The Law and Practice of Shareholder Inspection Rights: A Comparative Analysis of China and the U.S.

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Abstract

Shareholder inspection rights allow a shareholder to access the relevant documents of the company in which they hold an interest, so as to address the problem of information asymmetry and reduce the agency costs inherent in the corporate structure. While Chinese corporate governance and American corporate governance face different sets of agency cost problems, this paper shows that shareholder inspection rights play an important role in both China and the U.S.. On the books, while shareholder inspection rights in both countries are broadly similar, there are some important differences on such issues as the proper purpose requirement. Our empirical analysis further sheds light on how inspection rights operate on the ground. We find that many inspection cases are filed in both China and in Delaware. These cases are resolved by the courts relatively quickly. While inspection rights in both countries are frequently used as a pre-suit discovery device, the types of subsequent litigation that can be filed in each country are quite different. Efforts are made to explain, and draw implications from, the similarities and differences on shareholder inspection rights between the two countries.

Keywords: inspection rights; corporate governance; agency costs; China; U.S.

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Vanderbilt Journal of Transnational Law (forthcoming)

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I. Introduction

The shareholder's right to inspect corporate documents has a long history, originating in the common law in the 1700s.[1] In the U.S., all states have now codified shareholder inspection rights, albeit with some significant differences amongst them. Drawing upon overseas experiences such as the U.S. law, China introduced the concept of shareholder inspection rights in broad terms when its first national company law was enacted in 1993, and has since continued to improve the regime, particularly in the 2005 company law revision.[2]

Shareholder inspection rights allow a shareholder to access the documents of the company in which they hold an interest, so as to address the problem of information asymmetry and reduce the agency costs inherent in the corporate structure. By inspecting corporate documents, the shareholders can obtain relevant information to monitor the company's performance, evaluate the company's financial status, and determine whether and how to take proper action such as a proxy fight to replace the incumbent management team or a derivative suit against directors and others who cause harm to the company.

As is well-recognized in comparative corporate law scholarship, agency problems and thus the strategies used to deal with them differ systematically across jurisdictions.[3] There are three main agency problems in the company, namely the conflict between the shareholders and the managers, the conflict between the majority shareholders and the minority shareholders, and the conflict between the shareholders and the non-shareholder stakeholders such as creditors, employees and customers. In the U.S. where the publicly traded company is characterized by dispersed ownership, the shareholder-manager conflict is the main type of agency problems. In contrast, in China, where the ownership of shares is more concentrated in the hands of majority shareholders, whether the state or wealthy families, the second agency problem is more severe. In both contexts, shareholder inspection rights can play an important role in generating relevant information needed for controlling agency problems, but variations may exist due to institutional differences.

This paper thus aims to compare shareholder inspection rights in China and the U.S. which is mostly represented by Delaware, the preeminent corporate law jurisdiction in the U.S. In doing so, we do not only examine the law on the books, but also the law in practice. Part II and Part III provide detailed discussions of the law and practice of shareholder inspection rights in China and Delaware respectively. Part IV conducts a China-U.S. comparison of the key aspects of shareholder inspection rights,

[1] Randall S. Thomas, 'Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information', 38 *Arizona Law Review* 331, 337 (1996).

[2] 中华人民共和国公司法(Zhonghua Renmin Gongheguo Gongsi Fa, Company Law of the People's Republic of China), first promulgated by the Standing Comm. Nat'l People's Cong. on Dec. 29, 1993. The law underwent major changes in 2005, and relatively minor changes in 1999, 2004, 2013 and 2018. Hence it is customarily abbreviated as the 2005 Company Law.

[3] Reinier Kraakman, John Armor, Paul Davis et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford, 2017, 3rd ed.), chapter 2 (agency problems and legal strategies).

and then tries to explain the similarities and differences between them. It finishes with some brief conclusions.

II. Shareholder Inspection Rights Under Chinese Law

A. The Legal Framework

The Chinese regime for shareholder inspection rights can be traced back to the first national company law of the PRC, namely the 1993 PRC Company Law.[4] The relevant provisions therein, however, were very brief and general, simply stating that the shareholders have the right to inspect certain materials such as the minutes of the shareholders' meetings and the financial reports. The 1993 Company Law underwent several minor amendments before it was overhauled in 2005 and was thus called the 2005 PRC Company Law which is still in force today despite some minor revisions thereafter. The 2005 PRC Company Law represents a significant improvement over its 1993 predecessor, providing more details on the regime of shareholder inspection rights. However, over the years, even the 2005 PRC Company Law proved to be inadequate in relation to shareholder inspection rights.

On 25 August 2017, the Supreme People's Court (SPC) promulgated the long-awaited fourth judicial interpretation on the 2005 Company Law (2017 Judicial Interpretation), which came into effect on 1 September 2017.[5] A total of six provisions in this instrument are devoted to inspection rights litigation, providing more guidance on how the cases should be brought and heard. The key features of shareholder inspection rights under the Chinese law are summarized below.

First, shareholder inspection rights are regulated differently according to the type of companies concerned. There are two main types of companies allowed under the Chinese company law, namely the limited liability companies (LLC) and the joint stock limited companies (JSC).[6] The 2005 PRC Company Law sets out two provisions, namely §33[7] and §97[8], to stipulate shareholder inspection rights in the context of LLCs and JSCs separately.

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[4] 1993 PRC Company Law, §32 and §110.

[5] 《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)》[The Fourth Judicial Interpretation of the Supreme People's Court on Various Issues Concerning the Application of the PRC Company Law] (promulgated on 25 August 2017, effective from 1 September 2017). In China, the judicial interpretation as issued by the SPC carries the force of law.

[6] From a comparative law perspective, the Chinese LLC is broadly similar to the close corporation in the US or the private company in British Commonwealth jurisdictions, while the JSC corresponds to the publicly held corporation or the public company in the Anglo-American world. Internationally, the term 'corporation' in the U.S. is the counterpart of the term 'company' commonly used in many British Commonwealth jurisdictions as well as in China. For convenience, the two terms are used interchangeably in this paper, unless specifically indicated.

[7] This provision states that:

> Every shareholder shall be entitled to review and duplicate the company's bylaw, the minutes of the shareholders' meetings, the resolutions of the board of directors' meetings, the resolutions of the board of supervisors' meetings, as well as the financial reports.
>
> Every shareholder may request to review the accounting books of the company. Where a shareholder requests to review the accounting books of the company, it shall submit a written request, which shall state his motives. If the company, has the legitimate reason to believe that the shareholder's requests to review the accounting books has an improper motive and may impair the legitimate interests of the company, it may reject the request of the shareholder to review the books and shall, within in 15 days after the shareholder submits a written request, give the shareholder a written reply, which shall include an explanation. If the company reject the request of any shareholder to review the

Second, there are no statutory restrictions on the eligibility of the shareholder to exercise inspection rights, such as the requirements of a minimum shareholding level and specified holding period. According to the 2017 Judicial Interpretation, if a shareholder of a company files for inspection rights under §33 or §97 of the 2005 PRC Company Law, the court should accept the case. But if the company produces evidence that the plaintiff does not have the status of shareholder at the time of pleading, the court should dismiss the case. There is an exception, however, under which if a former shareholder can produce *prima facie* evidence that their interests were harmed at the time when they held shares, they also have right to inspect relevant materials falling within their shareholding period.[9]

Third, the materials subject to inspection rights are divided into different categories. The first category consists of the company's bylaw, the minutes of the shareholders' meetings, the resolutions of the board of directors' meetings, the resolutions of the board of supervisors' meetings, as well as the financial reports. The second category is the accounting books of the company. Ambiguity may arise here as to whether the term 'accounting books' includes original accounting vouchers and whether the inspection right can extend to other materials not listed in the law such as contracts. For the purpose of this paper, original accounting vouchers and other materials are treated as belonging to the third and fourth categories of materials discussed in the text above, respectively.

For LLCs, the shareholder can request for both the first and second categories of materials. By contrast, only the first category of materials is explicitly provided for the shareholders of JSCs.[10] However, there are two additional items listed for JSC shareholders, namely the stock ledger and the stubs of corporate bonds, which are not available to LLC owners.[11]

Fourth, a bifurcated approach is taken to setting out the prerequisites for exercising inspection rights, depending on what category of materials the shareholder is trying to access. Basically, for the first category of materials, access is more liberal without any explicit prerequisites laid down in the law. In contrast, as the second category of materials is more sensitive, there are both procedural and substantive restrictions. To start with, the shareholder needs to submit a written request for this type of information, which shall state a proper purpose. Then, if the company has

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accounting books, the shareholder may plead a people's court to demand the company to open the books for his review.

[8] This provision states that:

The shareholders shall be entitled to review the bylaw, the register of the shareholders, the stubs of corporate bonds, the minutes of the shareholders' assembly meetings, the minutes of the meetings of the board of directors, the minutes of the meetings of the board of supervisors, and the financial reports, and may put forward proposals or raise questions about the business operations of the company.

[9] 2017 Judicial Interpretation, §7.

[10] Presumably, as many JSCs are listed companies and thus are required to publicly disclose accounting information, there is usually little need to resort to inspection rights litigation to get these documents.

[11] The stubs of corporate bonds are the original record of the bonds that the company has issued, and a shareholder would want to inspect them to verify the truthfulness of the corporate bonds. In China, only JSCs can issue corporate bonds, hence the right to inspect the stubs is only provided to JSC owners.

