Law*, pp. 262-291.
[1195] Ibid. and supra. 1187.

After confirming independent directors' role as minority shareholder guardians, they should be held accountable to the principal. Considering the controlling-minority conflicts, this promise seems rather empty given that the general meeting appoints independent directors. Although qualified minority shareholders have the right to nominate some independent directors, the *Independent Director Opinion* still chooses to leave the final say to the general meeting, which may, in fact, deprive minority shareholders of any real chance to appoint their own representatives.

To alleviate this complete dependence on the company controller, one option is to hold some of the independent directors truly accountable to minority shareholders.[1196] Specifically, this research has pinpointed four aspects that may be relevant in ensuring the effective functioning of the independent director system. First, minority independent directors (i.e., independent directors appointed by minority shareholders) may become possible either by upgrading existing minority nomination right to an appointment right, or combining the nomination right with the cumulative voting. Minority independent directors can guarantee that there will be independent directors who represent minority interests, and they may also prevent arbitrary rejections made by the controlling shareholder. To prevent minority expropriations, these minority independent directors may have certain approval powers that mainly focus on monitoring executive directors and conflict of interest transactions.[1197] Additionally, legislation may consider granting minority shareholders the right to a private cause of action in order to remove unqualified independent directors.[1198] Currently, the *Chinese Company Law* only has one article stating that a listed company should have independent directors. The rest of the independent director system is stipulated by regulatory documents, the lower legal effect of which may devalue the practical impact. Hence, some thought should be given to establishing a comprehensive independent director system on the level of national law.

Second, the *Equity Incentive Plans* permits a listed company to award shares to its supervisors but not to independent directors. Under the hypothesis of

1196 Lucian A. Bebchuk and Assaf Hamdani, 'Independent Directors and Controlling Shareholders', 165 (2017) *University of Pennsylvania Law Review*, pp. 1271-1315.
1197 Minority independent directors' powers should be limited to minority-related issues, to avoid excessive interference in the governing of the company. See: ibid.
1198 Supra. 1187.

minority independent directors, share rewards may be regarded as an instrument to bundle minority interests with the interests of independent directors. Reasonably, these share rewards should be limited to a small proportion; otherwise, they would have the opposite effect of aligning independent directors with the company controller. In the Netherlands, share rewards for supervisors or non-executive directors are generally prohibited. However, supervisors or non-executive directors' share ownership is eligible as long as it constitutes a long-term investment. Thus, the "long-term" element may be another variable that stimulates minority independent directors' monitoring if small share rewards are allowed.

Third, the China Securities Regulatory Commission may assist in temporarily filling the case law vacuum on the independence issue. In the US, besides the independence definition established by listing rules, courts play an important role in developing this concept on a case-by-case basis. Courts examine not only whether independent directors have faithfully fulfilled the task but also whether independent directors are indeed independent from the company. In contrast to the US, China does not have this case law tradition. Alternatively, the *Independent Director Opinion,* issued by the China Securities Regulatory Commission, confirms that the CSRC has the power to examine the qualifications of independent directors.

Fourth, Chinese legislation has underlined the value of cooperation between the secretary of the board of directors and independent directors.[1199] The board secretary has wide access to company information and is in charge of many disclosure issues. By aligning the board secretary with independent directors, the provision aims to enhance the latter's right to know and to ensure they receive equal information as executive directors. Research highlights that cooperation between the supervisory board and other supervision mechanisms is beneficial to internal supervision.[1200] Similarly, in the Dutch one-tier and two-tier debate, scholars have argued that the "interaction of members"[1201] may provide internally-driven initiatives,[1202]

[1199] *Public Shareholder Provision*.

[1200] Tian Xiangang, 'Analysis of the Functions of Supervisory Board System in Modern Chinese Companies', 51 (2009) *International Journal of Law and Management*, pp. 153-168.

[1201] Jaap Winter and Erik van de Loo, 'Board on Task Towards a Comprehensive Understanding of Board Performance', in Massimo Belcredi and Guido Ferrarini (eds.), *Boards and Shareholders in European Listed Companies* (Cambridge: Cambridge University Press,2013), pp. 225-250.

[1202] Pieter-Jan Bezemer, Stefan Peij, Laura de Kruijs and Gregory Maassen, 'How Two-Tier Boards Can Be More Effective', 14(2014) *Corporate Governance: The International Journal of Business in Society*, pp. 15-31.

which are crucial for increasing board efficiency. Accordingly, it is proposed to encourage cooperation between independent directors and supervisors. Cooperation among the secretary, independent directors, and the supervisory board may reduce information asymmetry both within the board of directors and between the two boards. If this three-party cooperation could be achieved, it may strengthen the supervision of Chinese listed companies and benefit minority shareholders.

Sub-question 3: How are minority shareholders protected in takeovers, especially by courts, in China, the US and the Netherlands?

Generally speaking, the conflicts of interest between the company controller and minority shareholders are severe in takeover transactions. Although all three countries provide special protection to minority shareholders in takeovers, such as the mandatory bid rule and the appraisal right, this research has found that the Chinese version of these rules are still problematic, and the biggest distinction between China and the other two countries lies at the level of the judicial protection.

US courts constantly weigh up the options between the two core values of director primacy and shareholder protection, relying on the two weapons of fiduciary duty and the shareholder model. The first endeavour can be found in the business judgment rule. For a standard transaction, which involves neither sale of control nor self-dealing, courts apply the business judgment rule, with deference to directorial authority. Meanwhile, courts' rulings consistently hold directors accountable for the singular goal of shareholder welfare.[1203] The second endeavour lies in the rebuttal of the business judgment rule. For a sale of control transaction, in which the board's interest may conflict with shareholders' interests, courts apply a stricter enhanced scrutiny standard. For a self-dealing transaction, courts apply the strictest entire fairness standard to protect minority interests. The third endeavour points to the shift of judicial review standard. If sufficient procedural protection has been provided to mimic an at-arm's-length transaction, courts shift the review standard from entire fairness to the business judgment rule. Besides, courts actively partake in implementing the appraisal right.

