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ABSTRACT OF THESIS

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Summary: There are two tasks of this dissertation. Firstly, it will make a contribution from a theoretical perspective. Some Western scholars conclude that rules and institutions transplanted from Western jurisdictions have not worked well in the Chinese legal system so far. This is because the level of consistency between the transplanted rules or institutions and the local context is still at a low level. However, this dissertation takes a different position. By solving a series of unanswered questions, it will make a theoretical contribution to the scholarship on comparative corporate governance in the context of the transitional economy. By and large, it will answer the question: "why can China, as representative of a transitional economy, not escape from the faith of legal transplant in its legal reform of corporate governance". Secondly, this dissertation will make a contribution from a practical perspective. Many Chinese lawyers and Western scholars complain that Chinese company law is suffering deeply from the problem of ambiguity. Indeed, it is poorly and inconsistently drafted. There is, nevertheless, no systematic study on how to solve this problem in a pragmatic manner. In light of the proposed theoretical research, this dissertation will provide an important response on this issue. It rebuilds the director's fiduciary duties and shareholder's fiduciary duties by inserting some workable legal rules from the UK into the existing legal regime in China.

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Chapter I. Introduction

1.1. The Current Debate on Comparative Corporate Governance: Formal Convergence versus Functional Convergence

In this era of globalization, the comparative investigation of corporate governance across jurisdictions is a leading topic for corporate lawyers. There are at least two major driving forces, which encourage corporate law scholars to place increasing emphasis on this topic. The first is an inevitable practical need. Economic globalization leads to the decompression of trade barriers. In this highly competitive global market, competition is not only between products, but also between corporate systems.¹ In order to gain an advantaged position in the global market, corporate lawyers take on the responsibility of finding the most efficient corporate model for their own jurisdiction.² The second driving force is largely, but not entirely, caused by the first. Scholars encounter an important theoretical issue in the process of discerning an economically efficient corporate governance model, namely how corporate governance can be transformed into the most efficient model. On one hand, from a Darwinist perspective, in a fully competitive global market, it seems that corporate governance systems in different jurisdictions driven by economic and efficiency considerations will be convergent to a similar pattern. One popular view is to regard the US corporate governance system, which is oriented around shareholder value, as a paradigm for other jurisdictions.³ On the other hand, this cross-border view of the

¹ See R. Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function' (2001) 49 American Journal of Comparative Law 330, also see A. Pinto, 'Globalization and the Study of Comparative Corporate Governance' (2005) 23 Wisconsin International Law Journal 477

² See R. Gilson (n 2) 330-331, and also see C. Xi, 'In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China' 2006 (22) Connecticut Journal of International Law 1

³ H. Hansmann and R. Kraakman, 'The End of History for Corporate Law' (2001) 89 Georgetown Law Journal 439, and L. Cunningham, 'Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance' (1999) 84 Cornell Law Review 1133, and also see A. Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism* (Belknap Press, Cambridge, MA, 1990) for a summary of the arguments surrounding "Darwinian evolution of company law toward the US shareholder value model", see B. Cheffins, 'Law Economics and the UK's System of Corporate Governance: Lessons from History' (2001) 90 Journal of Corporate Law Studies 71, 76 87 89, R.

corporate governance gives rise to an important methodological issue, namely what drives the development of the legal regime of corporate governance. Many comparative corporate lawyers take a suspicious view of the cross-referencing of rules and institutions among different corporate governance systems. They argue that there is no single blueprint for success. Law is not only fostered as a result of economic force, but political and cultural context.⁴ Therefore, the pressure of global competition will not lead the different corporate governance systems to transform into a single model. Instead, different corporate governance systems, under such force, will become more divergent in many aspects. In order to achieve an equal level of efficiency, the uniqueness of different systems needs to be consistently strengthened and developed in accordance with the local politico-cultural context and pre-existing legal infrastructure.⁵

Having drawn this rough picture of the theoretical debate on comparative corporate governance, it should be noted that the debate on legal borrowing is a long-standing core issue of the jurisprudence of comparative law. Moreover, a considerable number of landmark studies have developed their comparative corporate governance arguments on the basis of various theories of comparative law. Therefore, investigating how corporate governance can be transformed into a success model is

Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 5-14 This group of scholars argue the essential elements of company law are converging across major jurisdictions.