For the stock ledger, it is generally unnecessary to seek it in the context of LLCs where the number of shareholders is normally small and shareholders tend to know each other well. In any event, the shareholder register of LLCs can be readily available from the company registrar and there is little need for inspection rights litigation.

legitimate reasons to believe that the shareholder's request for inspecting the accounting books is for an improper purpose, and may impair the legitimate interests of the company, it may reject the request of the shareholder to inspect the books. If it chooses to do so, it must within 15 days after the shareholder submits a written request, give the shareholder a written reply to explain the rejection. Finally, once the company refuses the shareholder's request, the shareholder may apply to the appropriate court for an order compelling production. If the court supports the shareholder's request, the judgment should clearly specify what materials the shareholder can inspect as well as when and where to inspect those materials.[12]

The difficult and perennial question here is what constitutes an 'improper purpose' on the part of the requesting shareholder. The 2017 Judicial Interpretation sheds some light on this issue, enumerating four circumstances where an improper purpose may be found. The first three circumstances are specific, while the fourth is a catch-all provision.[13]

Finally, several other rules are designed to strike a balance between protecting legitimate use of and preventing abuse of shareholder inspection rights. For example, a shareholder cannot be substantially deprived of their inspection rights by the company's bylaws or any agreement between shareholders.[14] Further, if a director or a senior executive of a company fails to perform duties in making or preserving the company's documents and materials covered within the shareholder inspection rights, and this act causes harm to a shareholder, the officer/director can be held personally liable to compensate the shareholder.[15] However, if a shareholder of a company divulges any trade secret of the company it learned of from exercising its inspection right, and this disclosure causes damage to the company's lawful interests, then the shareholder can be held liable to compensate for the relevant losses suffered by the company.[16]

Although China has gradually set up a relatively complete legal framework for shareholder inspection rights, there are still many unanswered questions. For instance, can the inspection right be exercised by a beneficial owner whose shares are held in a voting trust or by a nominee on their behalf? What is the full extent of the materials that can be inspected? What is the content of the 'improper purpose' restriction? What is meant by a substantial deprivation of the shareholder's inspection right? To shed light on how the shareholder inspection right has been exercised in China, we conduct an empirical study of how courts have treated inspection right cases.

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[12] 2017 Judicial Interpretation, §10.

[13] 2017 Judicial Interpretation, §8. This provision states that:

(1) The shareholder is engaged in any business in substantial competition with the main business of the company for the shareholder's own account or on behalf of any other person, except as otherwise specified by the company's bylaws or agreed upon by all shareholders.

(2) The shareholder's consultation of the company's accounting books for the information of any other person may damage the company's lawful interests.

(3) During the three years before the day when the shareholder files a request with the company for consultation of accounting books, the shareholder once consulted the company's accounting books for the information of any other person, causing damage to the company's lawful interests.

(4) Any other circumstances showing that the shareholder has an illicit purpose.

[14] 2017 Judicial Interpretation, §9.

[15] 2017 Judicial Interpretation, §12.

[16] 2017 Judicial Interpretation, §11.

B. Empirical inquiry on Chinese Inspection Rights

1. Overview

How is China's inspection rights regime applied in practice? To answer this question, we examine all inspection cases across the country for a roughly six-year period of 1 January 2012 to 31 August 2017.[17] We used an authoritative and widely-used electronic database for Chinese law, Bei Da Fa Bao,[18] employing search terms based on the relevant legislative provisions.

Table C1:[19] Distribution of Total Cases from 2012 to 2017

Year	Number of cases	Percentage of all cases
2017[20]	2440	32.34%
2016	2109	27.95%
2015	1347	17.99%
2014	990	13.12%
2013	395	5.24%
2012	264	3.46%
Total	**7545**	**100%**

As illustrated in Table C1, the number of cases has increased steadily and significantly over the years. We found a total of 7545 cases over the six-year period of 2012 to 2017. Geographically, in untabulated data, we find that Jiangsu Province had the most cases (1048), followed by Shanghai (895), Guangdong province (634), Zhejiang province (548) and Beijing (518), all of which are considered to be economically developed regions in China.

In order to reduce the number of cases to a more manageable volume for our analysis, we use a random sampling to extract a sample of 193 cases.[21] We use these cases for the rest of the empirical inquiry in this paper.

[17] Ideally, because the 2017 Judicial Interpretation became effective on 1 September 2017, we would like to examine cases before and after this event separately. Unfortunately, the 2017 Judicial Interpretation has been in effect for a very short period of time, so we will need to wait for more data to assess its effect. Hence, our empirical analysis is focused on the cases filed before it took effect.

[18] Bei Da Fa Bao, available at http://Chinalawinfo.com (lasted accessed 22 January, 2019).

[19] All the tables on the Chinese cases have a prefix code of "C" (China).

[20] It should be noted that in Table C1, the number of cases in 2017 means the cases in the whole year of 2017, because the purpose of Table C1 is to compare the number of cases on a yearly basis. As noted in the text above, however, the study period of our research ends on 31 August 2017, so the year of 2017 mentioned in the empirical data in the tables below means the period from January 2017 to August 2017, unless otherwise indicated.

[21] There is an empirical study published in 2013 on China's inspection rights cases which randomly selected a sample of 192 cases out of all cases adjudicated from 2006 to 2011 across China. See Jianwei Li, 'Research on Shareholder Inspection Rights Litigation' (2013) 2 *Zhongguo Faxue [China Legal Science]* 83. Our study chooses a more recent research period of 2012 to 2017 when China's inspection rights regime has become more mature, using a random sampling exercise to get a similar-sized sample of 193 cases. For more information on the random sampling methodology and a comparison of our study findings with those of other earlier studies, see Robin Hui Huang, *Shareholder Inspection Rights in China: An Empirical Inquiry* (working paper May 18, 2019) (file available on request with author).

2. The Hearing Time Length

Table C2 provides information on the number of days between the date of the initial court filing and the date of the final judgment. In China, a civil case should normally be closed within six months of its filing date; a six-month extension is available in special circumstances and upon the approval of the president of the court; further extension is possible with the approval of the next higher court.[22] These limits have a strong effect on the time for resolving inspection cases.

Table C2 shows that during the whole period of 2012 to 2017, the mean delay is around 101.46 days (around 3.38 months), while the median delay is roughly 81 days (2.7 months). The mean and median of the number of days taken to close an inspection case in China are both 6 months, illustrating that the Chinese courts tended to adjudicate these cases quite quickly.

We also conducted a longitudinal study of whether there is any change in the time length of the case over the years. It seems that apart from 2012 and 2017, the mean and median of the number of days taken to close an inspection case are relatively stable.

Table C2 Number of days between court filing and final outcome

Year	Mean	Standard Deviation	Minimum	Median	Maximum
2017	135.708	106.41	14	111.5	408
2016	70.933	40.259	13	72	175
2015	103.04	70.639	18	82	248
2014	94.913	56.991	25	69	354
2013	112.833	71.899	25	114.5	195
2012	91.333	42.730	51	86	170
Total	101.46	77.091	13	81	408

3. The Shareholding Levels of Plaintiff Shareholders

In China, the shareholders have varying governance powers, depending on their shareholding levels, which may impact their use of inspection rights. To understand this point, we must first briefly discuss these powers. To begin with, shareholders individually, or collectively, holding 3% or more of the shares of the company have power to put forward an interim proposal at the shareholders' assembly for discussion.[23] Second, the shareholders separately, or collectively, holding 10% or more of the shares of the company can ask for an interim shareholders' assembly session to be held.[24] Further, shareholders that hold ten percent or more of the voting rights are empowered to ask the people's court to dissolve the company if the company's operations result in heavy losses for the shareholders and its problems cannot be solved by any other means.[25] Third, under the Chinese law, the

[22] Zhonghua Renmin Gongheguo Minshi Susongfa [Civil Procedure Law of the People's Republic of China] (promulgated in 1991, amended in 2007, 2012 and 2017), §149.

[23] 2005 Company Law, §102(2). Under the Chinese company law, the shareholders' meeting in JSCs is called the shareholders' assembly.

[24] 2005 Company Law, §100(3).

[25] 2005 Company Law, §182.

shareholders individually, or in the aggregate, holding 30% or more of shares are considered to be controlling shareholders.[26]

Table C3 displays data on plaintiffs' shareholding percentage for our sample. The bulk of cases are brought by shareholders holding between 10% and 30%. In other words, inspection right suits provide a remedy mainly for minority shareholders.

It is worth noting that up to 10 of our 193 cases were filed by plaintiffs holding 50% or more of their company's shares. This is surprising because those shareholders presumably had control over their companies and there should be no need for them to resort to inspection right suits to get relevant information. Upon closer examination, these ten cases share a common feature that ownership and management of the company are relatively separated, that is, the minority shareholder is the legal representative and executive director of the company, while the majority shareholder acts as a supervisor or sometimes has no management position.[27]

When a majority-minority shareholder conflict arises, the majority may not easily solve the issue through the exercise of its voting power.[28] For one thing, the position of legal representative has important power to represent the company to sign contracts and bring suits, and can only be removed by a special resolution of the shareholders' meeting which requires approval by two-thirds or more of the voting rights.[29] In most of the cases, the majority shareholder held more than half but less than two-thirds of voting powers. Further, directors usually serve a term of three years and cannot be removed without cause.[30] Finally, in practice, even if the majority shareholder may succeed in exercising its voting power to change legal representative or executive director, the former legal representative or executive director (the minority shareholder) may refuse to hand over company seals and documents. Hence, the majority shareholder may have to bring inspection right suits to obtain relevant information.

Table C3 What was the plaintiff's shareholding level?

Shareholding Level	**Number**	**Percentage**
Less than 3%	16	8.21%
More than 3% and Less than 10%	18	9.23%
More than 10% and less than 30%	58	29.74%
More than 30% and less than 50%	42	21.38%
More than 50%	10	5.13%
Not clear	51	26.15%
Total	193	100%

[26] Zhonghua Renming Gongheguo Zhenquan Fa [Securities Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999, amended in 2004, 2005, 2013 and 2014), §88.

[27] See e.g., Liu Ye vs Shanghai Xinxin Gongmao Co, Shanghai Municipality Qingpu District Court, (2014) Qing Min Er (Shang) Chu Zi No163; Chen Fuqian vs Tianjin Minchuang Jiancai Shichang Co, Tianjin Municipality Beicheng District Court, (2014) Chen Min Chu Zi No 3128; Zhongshang Zichan Pinggu Co vs Luo Donghao (Appeal), Jilin Province Changchun City Intermediate Court, (2015) Chang Min Si Zhong Zi No175.

[28] For the same reason, derivative actions have also been found to be brought by majority shareholders in China. See Robin Hui Huang, 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis' (2012) 27(4) *Banking and Finance Law Review* 619, 634 (footnote 54).

[29] 2005 Company Law of China, art.43.

[30] 2005 Company Law of China, §45.