[1203] Leo E. Strine, Jr., 'The Danger of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporate Law', 50 (2015) *Wake Forest Law Review*, pp. 761-803.

Correspondingly, the Enterprise Chamber has great value in levelling out minority interests with other interests in the Dutch system. One of its most prominent weapons is the extensive power to take provisional measures, such as to suspend or nullify a resolution, and to suspend, dismiss or even appoint directors or supervisors. Through these provisional measures, the Enterprise Chamber can protect shareholders from danger by correcting any mismanagement. Moreover, Dutch courts actively apply the reasonableness and fairness principle to redress minority oppression in takeovers. Grounded on the stakeholder model, they show a lenient attitude towards takeover defence and deferring to board authority. This stance seems to imply the courts' intention to discourage the cultivation of a super-controlling shareholder or active major shareholders.

In comparison, Chinese courts are in the initial stages of resolving highly complex commercial cases. Hardly any fiduciary duty cases are raised by shareholders of listed companies. To address this problem, the newly revised 2020 *Chinese Securities Law* has adopted some litigation-friendly rules to motivate shareholder litigation. In the direction also been proposed in this research, the Chinese "representative action" is established and the ISC is endowed with the right to bring derivative actions (the ISC will also provide support for shareholder litigation in general). For these rules to make a difference in practice, the key question is whether the ISC or other qualified minority shareholders will take an active role in leveraging the judicial remedies to redress minority expropriations and whether Chinese courts will be more involved in reviewing securities cases. In addition, the lack of clear judicial review standards is another reason behind the ineffective judicial protection in Chinese takeovers. An example can be found in the US courts, which require both approval of independent directors and approval of a majority of minority shareholders to shift the review standard from the entire fairness to the business judgment rule in self-dealing cases. These "double approval" procedures are not unheard of in China. In fact, Article 5 of the *Independent Director Opinion* states that material related-party transactions should be recognised by independent directors before they can be sent to the board of directors for discussion. Article 1 of the *Public Shareholder Provision* prescribes that major issues should be approved not only by the general meeting but also by a majority of public shareholders. For self-dealing transactions, which cause a direct conflict of interest between the controlling and minority shareholders, it would be helpful if a clear judicial review standard could be written into the law by combining the above two articles. Subsequently, Chinese courts should gradually improve judges' capability, thus opening the gates to more securities cases. Chinese Courts should also take advantage of the very recent innovation of using standard adjudications to guide securities group actions, to enrich their experience in handling mass litigation.

Sub-question 4: What can China learn from the US and the Netherlands to improve minority shareholder protection in Chinese listed companies?

By analysing the above three sub-questions, this research has found that minority shareholder protection is a common goal in all three corporate law systems. In the US and the Dutch systems, shareholders are protected by an efficient securities market that underlines high-quality disclosure under the supervision of the SEC/AFM. Moreover, both systems strive for "checks and balances" through two key intermediaries, namely courts and the board of directors. By designating the board of directors as the governing body, and together with the coordination of the court, both systems attempt to sustain a balance between the agent and the principal. The task of corporate law is to maintain this equilibrium. In comparison, the main concern in China is how to establish a balanced system by transforming protection in the books into protection in action. Learning from US and the Dutch experiences, minority shareholder protection in China should focus on implementation to address three main areas: market supervision, judicial supervision and the internal supervision within a listed company. Regarding the first two areas, what China can learn from the other two countries has been answered in above three sub-research questions. Certainly, a mature and efficient securities market and judicial system cannot be built in the short term, and scholarly opinions, such as the legal origin and the path dependence theories, to a certain extent recognise that the transformation from a traditional Chinese court system to an active and efficient one as well as the formation of a more developed securities market will be costly and time-consuming. Before achieving the long-term goal of effective judicial supervision and market supervision, another option would be to strengthen the internal checks and balances of a Chinese listed company. The analysis below will focus on how to strengthen supervision inside a company.

In the US, directors serve as an intermediary to compensate for weak shareholder power in the books with pro-shareholder decisions in action, while in the Netherlands, directors serve as an intermediary to neutralise shareholder power in the books with pro-stakeholder decisions in action. Thus, a direct answer drawn from the US and the Dutch experiences will be that the board of directors is the solution to internal checks and balances.

When exploring this "board solution" in the Chinese context, several fundamental differences are worthy of analysis. Different from the dispersed ownership structure, the highly concentrated ownership structure in China generates controlling-minority conflicts. Different from director primacy, the general meeting is the governing body of a Chinese listed company. The controlling shareholder, however, may effortlessly dominate any directorial appointments, so it is unrealistic to expect a controller-dominated board to safeguard minority interests by acting against the controlling shareholder. If the controlling shareholder fails to supervise management, insiders may usurp power to exploit minority shareholders rather than to protect them.

Besides the "board solution", "shareholder activism" is a phenomenon in both the US and the Dutch markets. Traditionally speaking, both the US and the Dutch laws have taken a somewhat cautious attitude to shareholder activism, and academics hold mixed views on the issue. However, recent scholarly opinion proposes distinguishing "good activists" from "bad activists".[1204] The debut in 2017 of the *Framework for U.S. Stewardship and Governance*,[1205] the amendment of the *Shareholder Rights Directive* in 2017,[1206] the revision of the *Dutch Corporate Governance Code* in 2016[1207] and the promulgation of the *Dutch Stewardship Code* in 2018[1208] have demonstrated a positive attitude towards shareholder engagement in corporate governance. In other words, another alternative can be to establish the checks and balances through the "principal solution".