⁴ W. Bratton & J. McCahery, 'Comparative Corporate Governance and the Theory of Firm: The Case Against Global Cross Reference' (2000) 39 *Columbia Journal of Transnational Law* 214, D. Branson, 'The Very Uncertain Prospect of 'Global' Convergence in Corporate Governance' (2001) 34 *Cornell International Law Journal* 321, S. Jacoby, 'Corporate Governance in Comparative Perspective: Prospect for Convergence' (2000) 22 *Comparative Labour Law and Policy Journal* 5, for political determinants of corporate governance, see M. Roe, 'Political Preconditions to Separating Ownership from Corporate Control' (2001) 53 *Stanford Law Review* 539, cultural determinants of corporate governance, see A. Licht, 'Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform' (2004) 20 *Berkeley Journal of International Law* 103, and A. Licht, 'The Maximands of Corporate Governance: A Theory of Values and Cognitive Style' (2004) 29 *Delaware Journal of Corporate Law* 649

⁵ L. Bebchuk & M. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' 1999 (52) *Stanford Law Review* 127, Braendle, C. Udo and J. Noll, 'On the Convergence of National Corporate Governance Systems' (August 2005). Available at SSRN: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=506522> accessed 20th July 2011, M. Roe, 'Some Differences in Corporate Structure in Germany, Japan and United States' (1993) 102 *Yale Law Journal* 1928, and also see R. Gilson, 'Corporate Governance and Economic Efficiency: When Do Institutions Matter?' (1996) 74 *Washington University Law Quarterly* 327

not only a response to increasingly intensive global competition, but also tests the current comparative law theories. A brief introduction to the fundamental comparative law theories is essential to an accurate understanding of the debates surrounding comparative corporate governance.

The "legal transplant" theory was originally developed by Watson based on his study of Roman law. It refers to the "moving of a rule or a system of law from one country to another, or from one people to another".⁶ By legal transplant theory, Watson tries to prove a series of propositions including that "law is autonomous", "legal transplant is socially easy"⁷ and even that "the idea of a close relationship between law and society is a fallacy".⁸ Watson believes that the legal traditions and the beliefs amongst legal professions, as compared with social, political and economic demands, are much more important factors in influencing law-making.⁹ Consequently, divergence between law and social demands become inevitable.¹⁰ Although, this terminology is widely used to refer to the "legal borrowing and reception" phenomenon in comparative law discipline, the theoretical implications attached to the terminology are significantly different. Many users of this terminology are not convinced by Watson's theory. One of the most pre-eminent of these user groups are the contextualists. They challenge Watson's hypothesis by arguing that law is deeply embedded in context and that any kind of law reform is pursuant to the demands of external forces. They assert that overall, law is not autonomous, but a mirror of society. For example, in Otto Kahn-Freund's landmark literature, he says that "any attempt to use a pattern of law outside the environment of its original country entails a risk of rejection...its use requires a knowledge not only of the foreign law but also of its social and above all the political, contexts."¹¹ Friedman, another leading supporter for the context theory, once said: "I assume that if massive changes had taken place in

⁶ A. Watson, *Legal Transplant: An Approach to Comparative Law* (2nd edn, Athens: University of Georgia Press 1993) 21

⁷ *ibid* 95

⁸ *ibid* 108

⁹ A. Watson, 'Society's Choice and Legal Change' (1980-1981) 9 *Hofstra Law Review* 1473

¹⁰ *ibid* 1480

¹¹ Otto Kahn-Freund, 'On Uses and Misuses of Comparative Law' (1974) 37 *Modern Law Review* 27

Japanese society-and they certainly did-the legal system would have been absolutely *forced* to change."¹² In addition to the contextualists' scepticism, the culturalist counter-argument is even stronger. They generally argue that "legal transplants" are impossible. For example, Legrand states that "In any meaningful sense of the term, 'legal transplants,' therefore, cannot happen."¹³ Bearing such general disputes in mind, the debates on comparative corporate governance can be investigated in detail.