4. The Features of Defendant Companies

Table C4 presents information on the types of defendant companies involved in the sample cases. Only 4 of the defendant companies are JSCs; the rest are overwhelmingly LLCs.[31] In addition, there are a small number of other types of business entities such as joint ventures and even private schools.[32]

Why are there so few inspection right suits for JSCs? For one thing, the JSCs, particularly those that are listed companies, have a heightened level of disclosure duties because they are subject to the securities law, making it unnecessary for their shareholders to resort to inspection right suits. Moreover, as discussed in section IIA, unlike LLC shareholders, JSC shareholders are not empowered to inspect company accounting books under to the Chinese company law. Further, JSC shareholders can inspect, but are not allowed to copy, the relevant company documents without filing an inspection suit.

Table C4 what was the type of the defendant company?

Company Type	Number	Percentage
LLC	183	94.81%
JSC	4	2.07%
Others	6	3.12%
Total	193	100%

Table C5 shows that very few defendants were State Owned Enterprises (SOEs). One possible reason is that it can be harder to gain access to non-public information of SOEs is that it can be considered by the court to be too politically sensitive.

Table C5 Was the Defendant Company as SOE?

SOE	Number	Percentage
Yes	9	4.66%
No	183	94.82%
Unclear	1	0.52%
Total	193	100%

5. The Types of Materials Requested for inspection

Table C6 examines what information the plaintiffs asked for in their inspection suits and whether their requests were approved by the court. As discussed earlier, the information requested can be broadly divided into four categories. In practice, the

[31] Most of the JSCs concerned here were not listed on the two national stock exchanges, namely the Shanghai Stock Exchange and the Shenzhen Stock Exchange, but rather on regional stock exchanges such as the Tianjing Equity Exchange. See e.g., Huang Tianyi vs Hubei Wudang Liquor Co, (2014) Hubei Province Danjiangkou City Court, E Danjiangkou Min Chu Zi No.01768.

[32] See e.g., Shanghai Jiahua Enterprise Ltd vs Shanghai Jiahua Continuing Education School, Shanghai Municipality 1st Intermediate Court (2016). This case was included in the *Zuigao Renmin Fayuan Gongbao [Supreme People's Court Gazette]* (2019) vol 2, holding that although private schools do not take the company form in China, their organizers can bring inspection right suits in a way by analogy with the company law.

plaintiffs usually request documents from more than one category in a case, which explains why the total number of entries in Table C6 is significantly higher than the number of inspection right suits in the sample. In adjudicating the case, the court will look at the multiple requests separately and make decisions accordingly. We calculate the rate of support for each category separately.

Table C6 What Materials Were Requested?

Types of Materials requested for inspection	**Number**	**Percentage**	**Approved by Court**	**Not approved**	**approval rate**
1st category (stockholder list etc.)	164	34.10%	141	23	85.98%
2nd category (accounting books)	172	35.76%	132	40	76.74%
3rd category (original accounting vouchers)	109	22.66%	68	41	62.39%
4th category (contracts, client list etc.)	36	7.48%	5	31	13.89%
Total	481	100%	346	135	71.93%

As Table C6 shows, for the 193 sample cases, there are totally 481 total information requests. Within the four categories of information requested, the second category (accounting books) was most frequently requested (35.76%), closely followed by the first category (34.10%). The fourth category was requested the least (7.48%).

Out of the total 481 requests, 346 requests were approved by the court, making the average approval rate 71.93%. However, this rate varies greatly amongst the different categories of information. Not surprisingly, the first category has the highest support rate (85.98%), since it is clearly allowed under Article 33 for LLCs and Article 97 for JSCs. The major reason for rejecting a request for the first category of information is that the plaintiffs were found not to be the shareholders of the defendants.

The second category of information gets the second highest support rate (76.74%). Again, Article 33 clearly allows access to the second category of information, but there is a procedural prerequisite, that is, the plaintiff should send a prior written request to the company. In some cases, the plaintiff shareholder lost simply because they failed to satisfy this procedural requirement.

The support rate of the third category of information is also quite high (62.39%). In general, the courts consider original accounting vouchers to be covered under inspection right provisions. The failure of the plaintiff shareholders in those unsupported suits is usually either due to their lack of shareholder status or because they did not fulfill the procedural prerequisite as noted above. In contrast, the request for the fourth category of information was seldom supported (13.89%), as the courts generally consider it to fall outside the scope of the inspection right provisions.

6. The 'Improper Purpose' Defence

Table C7 illustrates how the defense of improper purpose has been used by the defendant company in certain inspection right suits. Overall, the improper purpose defense was raised in 59 cases, representing 30.57% of all cases. As discussed earlier, the 2017 Judicial Interpretation provides guidance on the meaning of improper purpose by listing four types of improper purposes. Amongst the three specific types of improper purposes enumerated therein, the first type was most frequently raised (32.76%), while there is no case raised the second type and only one case claimed to be of the third type.

As the fourth type is a catch-all category of "other circumstances", we further divide this group into four sub-categories which we found used by the defendant company in some sample cases. The first sub-category was very general and raised in 29 cases, accounting for almost half of all cases.

Table C7 What improper purposes were claimed by Defendants as defences to requests for accounting books?

Types of claimed improper purposes	**Number**	**Percentage**	**Approved**	**Not approved**	**approval rate**
The shareholder is engaged in any business in substantial competition with the main business of the company	19	32.2%	1	18	5.26%
The shareholder is seeking inspect rights to provide information to others	0	0			0
The shareholder did seek inspect rights to provide information to others within the past three years	1	1.69%	0	1	0
Other circumstances	**39**	**66.1%**	**0**	**39**	**0**
The shareholder may damage the interest of the company	29	49.15%	0	29	0
The shareholder may affect the normal operation of the company	4	6.78%	0	4	0
There is improper purpose	4	6.78%	0	4	0
The shareholder seeks to get information as evidence in another case	2	3.39%	0	2	0
Total	59	100%	1	58	1.69%

Note that the defendant company was successful with this defense in only one case. There are several possible reasons for this lack of success. First, it is very difficult for the defendant company to establish an improper purpose on the part of the plaintiff shareholder. The only successful case is *Jianghan vs Qichang Xingli Haimen Railway Materials Ltd*, where the defendant company proved that the plaintiff shareholder was involved in another company which had the same business and the same target clients as the defendant company so that the first specific type of improper purpose applied.[33] Generally, if the plaintiff shareholder engages in a business which is not the same as the defendant company, the court is unlikely to find that the first specific type of improper purpose applies.[34]

Furthermore, for the catch all provision, we find that the defendant company just makes a general claim without giving concrete evidence. This helps explain why all of them were not approved by the court. Finally, before the promulgation of the 2017 Judicial Interpretation, it was less clear what might constitute improper purposes, and sometimes, the court did not even find an improper purpose when the requesting shareholder is engaged in a business in substantial competition with the main business of the company.[35] The new statute should change this once it is fully implemented.

7. Substantial Deprivation of Inspection Rights

As discussed earlier, it is stipulated in China that a shareholder of a company cannot be substantially deprived of their inspection rights by the company's bylaws or any agreement between shareholders. Table C8 shows how the 'substantial deprivation' rule has been applied. We see that out of the total 193 sample cases, defendants raised the substantial deprivation issue only 3 cases, only one of which finds it to have occurred. We infer that companies rarely restrict the shareholders' inspection right through their bylaws or in a shareholders' agreement in China. Finally, we note that the restrictions in dispute are mainly based on the confidentiality issue, and thus are functionally similar to the defense of improper purpose which also includes leaking information to others.

Table C8 Frequency distribution of circumstances of substantial deprivation

Forms of disputed substantial deprivation	Number of cases	Percentage	Not substantial deprivation	Substantial deprivation
Company constitution	1[36]	33.33%	1	0

[33] Jiangsu Province Haimen City Court, (2016) Su 0684 Min Chu No.1029.

[34] See e.g., *Zhang Zhenping vs Beijing Heshi Lianchuang Culture Promotion Ltd*, Beijing Municipality Changping District Court, (2017) Jing 0114 Min Chu No.12911. In this case, the defendant claimed that the shareholder was engaged in a business in substantial competition with the main business of the company, but the court rejected it because evidence showed that the plaintiff shareholder's spouse ran a company whose business scope only overlapped partly with the defendant company.

[35] See, e.g., *Yang Jianbing and Ma Haoran at al vs Jiangsu Province HuaiAn City Guoyuan Taxation Firm*, Jiangsu Province HuaiAn City Qingpu District Court, (2015) Pu Shang Chu Zi No.00513. In this case, the plaintiff shareholders left the company and joined another company in the same business. The court held that the non-competition rule applied to directors and not shareholders under the Chinese law, and that there was no evidence to suggest improper purposes on the part of the plaintiff shareholders. Had the case occurred after the 2017 Judicial Interpretation, the mere fact of the plaintiff shareholders engaging in business competition could suffice to find improper purposes.

[36] *Wujing vs Nanjing Xinliansheng Ltd*, Jiangsu Province Nanjing City Xixia District Court, (2013) Xi Shang Chu Zi No.286. In this case, the company's bylaw required that the shareholder should make

Shareholder resolution	2	66.67%	1[37]	1[38]
Total	3	100%	2	1

8. Subsequent Cases

Table C9 presents the information on 'subsequent cases', namely the cases filed by the same plaintiffs against the same defendants after the inspection right cases. The purpose here is to find out whether the inspection right cases in China were filed by the plaintiffs as a tool to investigate the company and collect relevant evidence to bring subsequent cases.

Table C9: Subsequent Cases Filed

Year	**Sample cases**	**subsequent suits**	**class action**	**derivative suits**	**appraisal suits**	**liquidation suits**	**other suits**
2017	40	1	0	0	0	0	1
2016	52	8	0	0	1	5	2
2015	47	11	0	0	3	3	5
2014	37	3	0	0	1	2	0
2013	9	0	0	0	0	0	0
2012	8	1	0	0	1	0	0
Total	**193**	**24**	0	0	6	10	8

As Table C9 shows, during the study period, the subsequent suit rate varied from year to year. Overall, there were 24 subsequent suits in relation to the 193 sampled cases, with the subsequent suit rate being 12.4%. Further, we group subsequent suits into four categories, namely derivative suits, appraisal suits, liquidation suits and other suits which are mainly related to disputes over validity of shareholders' resolutions, distribution of dividend, capital contribution by shareholders. In stark contract with the US, derivative suits and class actions are not found in China.[39] There were up to 10 liquidation suits and 6 appraisal suits, representing 41.7% and 25% of all subsequent suits respectively.