Applying the "principal solution" in China involves the "controller solution" and the "qualified minority shareholder solution". Concerning the "controller solution", discussions in Chapter 2 acknowledge both the advantages and the

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1204 Jennifer G. Hill, 'Good Activist/Bad Activist: The Rise of International Stewardship Codes', 41 (2018) *Seattle University Law Review*, pp. 497-524.
1205 Available at https://www.isgframework.org/corporate-governance-principles/. Last visited February 2019.
1206 Available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32017L0828. Last visited February 2019.
1207 Available at http://www.mccg.nl/?page=3779. Last visited February 2019.
1208 Available at https://www.eumedion.nl/en/public/knowledgenetwork/best-practices/2018-07-dutch-stewardship-code-final-version.pdf. last visited February 2019.

disadvantages of the concentrated ownership structure. According to the optimal reward theory, the controlling shareholder is positively related to the better monitoring of management, which reduces the principal-agent cost and increases company efficiency. As a result, minority shareholders also benefit from this enhanced corporate governance.[1209] Hypothetically, this controller advantage is possible in non-state-owned and state-owned listed companies with good corporate governance. However, some Chinese state-owned listed companies fail to match the ideal theoretical scenario, due to the “absence of owner” and “insider control” problems. To address this, the state controlling shareholder, in order to be fully present and to monitor management actively, should mandate its representatives and the party organisation in every state-owned listed company to behave like private investors. Despite obvious political connections, the state controller and the party organisation should keep a closer eye on former government officials acting as directors or managers of a state-owned listed company so that the insider control problem can be avoided.

The “qualified minority shareholder” solution, whereby minority shareholders are protected through qualified minority shareholders, may supplement the controller’s supervision of management and also oversee the self-supervision of the controlling shareholder in both state-owned and non-state-owned listed companies. As presented in Chapter 2, numerous research studies have pointed to the alignment of multiple, relatively “big” minority shareholders as a legal strategy to form a considerable force in counteracting the controlling shareholder, so that internal “checks and balances” may become possible. Particularly, it has been claimed that qualified minority shareholders may conquer the notorious “rational apathy” and “collective action” problems and effectuate minority shareholder monitoring.[1210]

There are two main reasons why the “qualified minority shareholder” solution may address the minority issue of Chinese listed companies. First, the affiliation between the board and the superpowerful controlling shareholder, or the “absence of owner” problem, inflicts great obstacles on a balanced corporate governance system, and the appearance of qualified minority

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[1209] See Chapter 2 of this research.

[1210] Edward B. Rock, ‘The Logic and (Uncertain) Significance of Institutional Shareholder Activism’, 79 (1990) *Georgetown Law Journal*, pp. 445-506.
Julian Velasco, ‘Taking Shareholder Rights Seriously’, 41 (2007) *U.C. Davis Law Review*, pp. 605-682.
Julian Velasco, ‘The Fundamental Rights of the Shareholders’, 40 (2006) *U.C. Davis Law Review*, pp. 407-468.

shareholders may force a change to this status quo. Specifically, research claims that neither the board of directors nor the supervisory board is effective in counterbalancing the controlling shareholder.[1211] The immature institutional environment and the underdeveloped financial market have prevented monitoring mechanisms from making a real difference in Chinese listed companies.[1212] It has been found that internal mechanisms may be more important than external mechanisms in impeding minority expropriations,[1213] and shareholders' incentives may play a bigger role than governance mechanisms in monitoring.[1214] In comparison with retail minority shareholders, qualified minority shareholders may have both the competence and the incentive to participate actively in the governance of a Chinese listed company.

Second, the negative effects of the "qualified minority shareholder" solution may be restricted in China. The two biggest concerns of shareholder activism are short-termism[1215] and the conflicts of interest between qualified minority shareholders and other retail minority shareholders.[1216] Several parties can play the qualified minority shareholder role in China, such as foreign strategic investors, institutional investors[1217] and the Investor Service Center. Chinese regulations on "strategic investors" demand that foreign shareholders should hold A shares of a Chinese listed company for at least 3 years (the latest *Amendment Consultation Draft* propose to change it to 12 months).[1218]

[1211] Victor Zitian Chen, Jing Li and Daniel M. Shapiro, 'Are OECD-Prescribed "Good Corporate Practices" Really Good in An Emerging Economy?', 28 (2011) *Asia Pacific Journal of Management*, pp. 115-138.

[1212] Jiwei Wang, 'A Comparison of Shareholder Identity and Governance Mechanisms in the Monitoring of CEOs of Listed Companies in China', 21 (2010) *China Economic Review*, pp. 24-37.

[1213] Nancy Huyghebaert and Lihong Wang, 'Expropriation of Minority Investors in Chinese Listed Firms: The Role of Internal and External Corporate Governance Mechanisms', 20 (2012) *Corporate Governance: An International Review*, pp. 308-332.

[1214] Supra. 1211.

[1215] John C. Coffee, Jr. and Darius Palia, 'The Wolf At The Door: The Impact of Hedge Fund Activism on Corporate Governance', 41 (2016) *Journal of Corporation Law*, pp. 545-608.
Xin Tang, 'Protecting Minority Shareholders in China: A Task For Both Legislation and Enforcement', in Hideki Kanda, Kon-Sik Kim and Curtis Milhaupt (eds.), *Transforming Corporate Governance in East Asia* (London: Taylor & Francis Books, 2008), pp. 141-167.

[1216] Bernard S. Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice', 39 (1992) *UCLA Law Review*, pp. 811-893.