Many lawyers have found significant evidence that a considerable level of cross-jurisdictional convergence in company law has already been achieved. More precisely, the rules and standards of company law in different jurisdictions have come to be increasingly similar. For example, in 2001 Hansmann and Kraakman published an important piece of work, which declared that company law in different jurisdictions would converge to the US style shareholder-oriented model. This conclusion was based on an assumption that the forces of logic, competition, interest group pressures, imitation, and compatibility tend to lead different jurisdictions to choose similar solutions to some universal problems (e.g. agency cost).¹⁴ Moreover, Siems's observations on shareholder law in six jurisdictions (including China) find that "convergence through congruence" is happening in the field of shareholder law.¹⁵ Indeed, as the socio-economic conditions in different jurisdictions become increasingly similar, the law itself will also be transformed into a similar pattern. By contrast, there is an uncertain perspective on the global convergence of corporate governance. Hill's research on legal transplant in Russian company law concluded that the "Russian privatization experiments are remarkably similar those taught by Montesquieu, who warned about the dangers of attempting to graft one legal system

¹² L. Friedman, 'Some Comments on Cotterrell and Legal Transplant', In D. Nelken and J. Feest (eds.), *Adapting Legal Cultures*, (Hart Publishing 2001) 95

¹³ P. Legrand, 'What "Legal Transplants"?', In D. Nelken and J. Feest (eds.), *Adapting Legal Cultures* (Hart Publishing 2001) 57

¹⁴ H. Hansmann & R. Kraakman, (n 3) 439-486

¹⁵ M. Siems, *Convergence in Shareholder Law* (1st edn, Cambridge University Press 2008) 250-290

onto another."¹⁶ Kanda and Milhaupt's study of transplanting director's duties from the US to Japan reached a similar conclusion that "transplanting law is 'socially easy' is open to question" and "the success or failure of the legal transplant...was determined largely by the degree to which the transplant fit the prevailing legal and non-legal infrastructure of which it was a part."¹⁷ Additionally, Bebchuk and Roe employ the path-dependence theory¹⁸ to explain why institutional differences among corporate governance regimes across different jurisdictions will persist. They argue that in jurisdictions where the protection of minority shareholders is weak, controlling shareholders could generally make extra profits by engaging in rent-seeking activities (e.g. self-dealing). This is because they aim to block any fundamental change which would potentially affect their interests adversely, and they generally hold the power to avoid such unpopular reforms. For example, the controlling shareholder can block the reform of ownership structure by refusing to sell shares to the general public. Furthermore even if reform is inevitable, functional convergence would be the first response to such reform because making a fundamental change to an existing institution is economically inefficient (e.g. sunk cost,¹⁹ network of externality²⁰).²¹ The effects of "path-dependence" would lead corporate governance regimes in different jurisdictions to retain their different forms.

As this theoretical review has shown, legal transplant theories in the context of

¹⁶ J. Hill, 'Comparative Governance and Russia-Coming Full Circle', In G. Doeker-Mach & K. Ziegert (eds.), *Law and Legal Culture in Comparative Perspective* (Franz Steiner Verlag Stuttgart 2004) 405

¹⁷ H. Kanda & C. Milhaupt, 'Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law' (2003) 51 *American Journal of Comparative Law* 887, 900

¹⁸ For the concept of path-dependence, see generally M. Siems, (n 15) 293-296

¹⁹ Sunk cost means the cost cannot be recovered. For details, see R. Posner, *Economic Analysis of Law* (7th edn. Aspen Publishers 2008) 7 and it is also defined as "the sunk cost effect is manifested in a greater tendency to continue an endeavor once an investment in money, effort, or time has been made. Evidence that the psychological justification for this behavior is predicated on the desire not to appear wasteful is presented." see Hal R. Arkes & C. Blumer, 'The Psychology of Sunk Cost' (1985) 35 *Organizational Behavior and Human Decision Process* 124

²⁰ The concept of "positive" network consumption externalities was firstly recognized in the context of telecommunications networks. There the value of a network to a subscriber increases with the number of its adopters. see R. Kaufmann, J. McAndrews and Y. Wang, 'Opening the 'Black Box' of Network Externalities in Network Adoption' (2000) 11 *Information Systems Research* 61, and it is defined as "markets in which the value that consumers place on a good increases as others buy the good." see M. Lemley & D. McGowan, 'Legal Implications of Network Economic Effects' (1998) 86 *California Law Review* 562

²¹ L. Bebchuk & M. Roe, (n 5) 127-170

comparative company law evolve into the debates of *formal convergence versus functional convergence*. The proponents of the formal convergence model argue that

telecommunications revolution, the ease of international jet travel, and pressure from law makers, stock exchanges, pension funds, and others, combine to motivate and enable those who control larger corporations to become conversant with corporate governance structure and practice.²²

On the other hand, supporters of functional convergence place more emphasis on the barriers which could deter the formal convergences, for example, cultural constraints, differences of ownership structure and political-economic barriers. Accordingly, the combined forces of globalization will lead different corporate governance regimes to become more divergent rather than convergent. Jurisdictions have to achieve global best practice by implementing different legal rules.²³ Having mapped this core debate, the following part will focus on how China's legal reform of corporate governance might be used to test these comparative corporate governance theories.