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a written request and a confidentiality commitment before exercising the inspection right. Under the bylaw, the company could also refuse the inspection request of the shareholder who has leaked the company's secrets before. The court held that the restrictions in the bylaw were reasonable and did not constitute substantive deprivation.

[37] *Yang Jianbing and Ma Haoran at al vs Jiangsu Province HuaiAn City Guoyuan Taxation Firm*, Jiangsu Province HuaiAn City Qingpu District Court, (2015) Pu Shang Chu Zi No.00513. In this case, the company's bylaw provided that the company can disallow a shareholder to exercise the inspection rights for the purpose of protecting its business secrets. The court did not hold this to be invalid, but nevertheless ordered the defendant company to provide information because it failed to produce evidence that the plaintiffs' request for information was for improper purposes.

[38] *Jiang Xuyang vs Sichuan Rongyi Holding Ltd*, Sichuan Province Chengdu City High-Tech Development District Court, (2017) Chuan 0191 Min Chu No.4142. In this case, the defendant company passed a shareholder resolution that because the requesting shareholder was involved in another case against the company, he would lose his inspection rights. The court found this shareholder resolution to constitute 'substantial deprivation', holding that 'the shareholders' inspection rights are the inherent rights of the shareholders, and should not be restricted through shareholder agreements or other means'.

[39] This issue will be further discussed and explained later. See below Part IV.C.

III. Shareholder Inspection Rights Under Delaware Law[40]

A. Overview

Under Section 220 of the Delaware General Corporation Law (DGCL), shareholders have a mandatory right to seek stocklists or books and records.[41] The information available for inspection is extensive and includes "documents relating to allegedly wrongful transactions."[42] This right is so central to shareholder ownership that it cannot be removed by amending the corporation's charter.[43] However, this right is not absolute, and questions of standing and proper purpose limit the abilities of a shareholder to demand documents.[44]

First, to have standing to demand inspection of corporate records, a stockholder must either be a holder of record or the beneficial owner of the stock, i.e. a voting trustee.[45] While the courts are generally lenient in regards to standing, plaintiffs who have already cashed out or exchanged their shares in a merger may not have standing.[46] Second, shareholders bear the burden of "demonstrat[ing] a proper purpose for making such a demand."[47] Section 220 defines a "proper purpose" as "a purpose reasonably related to such person's interest as a stockholder."[48] Case law has established a long list[49] of proper purposes including: (1) investigating corporate mismanagement;[50] (2) ascertaining the value of stock;[51] (3) soliciting support for derivative action;[52] (4) investigating the independence of special litigation

[40] All of the tables in this section are taken from James D. Cox, Kenneth J. Martin, and Randall S. Thomas, The Paradox of Delaware's "Tools at Hand" Doctrine: An Empirical Investigation (Working Paper 2019).

[41] Del. Ann. Code tit. 8, § 220 (West 2010).

[42] Randall S. Thomas & Kenneth J. Martin, *Using State Inspection Statutes for Discovery in Federal Securities Fraud Actions*, 77 B.U. L. Rev. 69, 90-91 (1997). Other examples include "corporate accounting records; minutes of all meetings of the shareholders, board of directors, and board committees; stocklist materials; the corporation's certificate of incorporation' corporate bylaws; written communications to shareholders; and copies of resolutions creating one or more classes of stock." *Id.*

[43] Cedarview Opportunities Master Fund v. Spanish Broad. Sys. Inc., No. 2017-0785-ABD, 2018 WL 4057012, at * 21 (Del. Ch. Aug. 27, 2018).

[44] §§ 220(c) (1), (2).

[45] § 220(a) (1). If the stockholder is a beneficial owner or an attorney or agent of the stockholder, proper documentation is required. DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN DELAWARE COURT OF CHANCERY § 9.07[a] [2] [i] [B] (2d ed. 2018).

[46] Weingarten v. Monster Worldwide, Inc., No. 12931-VCG, 2017 WL 752179, at *4-5 (Del. Ch. Feb. 27, 2017). For further discussion on standing, see WOLFE & PITTENGER, *supra* note 7, at § 9.07[b].

[47] King v. VeriFone Holdings, Inc., 12 A.3d 1140, 1145 (Del. 2011).

[48] § 220(b).

[49] For more on established proper purposes, see WOLFE & PITTENGER, *supra* note 7, at § 9.07[e][1]; EDWARD P. WELCH ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 220,05 (6th ed, 2014).

[50] *See* Sec. First Corp. v. U.S. Die Casting & Dev. Co., 687 A.2d 563, 567 (Del. 1997) ("It is well established that investigation of [corporate] mismanagement is a proper purpose for a § 220 books and records inspection.") (alteration added).

[51] *See* CM & M Group, Inc. v. Carroll, 453 A.2d 788, 792 (Del. 19982) (citing State *ex rel* Brumley v. Jessup & Moore Paper Co., 77 A. 16, 20 (Del. 1910)).

[52] *See* State *ex rel* Bloch v. Sentry Safety Control Corp., 24 A.2d 587, 590 (Del. Super. Ct. 1942); State *ex rel.* Foster v. Standard Oil Co. of Kansas, 18 A.2d 235, 238 (Del. Super. Ct. 1941); Compaq Comput. Corp. v. Horton, 631 A.2d 1 (Del. 1993) (non-derivative litigation against the defendant corporation).

committees;[53] and (5) communicating with other stockholders in order to effectuate management policy changes.[54] However, the Court of Chancery has discretion to refuse demands it finds to have an improper purpose.[55] Thus, in *Norfolk County Retirement System v. Jos. A. Bank Clothiers, Inc.*, the court noted that the primary purpose of the request "must not be adverse to the corporation's best interest."[56]

If a shareholder's books and records request is denied or ignored, the shareholder may, after five (5) days, bring a claim against the corporation in the Court of Chancery.[57] When demanding books and records, the requesting shareholder bears the burden of demonstrating a proper purpose for their request.[58] As a Section 220 action is essentially a tool for the shareholder to gather information of potential wrongdoing,[59] the shareholder need only demonstrate evidence that there is a *credible basis* of possible mismanagement warranting further investigation.[60] This standard carries "the lowest possible burden of proof"[61] to enable plaintiffs that may lack sufficient evidence to bring a claim directly to make requests that may lead to additional discovery of potential management wrongdoing.

However, despite this light burden of proof, the Delaware courts have understood the inspection rights to be a balancing act between the rights of stockholders and the corporation. First, the Delaware courts have stated that the credible basis standard does not allow for "fishing expeditions."[62] Second, even when a plaintiff's Section 220 action is successful, her inspection rights are limited to those documents that are "necessary and essential" to achieving her stated purpose.[63] Furthermore, a

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[53] *See* Grimes v. DSC Commc'ns Corp., 724 A.2d 561, 566 (Del. Ch. 1998); La. Mun. Police Emples. Ret. Sys. v. Morgan Stanley & Co., No. 5682-VCL, 2011 Del. Ch. LEXIS 42, at *1 (Del. Ch. Mar. 4, 2011).

[54] *See* Marathon Partners L.P. v. M&F Worldwide Corp., No. 018-N, 2004 Del. Ch. LEXIS 101, at *2 (July 30, 2014).

[55] *See* State *ex rel.* Healy v. Superior Oil Corp., 13 A.2d 453, 456 (Del. Super. Ct. 1940).

[56] No. 3443-VCP, 2009 Del. Ch. LEXIS 20, at *16 (Feb. 12, 2009) (citing *Grimes v. DSC Commc'ns Corp.*, 724 A.2d 561, 565 (Del. Ch. 1998).

[57] § 220(c).

[58] Thomas & Martin, *supra* note 3, at 85.

[59] Seinfeld v. Verizon Comm'cns, Inc., 909 A.2d 117, 118, 123 (Del. 2006) (emphasis added).

> A stockholder is "not required to prove by a preponderance of the evidence that waste and [mis]management are actually occurring." Stockholders need only show, by a preponderance of the evidence, a credible basis from which the Court of Chancery can infer there is possible mismanagement that would warrant further investigation—a showing that "may ultimately fall well short of demonstrating that anything wrong occurred.

Id. at 123 (alteration in original).

The credible basis requirement thus qualifies by rendering more specific the showing that the shareholder meets the "proper purpose" requirement set forth in Del. Code Ann. tit. 8, § 220 (b) (West 2010). Some states have followed Delaware in similarly conditioning record requests on alleging a "credible basis" of misconduct when records are sought as a possible prelude for a shareholder suit. *See, e.g.*, Arctic Fin. Corp. v. OTR Express, Inc., 38 P.3d 701, 704 (Kan. 2002); Cain v. Merck & Co., 1 A.3d 834, 842-43 (N.J. Super. Ct. App. Div. 2010) (finding guidance from Delaware to conclude that unsupported allegations of mismanagement do not present a proper purpose0. Other courts adhere to the more general "proper purpose: standard but closely scrutinize the request for information supporting the presence of wrongdoing. *See, e.g.*, Chitwood v. Vertex Pharm., Inc., 71 N.E.3d 492, 501 (Mass. 2017) ("request granted if there is 'reasonable inference . . . that would tend to indicate the existence of corporate wrongdoing or mismanagement'").

[60] *See* State *ex rel.* Healy v. Superior Oil Corp., 13 A.2d 453, 456 (Del. Super. Ct. 1940).

[61] *Id.*

[62] *Seinfeld*, 909 A.2d at 122.