[1217] The revised 2018 *CCGC* emphasised the positive role of institutional investors by adding Chapter 7 (Article 78-80) to encourage institutional investors to participate actively in corporate governance.

[1218] Article 5 originally set a minimum requirement of three years. But the latest *Consultation Draft of the Amendment of Measures for the Administration of Strategy Investment in Listed Companies by Foreign Investors, issued on 30th July 2018* changed it to 12 months. See: *外国投资者对上市公司战略投资管理办法* (*Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors*), Ministry of Commerce, China Securities Regulatory Commission, State Administration of Taxation, State Administration for Industry & Commerce, State Administration of Foreign Exchange, date of issue December 31st 2005.

Chinese regulations also require the ISC to consistently hold 100 A shares in most Chinese listed companies. If a qualified minority shareholder of a Chinese listed company is a foreign strategic investor or the ISC, then the provision overcomes short-termism and turns it into a mid- or a long-term shareholder.[1219] In state-owned listed companies, qualified minority shareholders, such as foreign strategic investors and institutional investors, and retail minority shareholders may share the same interest in pursuing economic returns and fighting against insider control and tunnelling.[1220] In non-state-owned listed companies, qualified minority shareholders, such as the ISC and retail minority shareholders, may share the responsibility of supervising the controlling shareholder to prevent minority shareholder expropriations.

The recent development of the ISC seems to match best with the profile of qualified minority shareholders.[1221] The ISC fits the long-term requirement, because its shares are not for sale in general. Besides, the ISC is an innovation "tailor-made" for minority shareholders by the Chinese government, particularly for retail minority shareholders. Though the state-affiliated ISC project is still at a very initial stage, the ISC can be further promoted to truly represent minority shareholders in exercising their rights, monitoring management and seeking compensation through judicial remedies.

In parallel, recent SOE reform calls for a mixed ownership structure that encourages the joint governing of both the state and private shareholders in Chinese listed companies. With the further development and privatisation of Chinese listed companies, private qualified minority shareholders, such as foreign strategic investors and institutional investors, might own a bigger shareholding and gradually engage in sustaining the internal checks and

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1219 It has been found that Western jurisdictions also encourage long-term shareholders by granting them preferential treatment. See: Andrea Sacco Ginevri, 'The Rise of Long-Term Minority Shareholders' Rights in Publicly Held Corporations and Its Effect on Corporate Governance', 12 (2011) *European Business Organization Law Review*, pp. 587-618.

1220 Research has found that qualified foreign insititutional investors imposed better monitoring on Chinese state-owned companies during the split-share reform, thanks to the absence of political pressure. See: Huang Wei and Zhu Tao, 'Foreign Institutional Investors and Corporate Governance in Emerging Markets: Evidence of A Split-share Structure Reform in China', 32(2015) *Journal of Corporate Finance*, pp. 312-326.

1221 Currently, foreign strategic investors and institutional investors jointly only occupy a small portion of the Chinese market. Moreover, the peculiar party state economic system may further increase difficulties in the governance of foreign strategic investors and institutional investors in China. In comparison, the ISC, as a non-profit company designed by the Chinese government particularly to serve minority shareholders, has a better chance of having an impact in practice. See: Tamar Groswald Ozery, 'Minority Public Shareholders in China's Concentrated Capital Markets-A New Paradigm', 30 (2016) *Columbia Journal of Asian Law*, pp. 1-50.

balances of Chinese listed companies in the future. Existing empirical research demonstrates mixed results in terms of institutional investors' impact on Chinese listed companies. Proponents hold the opinion that the coalition of institutional investors may substantially empower small and medium shareholders and allow minority shareholders to participate in governing the company,[1222] while the other side of the coin claims that institutional investors may collude with the controlling shareholder.[1223] Neither the ISC nor private qualified minority shareholders are perfect, thus it is necessary to encourage the growth of both so that they can compensate for each other and create better supervision. For the "qualified minority shareholder" solution to work in China, it is also important for Chinese law to prescribe explicitly certain participation-friendly instruments, such as cumulative voting, separate vote-counting rule and minority independent directors.[1224]

On the basis of the previous four sub-questions, this research will conclude by returning to the central research question: *How could minority shareholder protection in Chinese listed companies be improved in comparison to that in the US and the Dutch systems?*

To answer the central question, this research has analysed the Chinese context and highlighted three key obstacles to minority shareholder protection in listed companies. (1) the lack of independence and strong powers of independent directors reduces the essential protection that Chinese minority shareholders could receive; (2) without sufficient internal supervision, the imbalanced corporate governance of a super-controller with a powerful management team is easily formed within Chinese listed companies; and (3) the immature

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1222 Lu Tong and Yu Baoliang, '格力电器中小股东何以胜出-加强机构投资者参与公司治理的意愿和能力 (How Could the Small-and-Medium Shareholders of Gree Electric Win-Enhancing the Willingness and the Capacity of Institutional Investors to Participate in the Corporate Governance)', 7 (2012) *资本市场* (*Capital Markets*), pp. 116-119.
Li Wei'an and Li Bin, '机构投资者介入公司治理效果的实证研究 (An Empirical Study on the Effect of Institutional Investors Participating in Corporate Governance: Based on the Data of 2004-2006 CCGINK)', 1 (2008) *南开管理评论* (*Nankai Business Review*), pp. 4-14.

1223 Li Wenjing, Kong Dongmin, Liu Shasha and Xing Jingping, '中小股东仅能搭便车么？-来自深交所社会公众股东网络投票的经验证据(Are Small-and-Medium Shareholders Merely Free-Riders?- Empirical Evidence of Online Voting of Public Shareholders of SZSE)',3 (2012) *金融研究* (*Financial Research*), pp. 152-165.