1.2 China's Legal Reform of Corporate Governance and Comparative Corporate Governance Theories

1.2.1 The Significance of China as a Test for Comparative Corporate Governance Theories

China is an extraordinarily interesting transition economy for testing comparative corporate governance theories in at least three respects. Firstly, China is the second largest economic entity in the world, behind the US and ahead Japan. It is a rising economic superpower predicted to have the world's largest economy by the middle of

²² D. Branson (n 4) 324

²³ L. Bebchuk & M. Roe, (n 5) 127-170

this century.²⁴ China's membership of the World Trade Organization (WTO) has meant that in the last decade it has made substantial progress in building a sound commercial environment by forming a functional legal system. In 2010, China ranked 27th out of 133 countries on the 2010 World Economic Forum's Global Competitive Index,²⁵ 22nd out of 57 countries on the 2010 World Economic Forum's Financial Development Index,²⁶ 18th out of 58 countries on the Institute for Management Development's World Competitiveness Index 2010.²⁷ Furthermore, according to the Fortune 500 index, Chinese enterprises occupied 54 positions in the top 500 companies in the world.²⁸ Moreover, the *Financial Times*' latest report shows that three Chinese State-owned companies are nominated as the top 10 most valuable companies in the world.²⁹ For the first time, PetroChina, has overtaken Exxon Mobil as the world's most valuable company.³⁰ In 2007, half of the six largest companies in the world (by market capitalization) were Chinese. The market capitalization of Chinese companies (listed both in China and abroad) totalled over double China's GDP.³¹ The dramatic boost to China's national economy as well as the fast expansion of its large corporate groups makes China an interesting example for testing

²⁴ D. Wessel and M. Walker, 'Good News for the Globe; Nobel Winners in Economics Are Upbeat About the Future As China and India Surge' (2004) September 3rd Wall Street Journal (Eastern Edition) a latest report by The Economist made a similar prediction, it says "According to our latest projections, China's economy will have become bigger than America's: we think it might happen by 2027." in 'Jim O'Neill looks at the global economy of 2036' (Nov. 22nd, 2010) Economist, The World in 2011

²⁵ Global Competitiveness Report 2010-2011 issued by World Economic Forum is available at <http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2010-11.pdf> accessed 20th July 2011

²⁶ See The Financial Development Report 2010, at <http://www3.weforum.org/docs/WEF_FinancialDevelopmentReport_2010.pdf> accessed 20th July 2011

²⁷ For the index, see <<http://www.imd.org/research/publications/wcy/upload/scoreboard.pdf>> accessed 20th July 2011

²⁸ See Chinese companies on Fortune 500 index at <http://www.fortunechina.com/fortune500/c/2010-09/29/content_42290.htm> accessed 20th July 2011

²⁹ See FT Global 500 at <<http://www.ft.com/reports/ft500-2010>> accessed 20th July 2011

³⁰ See FT Global 500 at <<http://www.ft.com/reports/ft500-2010>>

³¹ G.S. Swan, 'The Political Economy of the Rule of Law in China' (2009) 5:2 Hastings Business Law Journal 309, 331

comparative corporate governance theories.³²

Secondly, compared to its rapid economic development, China's political reform has been much slower. Unlike other transition economies which have ideologically transitioned from socialism to liberal democracy, China retains its socialist ideology with a one-party system. As one commentator indicates,

China's Communist Party is legally untouchable. The 73-million strong Party dominates politics, and much business activity. It is deeply entrenched in the separate governmental administration. It stands above the law, with its own courts and disciplinary processes. ³³

This political regime which is dominated by one party is even occasionally labelled "totalitarian" or "dictatorial". Furthermore, the Chinese government has consistently demonstrated that political goals that facilitate communitarian Communist principles take primacy over the legal protection of individuals. This ideology clashes intensely with individual shareholder protection, which is the main aim of the modern corporate governance regimes of most developed jurisdictions. It is therefore interesting to observe how socialist ideology interacts with rules that have been transplanted from Western jurisdictions.