[63] Saito v. McKesson HBOC, Inc. 806 A.2d 113, 116 (Del. 2002) (citation omitted); *see also* Helmsman Mgmt. Servs., Inc. v. A & S Consultants, Inc., 525 A.2d 160, 167 (Del. Ch. 1987). In addition to stating a proper purpose, a stockholder seeking a Section 220 inspection must satisfy certain

stockholder's inspection right does not allow it "wide ranging discovery that would be available in support of litigation."[64] Rather "it is restricted to inspection of the books and records needed to perform the task. . . ."[65] In certain cases, Delaware courts have further required plaintiffs seeking a Section 220 action to "make specific and discrete identification, *with rifled precision*, of the documents sought."[66]

In addition to these limitations, the Chancery has broad discretion in limiting or conditioning an inspection.[67] One limiting factor requires that the books and records "address the 'crux of the shareholder's purpose' and that the information 'is unavailable from another source.'"[68] Furthermore, in some cases, when nonpublic information is sought,[69] the Delaware courts have upheld as reasonable defendants' request that a stockholder sign a confidentiality agreement.[70] Documents obtained under a Section 220 action that are subject to a confidentiality agreement "will be treated as confidential unless and until disclosed in the course of litigation or pursuant to some other legal requirement."[71]

B. The Tools at Hand Doctrine

The usefulness of a section 220 request for books and records as a discovery tool was not initially apparent to plaintiffs in Delaware. In the 1980s and 1990s, shareholder plaintiffs rarely utilized the inspection statute to request books and records.[72] Even when a section 220 request was made, the large majority of them were for stocklists.[73] Thus, according to an empirical study conducted by one of the

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form and manner requirements outlined in the statute. *See* West Coast Mgmt. & Capital, LLC v. Carrier Access Corp., 914 A.2d 636, 641 (Del. Ch. 2006) (citing Highland Select Equity Fund, L.P. v. Motient Corp., 906 A.2d 156, 163 (Del. Ch. 2006)) For example, a stockholder is required to serve a "written demand under oath stating the purpose thereof . . . directed to the corporation at its registered office in [Delaware] or at its principal place of business." DEL. CODE ANN. tit. 8, § 220(b) (West 2010). If the corporation refuses to permit the demanded inspection or fails to respond "to the demand within 5 business days after the demand has been made, the stockholder may apply to the Court of Chancery for an order to compel such inspection." *Id.* at § 220(c). When filing a Section 220 complaint, the plaintiff stockholder is required to attach proof of being a stockholder of record. *Id.*

[64] Saito v. McKesson HBOC, Inc., 806 A.2d 113, 114 (Del. 2002).

[65] BBC Acquisition Corp. v. Durr-Fillauer Med., Inc.623 A.2d 85, 88 (Del. Ch. 1992).

[66] Brehm v. Eisner, 746 A.2d 244, 266-67 (Del. 2000) (emphasis added).

[67] § 220(c). The Court of Chancery's imposition of a condition or limitation is determined on a "case-by-case and 'fact specific'" basis. United Techs. Corp. v. Treppel, 109 A.3d 553, 558 (Del. 2014) (quoting Espinoza v. Hewlett-Packard Co., 32 A.3d 365, 372 (Del. 2011)).

[68] Wal-Mart Stores, Inc. v. Ind. Elec. Workers Pension Trust Fund IBEW, 95 A.3d 1264, 1271 (Del. 2014).

[69] R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, 1 THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 7.48 (3d ed. 2018) (citation omitted).

[70] Disney v. Walt Disney Co., 857 A.2d 444, 447 (Del. Ch. 2004).

[71] Stone v. Ritter, No. 1570-N, 2005 Del. Ch. LEXIS 146, at *4 (Del. Ch. Sept. 26, 2005); *see also Disney*, 857 A.2d at 450 ("[A] stockholder making a books and records demand can expect that documents designated as confidential pursuant to a reasonable confidential agreement will remain confidential unless the stockholder concludes that grounds exist to initiate litigation and the court in which the proceeding is brought determines to include those documents in the public record.").

[72] Thomas & Martin, *supra* note 3, at 90.

[73] Thomas & Martin, *supra* note 3, at 90, 102-07. However, the study presented may not accurately reflect the actual breakdown in Section 220 requests. This is largely because when a demand is made, companies are incentivized to produce some documents than to reject the investor's demand, forcing a lawsuit. For a discussion on why companies are incentivized to accede to shareholder demands, see Kevin Shannon, Corporate Litigation Partner, Potter Anderson Corroon LLP, Trending Developments:

authors, from 1981 to 1994 only 53 books and records cases were filed, while a total of 91 stocklist cases were brought during the same time period.[74]

But section 220 can be useful as a pre-filing discovery tool by plaintiffs. To understand how section 220 acts in this fashion, it is important to first understand the plaintiff shareholder's problem in filing breach of fiduciary duty cases. If they suspect management misconduct, plaintiffs can either bring a class action claim, alleging indirect injuries to the shareholder, or a derivative claim, alleging indirect harm to the shareholders due to an injury to the corporation. In the case of a derivative lawsuit, as the corporation is directly injured, a plaintiff is required to first request that the board bring the action. The directors then decide whether the corporation should file a suit against the alleged wrongdoers who are usually the very directors themselves.[75] However, in Delaware, if a plaintiff brings a demand for a derivative suit to the board, she concedes the board's independence and authority to pursue the action, waiving her future ability to litigate the claim.[76]

If plaintiffs decide to avoid the demand process, their demand excusal complaint must show with particularized facts that making demand on the board is futile.[77] However, under Delaware law, plaintiffs in a derivative suit are "not entitled to discovery to assist their compliance with the particularized pleading requirement of Rule 23.1 in a case of demand refusal."[78] Therefore, unless the facts required to meet the pleading requirement are publicly available, the plaintiffs will probably be unable to bring a derivative suit against the management.

In *Rales v. Blasband,*[79] the Delaware Supreme Court, acknowledging this barrier to discovery, urged derivative plaintiffs to use their Section 220 inspection rights to uncover corporate information to meet the particularized facts requirement for demand excusal.[80] This seminal case provides the basis for shareholders to employ Section 220, the so-called "tools at hand,"[81] as a form of pre-suit discovery. A few years later, in *Grimes v. Donald,*[82] the Delaware Supreme Court reiterated the importance of utilizing Section 220 to establish demand futility.[83] There, the court, finding that the derivative plaintiff failed to establish futility, dismissed the case and stated, "If the stockholder cannot plead such assertions consistent with Chancery Rule 11, after using the 'tools at hand' to obtain the necessary information before filing a derivative action, then the stockholder must make a pre-suit demand on the board."[84]

Despite the pleas of the Delaware courts, Section 220's use as a pre-suit discovery tool was largely unappreciated by the Delaware plaintiff's bar until the turn of the century. Finally the message seemed to get through. In *Brehm v. Eisner*, the

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Dealing with Books and Records Inspection Demands at the Third Annual Symposium on Corporate Law (Oct. 12, 2018) (oral presentation). Therefore, studies are largely limited to those Section 220 requests that end up in court.

[74] Thomas & Martin, *supra* note 3, at 102-07.

[75] Delaware accordingly has its own process to review that the directors actually reviewed whether bringing litigation against the wrongdoing managers was in the best interest of the corporation.

[76] Grimes v. Donald, 673 A.2d 1207, 1216, 1218-19 (Del. 1996).

[77] This requires them to show enough to "create a reasonable doubt either that: (1) a majority of the board is independent for purposes of responding to the demand or refusing the demand; or (2) the challenged action is protected by the business judgment rule." Thomas & Martin, *supra* note 3, at 82.

[78] Scatter Corp. v. Chicago Stock Exch., Inc., 701 A.2d 70, 77 (Del. 1997).

[79] 634 A.2d 927 (Del. 1993).

[80] Aaronson v. Lewis, 472 A.2d 805 (Del. 1984).

[81] *Rales*, 634 A.2d at 934-35 n. 10.

[82] 673 A.2d 1207 (Del. 1996) (en banc).

[83] *Id.*

[84] *Id.* at 1216.

shareholders claimed that the Disney board breached its fiduciary duty when it approved "an extravagant and wasteful" employment contract with Michael Ovitz and then agreed to a non-fault termination of Ovitz 14 months later, which entitled him to a $140 million payout.[85] Despite allegations of misconduct based on publicly available information, the complaint failed to survive a motion to dismiss, in large part, due to the discovery stay.[86] On appeal, the plaintiffs argued that the Delaware discovery stay was unfair and made pleading demand futility impossible.[87] However, the Delaware Supreme Court rejected these claims, stating:

Plaintiffs may well have the "tools at hand" to develop the necessary facts for pleading purposes. For example, plaintiffs may seek relevant books and records of the corporation under Section 220 of the Delaware General Corporation Law, if they can ultimately bear the burden of showing a proper purpose and make specific and discrete identification, with rifled precision, of the documents sought. Further, they must establish that each category of books and records is essential to the accomplishment of their articulated purpose for the inspection.[88]

The sentiment in *Brehm* has become a fixture in Delaware courts.[89] In fact, the Court of Chancery has warned that lawyers who fail to use the pre-suit discovery tool do so at their own peril.[90] Since then, the use of Section 220 as a pre-suit discovery tool has dramatically increased.[91]

C. Section 220 and Merger Litigation

Prior to 2014, the shareholder-friendly standards in the M&A context created by *Revlon*[92] and *Weinberger v. UOP, Inc.*[93] incentivized plaintiffs to file M&A lawsuits immediately following announcement of all proposed deals.[94] In this environment, class action suits were filed quickly so section 220 litigation could not be completed

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[85] 746 A.2d 244 (Del. 2000).

[86] *Id.* at 267.

[87] *Id.* at 266.

[88] *Id.* at 266-67.

[89] *See, e.g.*, Seinfeld v. Verizon Commc'ns, Inc. 909 A.2d 117, 120 (Del. 2006); King v. VeriFone Holdings, Inc., 12 A.3d 1140, 1145 (Del. 2011). In *Verizon*, the Delaware Supreme Court stated:

> More than a decade ago, we noted that "[s]uprisingly, little use has been made of Section 220 as an information-gathering tool in the derivative [suit] context." Today, however, stockholders who have concerns about corporate governance are increasingly making a broad array of Section 220 demands. The rise in books and records litigation is directly attributable to this Court's encouragement of stockholders, who can show a proper purpose, to use the "tools at hand" to obtain the necessary information before filing a derivative action. Section 220 is now recognized as "an important part of the corporate governance landscape."

Some commentators have argued that Section 220 demands are "especially relevant when shareholders in a company assert what are now commonly referred to as 'Caremark claims.'" Frank R. Schirripa & Daniel B. Rehns, *Is the Delaware Section 220 Tango Worth the Wait?*, ABA (Oct. 3, 2017), https://www.americanbar.org/groups/litigation/committees/class-actions/articles/2017/fall2017-delaware-section-220-tango.html.

[90] Mizel v. Connelly, No. 16638, 1999 WL 550369, at *2 (Del. Ch. Aug. 2, 1999).

[91] Cox et al., *supra* note 38, at 28-29 tbl. 1.