1224 Referring to the US experience, research has found that the shareholder engagement approach also works in controlled companies. Furthermore, one of the ways to effectuate this approach in controlled companies is to empower activist shareholders with the right to select minority directors. See: Kobi Kastiel, 'Against All Odds: Hedge Fund Activism In Controlled Companies', 60 (2016) *Columbia Business Law Review*, pp. 101-172.

institutional environment restrains protection from the market and the judicial system.

Referring to the US and Dutch experiences, it is notable that minority shareholder protection is achieved through balanced corporate governance in general, with special attention given to takeovers. Particularly, the principal-agent power equilibrium that is sustained by the court and the board of directors, alongside a mature securities market, are vital to a balanced system. Under the Chinese socialist market economy, this research argues that the Chinese concentrated ownership structure with a state controller could be efficient, if balanced corporate governance with Chinese characteristics can be established to protect minority shareholders. To reach such balance, the first two obstacles should be addressed by creating internal "checks and balances" through both the "principal" and the "agent". Internal and external protections are two inseparable parts that a mature institutional environment is to be built by progressively overcoming the third obstacle, alongside an enhanced internal supervision. In specific, this research concludes with four main recommendations for the Chinese corporate system, in particular with respect to the protection of minority shareholders.

1. The "agent solution" proposes reducing the affiliation between the board of directors and the controlling shareholder by:

- increasing the proportion of independent directors in the board from one-third to a simple majority;
- allowing a number of minority independent directors, either by replacing qualified minority shareholders' existing nomination right with appointment right or by bundling the nomination right with a mandatory cumulative voting;
- underlining minority independent directors' role in exercising "special powers" provided by the *Independent Director Opinion* regarding material related-party transactions, vote solicitation or other situations that may damage minority shareholders' interests, by granting such independent decisions a cleansing effect in judicial proceedings.

2. The "principal solution" is proposed from both the "controller" and the "qualified minority shareholder" perspectives.

(1) The controller solution:

- the controlling shareholder should dramatically increase its supervision of management and eliminate the "absence of owner" problem by exercising the appointment and removal rights to replace unqualified staffs when necessary;
- the party organisation within a Chinese listed company should respect the autonomy of the company and focus on monitoring instead of corporate decision-making—its powers, obligations and procedures for decision-making should be stipulated in the articles of association;
- government interference in business decisions should be limited to urgent and necessary circumstances, and any intervention should be fully disclosed. If the government pursues non-commercial interests, its reasons, potential impacts and measures adopted to protect investors should be disclosed in a timely manner to minority shareholders.

(2) The qualified minority shareholder solution: the Investor Service Center, as the government's most recent innovation, seems to be the most suitably qualified minority shareholder at the current time. The ISC should play a more active role and fully fulfil its mission to represent minority shareholders, exercise shareholder rights (such as appointment and removal rights), supervise management and the company controller and, especially litigate in the name of minority shareholders (especially for the distribution of dividends, for breach of disclosure duties, and breach of fiduciary duties). Considering the ISC's semi-governmental identity, which casts doubt on its neutrality in supervising the state controller, participation of private qualified minority shareholders, such as foreign strategic investors and institutional investors, should also be encouraged.

3. The "disclosure solution" proposes to protect minority shareholders by reducing information asymmetries.

- minority independent directors should actively exercise the "equal information right" provided by Article 2 *Public Shareholder Provision* by requesting the cooperation of the secretary of the board of directors;
- qualified minority shareholders should facilitate the implementation of minority shareholders' right to know prescribed in Article 97 *Chinese*

Company Law by bringing actions to seek compensations from responsible directors, board secretaries or senior managers based on Article 12 *Chinese Company Law Provisions IV*;

- the China Securities Regulatory Commission should enhance its supervision on disclosure by strictly enforcing the non-compliance sanctions prescribed in the newly revised 2020 *Chinese Securities Law*, particularly Article 197 (sanctions against the controlling shareholder, directors, supervisors or managers) and Article 213 (sanctions against intermediate agents);
- qualified minority shareholders should make good use of the newly added "representative action" (Article 95, 2020 *Chinese Securities Law*) to redress securities disclosure infringements, such as false statements, and to seek compensations on behalf of other minority shareholders.

4. The "judicial solution" proposes minority shareholder protection in takeovers, especially by courts.

- provisions of the mandatory bid prescribed in the *Takeover Measures* should be amended to remove different treatments between negotiated takeovers and indirect takeovers, and to be in consistent with Articles 65 and 73 of the 2020 *Chinese Securities Law*;
- appraisal right provisions should add specific procedural rules, and affirm courts to decide a reasonable appraisal price;
- the newly revised 2020 *Chinese Securities Law* exempts the Investor Service Center from the threshold of 1% shareholding plus 180 consecutive days for bringing a derivative action. It is reasonable to grant this preferential treatment to also private qualified minority shareholders;
- *Chinese Company Law* should specify the controlling shareholder's fiduciary duty instead of providing a general list of shareholders' prohibited behaviours in Article 20;
- for self-dealing transactions with a company's controlling shareholder, the law can consider combining Article 5 of the *Independent Director Opinion* and Article 1 of the *Public Shareholder Provision* to require approval from both independent directors and minority shareholders. This "double approval" requirement will function better if it is prescribed in the law instead of regulatory documents;
- Chinese courts should gradually build a more efficient judicial system with qualified judges who are independent and highly versed in handling

sophisticated and sensitive commercial cases. The Shenzhen Financial Tribunal and the Shanghai Financial Court provide a unique opportunity to experiment and test the effectiveness of a Chinese commercial court. If this pilot project proves to be a success in practice, the outlook is bright that minority shareholders will receive enhanced judicial protection in the future.