Thirdly, from a legal perspective, China is still undergoing an unusual process of legal reform. Following the Cultural Revolution, legal reform in China aimed to create a more business and investment friendly legal environment to help spur economic

³² For why these economic factors make China such an interesting test case for the application of these comparative theories, see the discussion in chapter IV. The major target for China's company law reform is to support consistently economic development. However, some scholars argue that China's economic development is not supported by the "rule of law" system. For this point, see 4.2.2.1 below at 111 and D. Clarke, P. Murrell and S. Whiting 'The Role of Law in China's Economic Development', (January 27th, 2006). GWU Law School Public Law Research Paper No. 187. Available at SSRN: <<http://ssrn.com/abstract=878672>>, accessed 20th July 2011. D. Kenneth, 'China as a Test Case: Is the Rule of Law Essential for Economic Growth?' (October 2006). U Chicago Law & Economics, Olin Working Paper No. 275. Available at <SSRN: <http://ssrn.com/abstract=880125>> accessed 20th July 2011

³³ G. Swan (n 31) 314

growth and reduce poverty.³⁴ China's legal reform of commercial law, which is found on instrumentalism, causes an unusual phenomenon. Indeed, it is apparent that, compared to Western jurisdictions, modern Chinese commercial law, especially company law, is fundamentally divorced from China's legal tradition and even its traditional culture. As some lawyers have argued; for the whole of the twentieth century, the development of Chinese law and legal science was a process of learning from, making use of, absorbing and digesting foreign experiences.³⁵ Following this trend, Chinese commercial lawyers and judges tend to take westernised approaches, deliberately keeping a distance from the Chinese legal tradition. Given these conditions, investigating why there is a significant divergence between existing Chinese law and China's legal tradition is important.

1.2.2. Mapping out the Two Major Scholarships

As one of the major transitional economies, China is widely considered to be an important laboratory to test the *formal convergence/functional convergence* debate. Broadly speaking, there are two major trajectories for current scholarship regarding the relationship between China's legal reform of corporate governance and these convergence theories. One is principally descriptive, whilst the other is normative in nature. One school of scholarship (School A), mainly focuses on what actually happens in China's reform. More precisely, it lays greater weight on addressing what kind of positive laws are introduced into the Chinese legal system during the reform process. In addition, it seeks to discern the dynamic forces, which drive policy-makers to adopt certain rules or institutions. Finally, this group of researches deeply appreciates the complexity of China's reform. As a result, they generally conclude that China's legal reform of corporate governance manifests a hybrid pattern, which is usually a combination of Western experience and local knowledge. The following part will draw a

³⁴ R. Peerenboom, *China Modernizes: Threat to the West or Model for the Rest* (Oxford University Press 2008) 36, 43

³⁵ J. Cheng, 'The Transformation of Chinese Law: From Formal to Substantial' (2007) 37 Hong Kong Law Journal 689

more vivid picture of the School A by providing some examples.

Siems uses the recent development of the Chinese corporate governance regime as evidence of the convergence of shareholder law between jurisdictions.³⁶ He finds that Chinese policy-makers have transplanted a large number of rules and institutions from Anglo-American jurisdictions into Chinese company law and securities law regimes. This reform implies the increasing congruence of economic infrastructure between China and Western jurisdictions. However, Siems also recognises that the legal rules adopted by the Chinese legal system are approximate rather than identical to their original forms. In general, there are still many differences in detail and actual enforcement between Chinese and Anglo-American systems.³⁷ Xi's recent research on China's "board reform" illustrates that China's reform strategy demonstrates a partial rather than complete formal convergence with the Anglo-American corporate governance mode.³⁸ For example, although the institutions of independent director and board sub-committees under the board of directors have already been introduced into the Chinese legal system, the two-tier board structure, which is a civil law mechanism, is not abolished.³⁹ Like Siems, Xi also provides an important insight into the dynamic force for this partial formal convergence toward Anglo-American system. He indicates that the pressure exerted by different interest groups may be the main force that leads policy-makers to adopt this partial convergence mode.⁴⁰ Finally, Howson's observation on the doctrine of director's fiduciary duties shares a similar view to those of Siems and Xi. Howson elaborates on the process by which the doctrine of director's fiduciary duties is evolving, namely, through an interaction between functional convergence and formal convergence in Chinese judicial practice. Howson finds that before the director's