[92] Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133 (2004).

[93] 457 A.2d 701 (Del. 1981).

[94] One study found that the vast majority of acquisition-oriented class actions were filed within three days of public announcement of the deal. Thompson & Thomas, *supra* note 56, 182-83 tbl. 9.

fast enough to be useful.[95] Over time, the increased filing of frivolous deal suits in Delaware pressured the Delaware legislature and judiciary to take action in the M&A sphere. As we explain below, the Delaware courts responded with decisions which helped reign in frivolous deal litigation, and created an environment that encouraged the use of Section 220.

1. Revlon and Corwin

Corwin endorsed the use of shareholder ratification as a cleansing device to dismiss deal litigation against directors. There the Delaware Supreme Court found that in an arms-length M&A transaction with no explicit conflict of interest for directors, a fully informed non-coercive vote of approval by the disinterested stockholders would lead it to review the actions of the target's board of directors under the business judgment rule.[96] By making it easier for directors to receive deferential review, *Corwin* mitigated the flood of deal litigation.[97]

2. Weinberger and MFW

Prior to 2014, in cases of self-dealing by controlling shareholders, the courts reviewed the actions of the shareholder under the entire fairness doctrine.[98] Most famously applied in *Weinberger v. UOP, Inc.*,[99] this heightened standard of judicial review made it difficult for defendants to dismiss cases using pre-trial motions. This gave all shareholder plaintiffs' claims value in the settlement process, incentivizing plaintiffs to bring even weak cases.[100]

The Delaware Supreme Court addressed this problem in *Kahn v. M&F Worldwide (MFW)*.[101] There, despite the presence of a typical self-dealing squeeze out of minority shareholders, the court applied the business judgment standard. They justified their decision by relying on the dual approvals the transaction required from an independent special committee and from a fully-informed, uncoerced majority of the minority shareholder vote.

3. Modern Usage of the Tools at Hand

The upshot of this shift towards applying the business judgment rule meant that the actions of many directors and controlling shareholders in M&A deals went virtually unreviewed by the Delaware courts. Since shareholders almost always approve the deal,[102] litigants generally attack director actions by arguing that the shareholder vote was not fully informed. When a shareholder litigant can show that the vote was not fully informed, the courts will apply a heightened judicial standard. However, in order to survive a motion to dismiss, plaintiffs must, prior to discovery, plead facts which sufficiently show that they would be entitled "to recover under any

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[95] *Id.*

[96] Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 308-09 (Del. 2015).

[97] For a discussion on the significance of *Corwin*, see James D. Cox & Randall S. Thomas, *Delaware's Retreat: Exploring Developing Fissures and Tectonic Shifts in Delaware Corporate Law*, 42 DEL. J. CORP. L. 323 (2018).

[98] Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

[99] 457 A.2d 701 (Del. 1981).

[100] *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 605 (Del. Ch. 2005).

[101] 88 A.3d 635 (Del. 2014).

[102] James Cox, Tomas Mondino and Randall Thomas, Understanding the (Ir)Relevance of Shareholder Votes on M&A Deals, 69 Duke Law Journal (forthcoming 2019).

reasonably conceivable set of circumstances susceptible of proof."[103] Only once the plaintiff can identify the deficiency in disclosure will the burden shift to the defendant.[104] However, it is extremely difficult for plaintiffs to meet this requirement relying solely on public information.[105] Section 220 has provided an essential discovery tool for plaintiffs in merger litigation.[106]

For example, in *Appel v. Berkman*, the plaintiff was able to discover the omission of material facts that helped it survive a motion to dismiss.[107] There, the plaintiff challenged the disclosures in a cash sale of the company to a private equity firm in a "two-step merger transaction involving a front-end tender offer followed by a back-end merger under Section 251(h)."[108] While the transaction was pending, the plaintiff requested books and records from the company.[109] Once the transaction was completed, the company fulfilled plaintiff's request.[110] It was through this request that plaintiff had grounds to plead an omission of material facts – among other things the company's founder, largest shareholder, and current Chairman, had abstained from approving the transaction.[111] As a result, the Delaware Supreme Court reversed and remanded the Chancery Court's decision, holding that the omission was material and necessary to make the disclosures not misleading.[112]

Similarly, *Morrison v. Berry* shows the pivotal role a § 220 books and records request can have in overcoming the "cleansing" effect of *Corwin* ratification.[113] There the information uncovered in an inspection case allowed plaintiff to file a breach of fiduciary duty claim against the corporate directors in connection with the sale of the company to a private equity firm in a friendly tender offer.[114] While the tender offer was pending, plaintiff had filed a Section 220 action seeking books and records from the company.[115] The company refused plaintiff's request, and the tender offer closed with a majority of shares tendered.[116] When the plaintiff brought her 220 demand to court, she successfully obtained the requested documents.[117]

This request uncovered a smoking gun; among other things, an email that revealed that Ray Berry, the company's founder, had already entered into an agreement to sell to the private equity firm and intended to thwart sales to other bidders.[118] This was not

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[103] *In re* Books-A-Million, Inc. Stockholders Litig., No. 11343-VCL, 2016 WL 5874974, at *21 (Del. Ch. Oct. 10, 2016).

[104] *In re* Solera Holdings, Inc. S'holder Litig., No. 11524-CB, 2017 WL 57839, at *9 (Del. Ch. Jan. 5, 2017).

[105] The need for pre-filing discovery has been heightened in light of the Delaware Supreme Court's decision in *Flood v. Synutra International, Inc.*, 195 A.3d 754 (Del. 2018).

[106] However, some plaintiffs' counsels have been sceptical about the value of Section 220 proceedings as a substitute for discovery in an M&A case. Joel E. Friedlander, *Vindicating the Duty of Loyalty: Using Data Points of Successful Stockholder Litigation as a Tool for Reform*, 72 BUS. LAW. 623, 648 (2017).

[107] Appel v. Berkman, No. 12844-VCMR, 2017 WL 6016571 (Del. Ch. July 13, 2017), *rev'd*, 180 A.3d 1055, 1064 (Del. 2018). The Chancery Court's decision that defendants were entitled business judgment rule under *Corwin* was reversed by the Delaware Supreme Court.

[108] 180 A.3d 1055, 1057 (Del. 2018).

[109] *Id.* at 1059.

[110] *Id.*

[111] *Id.* at 1057.

[112] *Id.*

[113] 191 A.3d 268 (Del. July 9, 2018).

[114] *Id.*

[115] *Id.* at 273.

[116] *Id.*

[117] *Id.*

[118] *Id.* at 273-74.

disclosed to the shareholders. The Delaware Supreme Court, finding that the vote was not fully informed as information material to a voting shareholder were not disclosed, reversed and remanded the Chancery Court's dismissal of the case.[119]

Furthermore, Section 220 can play a crucial role in litigating cases where a controlling shareholder may seek to utilize *MFW* protections. An ultimately unsuccessful use of Section 220 can be seen in *Olenik v. Lodzinski*, where plaintiffs were able to employ the tools at hand to obtain information. However, they were ultimately, dismissed as they could still not establish that defendants had made a material misstatement or omission.[120]

As illustrated by the cases above, Section 220 has proven to be an important means for plaintiffs seeking pre-suit discovery in an M&A transaction. As we show in the next section, the use of this right has increased dramatically since decision in *Brehm*.[121]

D. Empirical Data on the Use of Section 220[122]

In an earlier paper, one of the authors collected data on all section 220 cases filed in the Delaware Chancery Court from 2004-2016. Table D1 provides a description of the Section 220 cases filed during 2004-2016. There were only eight cases where the plaintiffs solely sought the stocklist. The vast majority of cases made requests only for books and records, while a significant number of other cases asked for both books and records as well as the stocklist. There is significant variation in the number of cases filed annually ranging from a low of 28 to a high of 62.

Table D1[123]: Section 220 Filings in Delaware Chancery Court to Obtain Stockholder List and/or Books and Records

Year Filed	Number of Cases	Stocklist Only	Books and Records Only	Both Stocklist & Books and Records
2004	49	2	30	17
2005	57	0	37	20
2006	40	3	27	10
2007	34	0	21	13
2008	33	1	20	12
2009	29	1	23	5

[119] *Morrison*, 191 A.3d.

[120] No. 2017-0414-JRS, 2018 WL 3493092 (Del. Ch. July 20, 2018).

[121] James D. Cox, Kenneth J. Martin & Randall S. Thomas, *The Paradox of Delaware's "Tools at Hand" Doctrine: An Empirical Investigation*, 28-29 tbl. 1 (working paper Feb. 5, 2019) (file available on request with author).

[122] This section draws heavily on an earlier study by one of the authors. James D. Cox, Kenneth J. Martin & Randall S. Thomas, *The Paradox of Delaware's "Tools at Hand" Doctrine: An Empirical Investigation*, 28-29 tbl. 1 and tbl 3 (working paper Feb. 5, 2019) (file available on request with author).

[123] All the tables on the Delaware law have a prefix code of "D" (Delaware).

2010	35	1	20	14
2011	38	0	27	11
2012	38	0	31	7
2013	56	0	47	9
2014	67	0	51	16
2015	48	0	39	9
2016	52	0	36	16
2017	61	0	48	13
2018	62	0	53	9
Total	699	8	510	181

It is interesting to contrast these values with those developed in an earlier study, which compiled similar data for 1981-1994.[124] Since that time, there has been a large increase in the number of section 220 filings. For example, stocklist filings increased substantially from 91 cases in the earlier study to 190[125] in the more recent time period. Even more strikingly, books and records request cases increased from 53 requests in the earlier study to 691 corporate actions in the more recent time period.[126]

What happened in these cases? In untabulated results, the more recent empirical study finds that there are 82 court decisions in the plaintiffs' favor in books and records cases and an additional 43 settlements where the parties state that the plaintiff is getting books and records. In 34 more cases, the court dismissed the action without awarding the plaintiff books and records, and in another 21 cases the plaintiff dismissed its case stating that it was not being given books and records. Summarizing the publicly available information about outcomes, plaintiffs were successful 125 times (82 decisions plus 43 explicitly productive settlements) and had 55 failures (34 court dismissals plus 21 settlements without documents.) The largest set of cases (462) have indeterminate outcomes 462 cases because the plaintiff dismisses its case without clearly indicating that it received books and records. For this group of cases, it is impossible to classify them as wins or losses based on publicly available information. Some experienced Delaware lawyers indicated that in their experience the plaintiff generally receives some documents in this situation, although not necessarily all that they request.[127]

Table D2 shows the number of days between the initial court filing and the final outcome in the case (DELAY), as well as the number of pages plaintiffs, defendants

[124] Cite to BU study

[125] This is the sum of stocklist only cases plus stocklist and books and records cases.