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Summary

The securities market is a platform through which listed companies can raise funds for further development and shareholders can pursuit more economic returns by investing in listed companies. The characteristics of modern listed companies have determined that it is infeasible for shareholders, especially minority shareholders, to participate or supervise every company decision. In the Chinese context, the concentrated ownership structure and the state controlling shareholder cause evident conflicts of interest between minority shareholders and controlling shareholders/management. To prevent minority shareholder expropriation, the Chinese corporate law system should sustain a balanced relationship between a listed company and its minority shareholders. To achieve this goal, this research intends to resolve the central research question: how could minority shareholder protection in Chinese listed companies be improved in comparison to that in the US and the Dutch systems?

To answer this question, a systematic comparative study of minority shareholder protection in China, the US and the Netherlands has been conducted through three main aspects, namely shareholder rights, monitoring mechanisms of disclosure and independence, and protection in takeover transactions (especially by courts), under the theoretical framework of "principal-agent conflict" and "principal-principal conflict". Traditionally speaking, a dispersed ownership structure mainly faces the principal-agent conflict between shareholders and directors. A concentrated ownership structure mainly faces the principal-principal conflict between the controlling and minority shareholders. Taking into consideration the characteristics of the Chinese market, the principal-agent conflict mainly refers to the conflicts of interest between minority shareholders and management. Principal-principal conflict in State-owned listed companies has been identified more often as political conflicts between the State controlling shareholder and minority shareholders, while principal-principal conflict in non-State-owned listed companies matches with the traditional understanding of economic conflicts between private controlling shareholders and minority shareholders.

This research has found that in the US, minority shareholder protection is not a separate goal of some specific minority-friendly rules, but the collective result of balanced corporate governance which establishes checks and balances among different parties within a company. Based on the dispersed market, US corporate law constantly strikes a balance between shareholder protection and director primacy. The federal securities regulations pursue the goal of shareholder protection through two main weapons, i.e. disclosure and independent directors. The state corporate law advocates the value of director primacy by portraying a powerful board of directors but also restrains directorial powers through fiduciary duties to guard shareholders' interests. Two elements, namely market supervision and judicial protection, are essential in preventing the board from going astray. In particular, the court plays a fundamental role in guarding minority interests in takeover transactions. Minority shareholders are protected by easy access to judicial remedies, a fair appraisal price decided by the court, and strict judicial review standards. By balancing between shareholder protection and director primacy, such corporate governance benefits shareholders as a whole.

In special situations where the risk of minority shareholder expropriation is high, for example in takeover transactions, minority shareholders are protected by both legislation and case law.

Guided by EU directives, Dutch corporate law follows a stakeholder model and designates the board of directors as the governing body of a company. This design, to a certain extent, averts a general meeting with many decision rights. Shareholders are generally protected by shareholder rights, transparency and independent supervision. In takeover transactions, minority shareholders' interests are underlined by special legislative protection. Moreover, the Enterprise Chamber is entitled to take provisional measures in an inquiry proceeding, which substantially improves its effectiveness in redressing minority shareholder oppressions. Minority interests are mainly protected in Dutch case law through the "reasonableness and fairness" principle and the "stakeholder model".

Comparing China with the US and the Netherlands, this research has identified five main differences between China and the two jurisdictions. First, different ownership structures create different conflicts of interest. The dispersed ownership structure mainly faces the conflicts of interest between shareholders and directors. The Chinese concentrated ownership structure deals with both conflicts of interest between management and minority shareholders and conflicts of interest between the controlling and minority shareholders. Second, both US and Dutch corporate laws designate the board of directors as the governing organ of a company, while Chinese corporate law designates the general meeting as the governing organ. Third, despite all three countries have adopted comprehensive disclosure rules and have appointed a regulatory institution to oversee the securities market, disclosure qualities and market transparencies of the US and the Dutch markets are generally higher than the Chinese securities market. Fourth, the three jurisdictions have different board structures, with a one-tier board in the US, a choice between one-tier and two-tier boards in the Netherlands and two-tier board (with independent directors) in China. Fifth, due to the lack of a case law tradition and the lack of experience of Chinese judges in adjudicating securities cases, Chinese courts still lag behind the US and the Dutch counterparts in proficiency and efficiency.

Taking into account these differences, this research further analyzes the Chinese context, examines key obstacles and provides specific recommendations on minority shareholder protection in Chinese listed companies. These recommendations concentrate on four main solutions. (1) The "agent solution" proposes measures to reduce the affiliation between the board of directors and the controlling shareholder. (2) The "principal solution" is proposed from both the "controller" and the "qualified minority shareholder" perspectives. (3) The "disclosure solution" proposes to protect minority shareholders by reducing information asymmetries. (4) The "judicial solution" suggests concrete measures to strengthen judicial protection of minority shareholders, particularly in takeovers.

Samenvatting

De effectenmarkt is een platform waar beursgenoteerde vennootschappen kapitaal kunnen aantrekken voor verdere ontwikkeling en waar aandeelhouders economisch rendement nastreven door te investeren in beursvennootschappen. De kenmerken van moderne beursgenoteerde vennootschappen maken dat het voor aandeelhouders, met name minderheidsaandeelhouders, niet haalbaar is om deel te nemen aan of toezicht te houden op elke ondernemingsbeslissing. In de Chinese context veroorzaken de geconcentreerde eigendomsstructuur en de staat als controlerende aandeelhouder evidente belangenconflicten tussen enerzijds de minderheidsaandeelhouders en anderzijds controlerende aandeelhouders/het bestuur van de vennootschap. Om benadeling van minderheidsaandeelhouders te voorkomen, moet het Chinese vennootschapsrecht een evenwichtige relatie zien te vinden tussen een beursgenoteerde vennootschap en haar minderheidsaandeelhouders. Om dit doel te bereiken, staat in dit onderzoek de volgende onderzoeksvraag centraal: hoe kan de bescherming van minderheidsaandeelhouders van Chinese beursgenoteerde vennootschappen worden verbeterd in vergelijking met die in de VS en Nederland?