³⁶ M. Siems (n 15) 396

³⁷ *ibid* 396

³⁸ C. Xi (n 2) 1-46

³⁹ *ibid* 31

⁴⁰ *ibid*

fiduciary duties were formally introduced into the China's *Company Law 2005*,⁴¹ the courts had already used several different legal mechanisms to achieve a functional equivalence to the doctrine of fiduciary duties. This reveals an interesting phenomenon in that there is a pre-formal functional convergence. In addition to their original contribution, Howson's findings also further support Siems and Xi's arguments by demonstrating that the doctrine of directors' duties in Chinese law is influenced by both the Anglo-American and the Civil law legal systems.⁴²

By contrast, the other school of scholarship (School B) generally goes beyond analysing what is actually happening in China's legal reform of corporate governance, evaluating China's reform from a normative perspective. In order to achieve this, commentators have used a number of case studies to assess whether transplanted rules or institutions have worked in China. Generally, this scholarship evaluates the performance of transplanted rules by two standards. Firstly, it assesses the transplanted rule or institution by examining whether it works as the legislator expected it to work in judicial practice. Secondly, they ask whether the transplanted rules in the Chinese context are as efficient as their original forms in the Western jurisdictions. In accordance with these two standards, School B concludes that Western rules and institutions have not worked well in the Chinese legal system so far. This is because the level of consistency between the transplanted rules or institutions and the local context is still at a low level. Some commentators provide their own solutions to China's legal reform. Although these solutions vary in detail, they generally suggest that policy-makers should enact rules with stronger Chinese characteristics so as to meet local needs.

⁴¹ China first passed a Company Law in 1993. See Zhonghua Renmin Gongheguo Gongsì Fa [Company Law of the People's Republic of China], adopted by Fifth Session of the Standing Committee of the Eighth National People's Congress, December 29, 1993, effective July 1, 1994 [hereinafter Company Law 1993]. The Company Law 1993 was substantially amended in 2005. See Zhonghua Renmin Gongheguo Gongsì Fa [Company Law of the People's Republic of China], was amended by National Congress of Communist Party of China on Oct. 27, 2005, effective January 1, 2006 [hereinafter Company Law 2005].

⁴² See N. Howson, 'Article 148 of China's 2005 Company Law: Precocious Convergence in the Chinese Court' in B.S. Wang (eds.), *Shi Jian Zhong De Gongsì Fa* [Company Law in Practice] (Zhongguo Shehui Kexue Chubanshe 2008) [China Social Science Academic Press 2008] 186. For another example of Scholarship A, see S. Shim 'Corporate Governance Reform in China' (2005) 57 *Company Lawyer* 8

Examples of School B scholarship are readily found in the current academic market. For example, Clarke uses the law relating to independent directors to view legal transplants in Chinese company law. He finds that the institution of an independent director does not work as expected in the Chinese regime, because it conflicts with the Chinese context at both macro and micro levels. At a micro level, the transplanted institution is not well tied into any system of incentives. The market participants are not motivated to comply with it. At a macro level, excessive State control also constrains the independent director's performance.⁴³ Similarly, research by Yang, Li and Lau on China's recent legal reform of corporate governance indicates that many transplanted rules are not compatible with China's political and cultural realities.⁴⁴ They point out that transplanting Western rules into the Chinese legal system is merely "window dressing", designed to appease foreign investors and lenders.⁴⁵ Another study by Miles and He reveals a similar phenomenon. They find that after being transplanted into the Chinese legal system, Anglo-American shareholder protection rules become far less efficient. They argue that this is because a number of local constraints, particularly the weak Chinese court system, curb the function of the transplanted rules.⁴⁶

In addition to pointing out the conflicts between Western legal rules and the Chinese context, these authors provide some suggestions on China's legal reform of corporate governance. Clarke's answer is to "consider China's particular conditions, and develop a system of corporate governance with Chinese characters."⁴⁷ This argument

⁴³ D. Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 Delaware Journal of Corporate Law 125