[126] *See supra* Section III.C (there are an additional 154 LLC/LP cases).

[127] Some of these settlements are in response to judicial pressure to resolve cases without unnecessary litigation, while others may arise because the filing of the Section 220 cases acts as "a shot across the bow," leading the defendant to seek to resolve the underlying dispute.

and the court filed. Delay generally favors defendants because a "subsequent derivative lawsuit could end up being dismissed on the grounds that other plaintiffs have already litigated the issue."[128] DELAY provides a measure of how long the plaintiffs are delayed before bringing any subsequent merits-based litigation. For books and records cases, the mean delay is around 10 months (309.8 days), while the median delay is approximately six months (190 days).[129]

Table D2: Descriptive Statistics of Variables Associated with Request for Books and Records

Variable	Mean	Standard Deviation	Minimum	Median	Maximum
DELAY	312	367.01	0	193	2,666
PLTPAGES	182	288.9	7	77	2,597
DEFPAGES	152	315.8	0	32	3192
COURTPAG	46	78.1	0	18	579
TOTPAGES	380	593.2	9	144	5,781
PLT%TOTA	58.1%	21.1%	7.7%	59.0%	100.0%

Variable definitions are as follows:

DELAY	Number of days between demand and outcome dates.
PLTPAGES	Number of pages filed by plaintiff.
DEFPAGES	Number of pages filed by defendant.
COURTPAG	Number of pages filed by the court.
TOTPAGES	Total number of pages filed: plaintiff + defendant + court.
PLT%TOTA	Percentage of total litigation pages filed by plaintiff.

For page filings, which provide some indication of the intensity of the litigation effort by the parties and the court, show some interesting differences from those compiled in the earlier study. For example, recent plaintiffs file more than twice as many pages as plaintiffs in the first study, while recent defendants file almost three times as defendants from the earlier period. This trend is true for both mean and median filings. The court itself produces a substantial number of documents with an average of almost 47 pages showing significant court involvement.

These data illustrate one very important point: books and records cases are not summary proceedings in many instances. The long case resolution times and the increased level of filing activity for both plaintiffs and defendants support that finding. Plaintiffs argue that defendants have turned books and records litigation into litigation of the possible merits of the suit to shareholders using it as a quick and easy pre-filing discovery tool.[130] This is true despite that fact that, "the Court of Chancery has

[128] Michael Greene, *Books and Records Disputes Getting Longer, More Complex*, BLOOMBERG BNA (May 5, 2016), https://www.bna.com/books-records-disputes-n57982070716/ (interviewing Megan McIntyre).

[129] These values are similar to those obtained in the earlier study. We did not separately calculate the differences in delay for stocklist and books and records cases in the second study.

[130] At a recent practitioner conference, a leading plaintiffs' lawyer made the further point that defendants are paid by the hour in books and records cases, whereas plaintiffs' counsel frequently has to bear its own costs in bringing these cases and is only compensated for their work if they successfully bring a subsequent merits-based lawsuit.

rebuked 'a continuing tendency' to use a section 220 suits for 'broad defensive as well as offensive purposes…"[131]

Finally, in Table 3, we examine how frequently books and records cases lead to the filing of a subsequent action involving the same defendant corporation, and if so, whether the case raised derivative claims, class action claims, individual claims or other types of claims.

Table D3: Frequency Distribution by Year of Section 220 Cases Where a Subsequent Case Is Filed by Plaintiff

	All subsequent related suits	Derivative suits	Class actions	Individual actions	Receiver appointment actions	Appraisal suits
2004	16	13	6	3	0	0
2005	20	12	11	3	0	1
2006	2	0	0	1	1	0
2007	3	2	1	1	0	0
2008	7	4	1	3	0	0
2009	4	3	1	1	0	0
2010	3	1	0	1	1	0
2011	11	5	1	5	1	0
2012	7	4	3	1	0	0
2013	12	8	2	3	0	0
2014	16	13	5	2	0	1
2015	12	9	3	2	1	0
2016	7	3	1	2	0	1
2017	10	5	4	2	0	0
2018	3	1	1	1	0	0
Totals	**133**	**83**	**40**	**31**	**4**	**3**

Table D3 shows that section 220 cases have led to the filing of 126 subsequent merits-based lawsuits over our sample period. Comparing the number of subsequent suits (126) to the number of all books and records cases in the second study (699), about 18% of all books and records cases result in the filing of a subsequent merits-based lawsuit.[132] Of the total number of subsequent cases, 26 raise both derivative and class claims resulting in an overlap so that the totals at the bottom of Table D3 exceed the number 126. Keeping this overlap in mind, we find about two thirds of the subsequent actions are derivative suits (some of which contain class action claims too), roughly one third are class actions (some of which contain derivative claims too), and about one quarter raise individual claims, with few other types of cases mixed in.

[131] ERNST L. FOLK & EDWARD P. WELCH, FOLK ON THE DELAWARE GENERAL CORPORATION LAW: FUNDAMENTALS, 421 (Edward P. Welch ed., 3d ed. 1994) (quoting Mite Corp. v. Heil-Coli Corp., 256 A.2d 855, 857-58 (Del. Ch. 1969)).

[132] Alternatively, we could calculate this fraction by dividing the number of subsequent suits (126) by the number of cases alleging mismanagement (437) and find that 29% of cases where the plaintiff is investigating wrongdoing result in subsequent litigation.

Overall, these data are consistent with the claim that the tools at hand doctrine is having its greatest impact on derivative suit litigation. M&A suits are filed much more quickly so section 220 cases are less useful. This suggests Delaware needs to rethink how it contains rapid filing of deal litigation if it wants to encourage the use of section 220 as a deal litigation improvement device.

E. Important Limitations on Section 220

Despite the important role that Section 220 plays in pre-suit discovery, the Delaware legislatures and judiciary have placed some significant restrictions on it. Recognizing the potential abuse of the tools at hand, the judiciary has allowed corporations to supplement the proper purpose requirement for inspection rights with "reasonable" conditions. Generally, "conditions that are in the interests of the corporation and its shareholder have generally been allowed."[133] For example, if a stay of discovery in an existing derivative action is in place, the Chancery has limited production of books and records so as to avoid sharing of information with anyone involved in the pending derivative action.[134] Second, if books and records are requested as pre-suit discovery to support a possible derivative complaint or direct action, the Court has limited inspections to only those documents required for a "well-pleaded complaint."[135]

Additionally, the Delaware courts have allowed companies to condition fulfillment of an inspection request on potential plaintiffs signing confidentiality agreements containing forum selection provisions. Thus, in *United Techs. Corp. v. Treppel*, the defendant conditioned fulfillment of a plaintiff's book and records request on signing a confidentiality agreement containing a forum selection provision.[136] The plaintiff refused, and the Chancery Court found for plaintiff but, the Delaware Supreme Court disagreed, holding that "the Court of Chancery erred in concluding it lacked the statutory authority to impose its own preclusive limitation here."[137] It reasoned that as a textual reading of the statute did not limit the Chancery Court's authority to restrict the use of books and records, it had wide discretion to "shape the breadth and use of inspections under [Section] 220 to protect the legitimate interests of Delaware corporations."[138]

The Delaware courts have also found that an "incorporation condition" is reasonable, as it balances the interests of the parties and the court.[139] This condition incorporates by reference the entire books and records production into any subsequent derivative action complaint.[140] It allows the court to review the actual documents to ensure plaintiffs do not "cherry-pick" documents to support their complaints.[141]

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[133] Michael Greene, *Del. Companies Placing More Conditions on Records Demands*, BLOOMBERG BNA (Aug. 25, 2016), https://www.bna.com/del-companies-placing-n73014446826/ (quoting Professor Lawrence Hamermesh).

[134] Freund v. Lucent Techs., No. 18893, 2003 Del. Ch. LEXIS 3, at *17 (Jan. 9, 2003).

[135] Kaufman v. CA, Inc., 905 A.2d 749, 753 (Del. Ch. 2006); *see also* Saito v. McKesson, HBOC, Inc., 806 A.2d 113, 115 (Del. 2002).

[136] 109 A.3d 553 (Del. 2014).

[137] *Id.* at 554.

[138] *Id.* at 554.

[139] Amalgamated Bank v. Yahoo!, Inc., 132 A.3d 752, 797 (Del. Ch. 2016).

[140] *Id.* at 796.

[141] *Id.* at 797-98.

However, some in the plaintiffs' bar argue that this allows the defendant to misconstrue the record to their benefit.[142]

Finally, some companies have conditioned stock options on employees waiving their books and records inspection rights.[143] Whether such a waiver will be upheld by the court, however, is currently unclear.[144] While restrictive, these conditions seem to reasonably address potential abuse of Section 220.

In conclusion, Section 220 provides shareholders with a very important right that helps balance the interests of all parties involved—plaintiffs have the ability to demand information in preparing their complaint, while defendants are protected from fishing expeditions and overly litigious shareholders, and the court is able to maintain judicial economy. However, despite the acclaim of this doctrine, recent decisions have imposed additional restrictions on it.

IV. Comparative Analysis and Policy Implications

A. General observations

Both China and Delaware provide for shareholder inspection rights and many similarities can be seen between them in terms of the law-on-the-books and the law in practice. By providing access to relevant information, inspection rights serve as an effective mechanism to deal with different types of agency problems in the company: not only the manager-shareholder conflict which is the most serious agency problem in the U.S., but also the conflict between majority and minority shareholders which mainly plagues the corporate governance system in China.

Inspection rights help to solve the issue of asymmetric information that is inherent in any principal-agent relationship, including those in the corporate form.[145] Possession of adequate information is an important precondition for the principal to meaningfully monitor whether the agent performs appropriately, and to decide whether, and how, to take appropriate action.