Om deze vraag te beantwoorden, is een systematisch rechtsvergelijkend onderzoek verricht naar de bescherming van minderheidsaandeelhouders in China, de VS en Nederland op basis van drie hoofdaspecten, namelijk 1) aandeelhoudersrechten, 2) monitoringmechanismen van openbaarmaking en onafhankelijkheid, en 3) bescherming bij overnametransacties (vooral door de rechter). Het theoretische kader van het "principaal-agent conflict" en het "principaal-principaal conflict" vormt daarbij het uitgangspunt. Traditioneel gezien is bij een wijdverspreid aandelenbezit vooral sprake van een principaal-agent conflict tussen aandeelhouders en bestuurders. Bij een geconcentreerd aandelenbezit is vooral sprake van een principaal-principaal conflict tussen de controlerend aandeelhouder en de minderheidsaandeelhouders. Gelet op de kenmerken van de Chinese markt is het principaal-agent conflict voornamelijk terug te voeren op de belangenconflicten tussen minderheidsaandeelhouders en het bestuur. Het principaal-principaal conflict bij beursvennootschappen die in handen zijn van de Chinese staat, wordt doorgaans gezien als politieke conflicten tussen de (Chinese staat als) controlerend aandeelhouder versus de minderheidsaandeelhouders, terwijl het principaal-principaal conflict bij beursvennootschappen die niet in handen zijn van de Chinese staat, overeenkomt met het traditionele begrip van economische conflicten tussen controlerend aandeelhouders en de minderheidsaandeelhouders.

Uit dit onderzoek is gebleken dat bescherming van minderheidsaandeelhouders in de VS geen afzonderlijk doel is van een aantal specifieke ‘minderheidsvriendelijke’ regels, maar het resultaat is van een evenwichtige corporate governance, die *checks and balances* tussen verschillende partijen binnen een beursvennootschap tot stand brengt. Gelet op het wijdverspreide aandelenbezit bij beursvennootschappen bewerkstelligt het Amerikaanse vennootschapsrecht voortdurend een evenwicht tussen bescherming van aandeelhouders en *director primacy*. De federale effectenwetgeving streeft naar het doel van aandeelhoudersbescherming via twee belangrijke instrumenten, namelijk openbaarmaking en onafhankelijke bestuurders. Het vennootschapsrecht van de deelstaten benadrukt enerzijds het belang van *director primacy* door een krachtige raad van bestuur, maar beperkt anderzijds de bestuursbevoegdheden door *fiduciary duties* om de belangen van de aandeelhouders te behartigen. Twee elementen, namelijk markttoezicht en rechterlijke bescherming, zijn essentieel om te voorkomen dat het bestuur de verkeerde kant op gaat. Met name de rechter speelt een fundamentele rol bij het beschermen van minderheidsbelangen bij overnametransacties. Minderheidsaandeelhouders worden beschermd door gemakkelijke toegang tot rechtsmiddelen, een eerlijke prijs die door de rechter wordt vastgesteld en strikte normen voor rechterlijke toetsing. Door een evenwicht te vinden tussen aandeelhoudersbescherming en het primaat van het bestuur komt een dergelijke corporate governance de aandeelhouders als geheel ten goede. In bijzondere situaties waarin het risico op benadeling van minderheidsaandeelhouders hoog is, bijvoorbeeld bij overnametransacties, worden minderheidsaandeelhouders beschermd door zowel wetgeving als jurisprudentie.

Het Nederlandse ondernemingsrecht, beïnvloed door EU-richtlijnen, gaat uit van het stakeholdermodel en wijst de raad van bestuur aan als het leidinggevende orgaan van de vennootschap. Dit ontwerp voorkomt tot op zekere hoogte een algemene vergadering met veel beslissingsrechten. Aandeelhouders worden over het algemeen beschermd door aandeelhoudersrechten, transparantie en onafhankelijk toezicht. Bij overnametransacties worden de belangen van minderheidsaandeelhouders onderstreept door speciale wettelijke bepalingen. Bovendien kan de Ondernemingskamer voorlopige voorzieningen treffen in een enquêteprocedure, wat haar effectiviteit bij het terugdringen van de onderdrukking van minderheidsaandeelhouders aanzienlijk verbetert. Minderheidsbelangen worden in de Nederlandse jurisprudentie voornamelijk beschermd door het beginsel van “redelijkheid en billijkheid” en het “stakeholdermodel”.

Door de rechtsvergelijking met de VS en Nederland heeft dit onderzoek vijf belangrijke verschillen tussen China en de andere twee rechtssystemen aan het licht gebracht. Ten eerste zorgen verschillende eigendomsstructuren voor verschillende belangenconflicten. Een wijdverspreid aandelenbezit leidt voornamelijk tot belangenconflicten tussen aandeelhouders en bestuurders. De Chinese geconcentreerde eigendomsstructuur leidt zowel tot belangenconflicten tussen het bestuur en minderheidsaandeelhouders als tot belangenconflicten tussen de controlerende aandeelhouders en minderheidsaandeelhouders. Ten tweede wijzen zowel het Amerikaanse als het Nederlandse vennootschapsrecht de raad van bestuur aan als het leidinggevende orgaan van de vennootschap, terwijl het Chinese vennootschapsrecht de algemene vergadering van aandeelhouders aanwijst als het leidinggevende orgaan. Ten derde, ondanks dat alle drie de landen uitgebreide openbaarmakingsregels hebben aangenomen en een toezichthouder hebben aangesteld om toezicht te houden op de effectenmarkt, is de kwaliteit van openbaarmaking en de markttransparantie van de Amerikaanse en de Nederlandse markten over het algemeen hoger dan die van de Chinese effectenmarkt. Ten vierde hebben de drie rechtssystemen verschillende bestuursstructuren, met een *one-tier board* in de VS, een keuze tussen *one-tier* en *two-tier boards* in Nederland en *two-tier board* (met onafhankelijke bestuurders) in China. Ten vijfde blijven Chinese rechtbanken door het ontbreken van een rechtspraaktraditie en het gebrek aan ervaring van Chinese rechters bij de beslechting van effectenzaken, achter op hun Amerikaanse en Nederlandse tegenhangers wat betreft bekwaamheid en efficiëntie.