Despite the general similarities, however, there are significant differences in how inspection rights are structured in the two jurisdictions. For instance, the Chinese law tends to have detailed rules on the application of inspection rights, such as the list of corporate documents that can be inspected and the list of circumstances that improper purposes can be found. In contrast, the Delaware statute is more standards-based, leaving significantly larger room for the court to exercise ex post review of many issues, including the scope of corporate documents produced by the defendants and any restrictions on inspection rights. This is largely due to the fact that standards cannot be effectively deployed in China where the judiciary is not sufficiently sophisticated on business law topics and may lack independence from the state.

B. Pro-shareholder vs pro-management

Perhaps because of the political power of the state and of controlling shareholders, in striking the balance between shareholders and corporate management, Chinese law is considerably more favourable to shareholders than the Delaware law. For example, while both jurisdictions require shareholders to have a proper purpose in requesting

[142] Greene, *supra* note 90 (quoting Mark Lebovitch).
[143] Rolfe Winkler, *Obscure Law Opens Startups' Books*, WALL ST. J., May 25, 2016, at B1.
[144] *Id.* (quoting Richard Grimm).
[145] Reinier Kraakman, John Armour and Paul Davies et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP, 3rd 2017), 29-31.

documents, the requirements under the Chinese are less stringent than those under the Delaware law. Moreover, our data are consistent with the claim that Delaware seems to be more tolerant of attempts to restrict the exercise of inspection rights through the corporate charter, bylaws or other management actions. In fact, these differences are not unique to inspection rights; rather, in general, while the Delaware corporate law has long had the reputation of being pro-management, its Chinese counterpart has a plausible claim to shareholder-friendly law. [146]

This difference arises in large part because corporate governance in China is a three-party game that involves not only shareholders and managers, but also crucially the state. As a result of China's socialism, the State plays multiple roles in the corporate arena, being an intrusive regulator, a major shareholder, and a defender of 'national champions' in which it may or may not hold an equity stake.[147] The state has traditionally held a majority of outstanding shares in, and is the controlling shareholder of, many listed companies.[148] Further, the state has control over, and indirect economic interests in, some of the main institutional investors in China, including the national social security funds and the funds of state-owned financial institutions such as banks, securities firms and insurance companies. Due to the crucial role the state has in so many companies, it is unsurprising that the Chinese company law adopts a pro-shareholder stance on many issues, including inspection rights.

C. Governance strategies vs Litigation strategies

While Chinese inspection right cases generate useful information for bringing subsequent shareholder suits, our empirical findings show this use seems to be less frequent than in Delaware: as shown earlier, the ratio of subsequent cases to sampled cases in China is 12.4%, which is lower than that in the U.S. (17.9%). A plausible explanation for this difference is that China and the U.S. rely on different strategies for reducing agency costs in the company.

In general, the legal strategies for controlling agency costs can be broadly divided into two groups, namely regulatory mechanisms and enforcement mechanisms. There are strong complementarities between the structure of share ownership and the types of legal strategies relied upon most heavily to control agency costs.[149] In China where the ownership of shares is highly concentrated, the shareholders face relatively low coordination costs in taking action. Hence, it is easier for the shareholders to rely on governance strategies to control managers, and also for small shareholders to unite against majority shareholders.

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[146] By 'shareholder-friendly', we mean that the corporate powers are mostly granted to the shareholders as opposed to the management. See 2005 PRC Company Law, §37 (for LLC) and §99 (for JSC). In the U.S., management decisions fall within the board's exclusive authority to manage the corporation and fundamental corporate decisions such as mergers and charter amendments must be initiated by the board. In China, however, the shareholders have initiation and veto powers in relation to a wide range of matters, including management and personnel issues. Hence, under the shareholder-centric model of corporate governance in China, the main agency problem is not the shareholder-manager conflict, but the conflict between the majority shareholders and the minority shareholders.

[147] Li-Wen Lin and Curtis J. Milhaupt, 'We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China' (2013) 65 *Stanford Law Review* 697.

[148] Robin Hui Huang, Securities and Capital Markets Law in China (UK, Oxford University Press, 2014), pp252-253.

[149] Reinier Kraakman, John Armour and Paul Davies et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP, 3rd 2017), 46.

By contrast, in the U.S. where companies normally have dispersed ownership, the coordination costs for the shareholders are higher. This inhibits shareholders' ability to engage in collective action and makes governance strategies less effective. Thus, regulatory strategies are more heavily relied upon in the form of public enforcement actions by regulators and private litigation by shareholders.

Unlike the Delaware board-centric company law, the Chinese company law is shareholder-centric, granting the shareholder meeting powers over a wide range of corporate affairs, including the appointment and removal of directors, changing constitutional provisions, the company's capital structure, and direct decision rights over various types of major transactions.[150] Shareholders can exercise these powers to address corporate governance problems with less need for corporate litigation. Armed with information obtained from inspection right cases, the shareholders can better determine whether to appoint or remove directors, whether to ratify management decisions on key issues, whether to approve the remuneration scheme for directors, whether to exit the company by exercising their appraisal rights in suitable circumstances, or simply selling shares in the market, as well as whether and how to bring litigation against corporate management.

D. Procedural differences in shareholder litigation

There are important differences in the types of subsequent shareholder litigation initiated in each of the two countries after shareholder inspection suits. Most importantly, in subsequent litigation, class actions and derivative suits are conspicuously absent in China, while they accounted for 20% and 46% of all subsequent cases filed in the U.S. As we explain below, there are good reasons for these differences.

China has a civil procedure for collective litigation, which is dubbed the Chinese-style class action, which bears some resemblance to the class action in the U.S. but also has some important differences.[151] A unique feature of Chinese-style class actions in JSCs (i.e. securities class actions) is the procedural prerequisite that in order to bring a class action for securities fraud misstatements, there must be a prior criminal judgement or administrative sanction decision by the relevant regulators, notably the China Securities Regulatory Commission. This means that securities class actions can only follow public enforcement of securities law. As a result, the shareholder plaintiffs have ready access to relevant information generated in the prior criminal proceeding or administrative sanction decision. Indeed, the civil court can simply rely on the fact-finding about securities fraud misstatements from the prior proceeding, such as false accounting records. As a result, there is a very high rate of recovery for the Chinese plaintiff shareholders in securities fraud cases.[152] For our purposes this is important because there is little need for the plaintiff shareholders to resort to an inspection suit to obtain relevant information to subsequently initiate legal action.

[150] Chinese Company Law, s37 (for LLC) and s99 (for JSC).

[151] Hui Huang, "Rethinking the Relationship between Public Regulation and Private Litigation: Evidence from Securities Class Action in China" (2018) 19 *Theoretical Inquiries in Law* 333, 339-341. The key difference is that while the US-style class action adopts an opt-out rule, the Chinese-style class action follows the "opt-in" rule under which in order to become members of a class, the plaintiffs need to register with the court at the time the case is filed, or later bring suits within a prescribed time period.

[152] Hui Huang, 'Private Enforcement of Securities Law in China: A Ten-year Retrospective and Empirical Assessment' (2013) 61(4) *American Journal of Comparative Law* 757.

For derivative actions, Chinese law is broadly similar to U.S. law, but again with some important differences.[153] Similar to the demand requirement in the U.S., the Chinese derivative suit regime has a pre-suit procedural requirement under which before actually filing a derivative suit, the plaintiff needs to first demand in writing that the company (through its board of supervisors) initiate a direct lawsuit against the alleged wrongdoers who caused harm to the company. Once the demand has been made, the plaintiff may proceed to bring the derivative suit if the demand is rejected, or the demand is not acted upon, by the company within 30 days of its receipt. In addition, the plaintiff shareholder can bring a derivative suit without making a demand if the failure to lodge such an action immediately will cause irreparable injury to the company.

Empirical research shows that as long as a demand is served to the company and then rejected by the company, the plaintiff shareholder can proceed with the derivative suit, regardless of the company's reason for the rejection.[154] In other words, once it has received the demand, the company cannot stop the derivative suit from being instituted unless the company decides to bring action itself. As a result, the Chinese demand requirement seems a pure formality and the shareholder plaintiffs do not need to exercise their inspection rights to obtain information to meet the demand requirement.

In Delaware, however, a stockholder cannot pursue a derivative suit once demand on the board is made because the board is entitled to assume control of the litigation if demand is made. Rather, the plaintiff will usually plead demand futility and seek to disqualify the board from dismissing the case.[155] However, in doing so, they are not entitled to discovery to get relevant information to prove demand futility,[156] and thus the so-called 'tools at hand' doctrine has been developed in Delaware under which the plaintiffs can use the inspection rights as an information-gathering tool for the purpose of excusing a demand.[157] Thus, it is not surprising that there are a substantial number of subsequent actions filed in the US, and about one half (46%) of them are derivative suits.

V. Conclusion

In this paper, we show that shareholder inspection rights play an important role in both China and the U.S. legal systems. We hypothesize that the primary reason that the law provides for these rights, and that shareholders exercise them, is to help shareholders monitor the actions of corporate management. While Chinese corporate governance and American corporate governance face different sets of agency cost problems, improved shareholder monitoring creates important benefits in both of them.

Shareholder inspection statutes in both countries are broadly similar: each requires that investors make an initial demand on the board, state a proper purpose, and detail

[153] 2005 Company Law of PRC, art. 151.

[154] Hui Huang, 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis' (2012) 27(4) *Banking and Finance Law Review* 619, 639.

[155] Randall S. Thomas & Kenneth J. Martin, *Using State Inspection Statutes for Discovery in Securities Fraud Actions*, 77 B.U. L. Rev. 69, 90-91 (1997).

[156] Scattered Corp. v. Chicago Stock Exch., Inc., 701 A.2d 70, 77 (Del. 1997);

[157] Rales v. Blasband, 634 A.2d 927 (Del. 1993); Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Grimes v. Donald, 673 A.2d 1207 (Del. 1996) (en banc).

the documents sought. However, beneath these similarities there lurk some significant differences. For example, both countries' legal rules require that shareholders state a proper purpose, but the Chinese law creates statutory categories that are limited in scope, whereas the Delaware system relies on broad judge-made categories.

Finally, our empirical analysis also sheds light on how inspection rights operate on the ground. We find that many inspection cases are filed in both China and in Delaware. These cases are resolved by the courts relatively quickly. While inspection rights in both countries are frequently used as a pre-suit discovery device, the types of subsequent litigation that can be filed in each country are quite different.

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