Rekening houdend met deze verschillen wordt in dit onderzoek een nadere analyse gemaakt van de Chinese context, worden de belangrijkste obstakels onderzocht en worden specifieke aanbevelingen gedaan betreffende bescherming van minderheidsaandeelhouders in Chinese beursgenoteerde vennootschappen. Deze aanbevelingen concentreren zich op vier hoofdoplossingen: (1) De "agent-oplossing" stelt maatregelen voor om de verbondenheid tussen de raad van bestuur en de controlerend aandeelhouder te verminderen; (2) De "principaal-oplossing" stelt maatregelen voor vanuit het perspectief van zowel de controlerend aandeelhouder als de gekwalificeerde minderheidsaandeelhouder; (3) De "disclosure-oplossing" stelt voor om minderheidsaandeelhouders te beschermen door informatieasymmetrie te verminderen; en (4) De "gerechtelijke oplossing" stelt concrete maatregelen voor om de rechtsbescherming van minderheidsaandeelhouders te versterken, met name bij overnames.

Curriculum vitae

Qiqi FU

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Short bio	
Qiqi Fu is a researcher from China with both Chinese and European education background. Her research interests focus on Corporate law, in particular, shareholder protection, corporate governance and M&A. Prior to her PhD, she held two master degrees, respectively in Comparative law and European and International law, and a bachelor degree in Chinese law. She speaks Chinese, English and Italian, and she is a lawyer in China.	
Education	
PhD candidate, Erasmus School of Law, Erasmus University Rotterdam	2013-2017
LLM, China-EU School of Law, University of Hamburg, Germany	2010-2013
LLM, China-EU School of Law, China University of Political Science and Law	2010-2013
Bachelor in Law, School of Law, Communication University of China	2006-2010
Work experience	
President of Board of the PhD in Law Association Rotterdam, Erasmus School of Law, Erasmus University Rotterdam	2014-2015
Legal Intern and Researcher, Chiomenti Studio Legale Bejing Office	2013
Research and Teaching Assistant of Professor Wintermuth, China-EU School of Law, China University of Political Science and Law	2012-2013
Prizes and awards	
China Scholarship Council PhD Full Scholarship	2013-2017
Scholarship for Summer School Program of Brussels, France and Italy, China-EU School of Law, University of Hamburg, Germany	2012
Scholarship of China-EU School of Law, China University of Political Science and Law	2010-2013

Best Oralist and Champion, China-EU School of Law Moot Court	2012
Best Oralist, The Willem C. Vis ICA Moot (CIETAC)	2010
Publications	
Qiqi Fu and Paola Pasquali, 'Legal Instrumentalism In China: The Case of Hukou Legislation in Beijing and Shenzhen' in Setsuo Miyazawa, Weidong Ji, Hiroshi Fukurai, Kay-Wah Chan and Matthias Vanhullebusch (ed.), East Asia's Renewed Respect for the Rule of Law in the 21st Century: The Future of Legal and Judicial Landscapes in East Asia (Leiden: Brill Nijhoff Publisher, 2015), pp. 261-281.	2015.
Others	
The Willem C. Vis International Commercial Arbitration Moot, Vienna, Austria	2013
58th Harvard National Model United Nations, Boston, United States	2012
Oxford Price Media Law Moot Court, Oxford, United Kingdom	2010

PhD Portfolio

Name PhD student : Qiqi Fu

PhD-period : 2013-2017

Promoters : Yuwen Li, Marnix van Ginneken

Co-promoter : Maarten Verbrugh

PhD training

EGSL courses	*year*
Academic Writing in English	2013-2014
Research Lab	2013-2014
Collaborating with your Supervisor	2013-2014
Introduction Legal Methods	2013-2014
Writing Clinic	2013-2014
Reflections on Social Science Research	2013-2014
Course on Presentation Skills	2013-2014
Specific courses	***year***
Corporate Governance	2013-2014
Company Law and Restructuring	2013-2014
Seminars and workshops	***year(s)***
Erasmus China Law Center Monthly Brown Bag Lunch	2013-2017
Erasmus China Law Center Quartely Seminar	2013-2017
Commercial and Corporate Law Lunch Lecture	2013-2017
Nudging and Beyond: Current Applications and New Perspectives on Behavioural Insights Conference	2013

Presentations	*year*
Presentation at Erasmus China Law Center Quarterly Seminars	2013-2017
Presentation at Commercial and Corporate Law Lunch Lecture	2013-2017
Attendance (international) conferences	***year***
8th Annual Conference: New Approaches and New Questions in Chinese Law, European China Law Studies Association, Oxford, UK	2013
International Conference: Rules for the Market and Market for Rules, Corporate Law and the Role of the Legislature, Fondazione Giorgio Cini Island of San Giorgio, Venice, Italy	2015
Teaching	***year***
n/a	
Others	***year***
n/a	