⁴⁴ A. Young, G. Li & A. Lau, 'Corporate Governance in China: the Role of the State and Ideology in Shaping Reforms' 2007 (28) Company Lawyer 204

⁴⁵ *ibid*

⁴⁶ See L. Miles & M. He, 'Protecting the Rights and Interests of Minorities Shareholders in Listed Companies in China: Challenge for the Future' (2005) 16 International Company and Commercial Law Review 275 A similar point, see C.X. Shi, 'International Corporate Governance Development: The Path for China' (2005) 71 Australian Journal of Asian Law 60 and also see J.Z. Yang, 'Comparative Corporate Governance: Reforming Chinese Corporate Governance' (2005) 16 International Company and Commercial Law Review 8. The author argues that "the legal rules transplanted from the United Kingdom and the United States do not fit the existing legal infrastructure and political economic system in China. Many cases were interfered with by the government because state control remains at the centre of both business operations and regulation enforcement."

⁴⁷ D. Clarke (n 43) 217

does not appear to completely deny the formal convergence model.⁴⁸ Rather it appears to suggest that policy-makers should invest a greater effort into equipping the transplanted legal rules with more local characteristics. By contrast, Yang et al take a stronger approach. They say that the "Chinese government should do more to raise the awareness of ethnic issues...reviving Confucius's teaching has a clear advantage apart from the cultural considerations."⁴⁹ According to their argument, the formal convergence model is unreliable and reform should be oriented by a group of ethical standards rather than legal rules and institutions.

1.2.3 China's Legal Reform of Corporate Governance: Unanswered Questions

Having provided the above review, it is necessary to recap what we should already know from the existing scholarship. The important insights offered by the above schools of scholarship may act as a point of departure from which to find areas of China's legal reform of corporate governance which remain unanalysed in terms of comparative corporate governance theories. This raises the question of what kind of contribution of such areas can make to the current debate on comparative corporate governance. Firstly, according to School A, if we define formal convergence broadly, the Chinese legal reform of corporate governance can be categorised as formal convergence.⁵⁰ These reforms are based on "transplant" rather than "copy". In fact, most Western rules or institutions are transformed in a hybrid form: the Vice President of China's Supreme Court, Xi Xiaoming states that "the *Company Law 2005* is a mixture of the Western experience and local resource".⁵¹ This is re-affirmed by Peerenboom's recent study, which concludes that "most [Chinese] reforms will involve a mixture of foreign and domestic inputs that interact in complicated ways, as

⁴⁸ For the definition of formal convergence model, see 4.1.1 below 72-74

⁴⁹ A. Young, G. Li & A. Lau (n 44) 211

⁵⁰ For the definition of formal convergence model and functional convergence model, see 4.1.1 below at 72-74

⁵¹ Zuigao Renmin Fayuan Guanyu Gongsifa Sifajieshi Yi Er de Lijie yu Shiyong [Understanding and Applying the Supreme Court's Interpretation I & II on the Company Law 2005], (Renmin Faguan Chubanshe 2008) [The People's Court Press 2008] 10

well as attempts to deduce what will work from both in China and abroad."⁵²

School B finds that placing an overwhelming emphasis on the transplanted Western rules and institutions may cause serious problems in the legal reform of corporate governance. Commentators have already provided substantial evidence to show the inconsistency between the Western rules and local contexts. This usually results from the profound differences between the social and cultural fabric of two different jurisdictions. Therefore, in order to improve the effectiveness of the legal rules, it is right for legislators to attach more importance to local political and economic realities.

By and large, the scholarship of Schools A and B are insightful and credible. They use large quantities of evidence to support their arguments. However, there are still neglected dimensions of China's legal reform of corporate governance in terms of convergence theories. Firstly, as J.H. Farrar states, "it is currently fashionable to talk about the history of corporate governance in term of path dependence...corporate structures, it is said, depend in part on the structures a country had in earlier times, in particular with which the economy started."⁵³ However, both of these Schools tend to focus only on the company law regime developed since the 1990s, and analyse this regime by looking at it in the ideological, cultural and political context of contemporary China (from 1949 to present). This research approach may produce misleading results. Indeed, history cannot be ignored in understanding the developing path taken by China's legal reform of corporate governance, as the present is influenced by that history. In order to gain a more accurate picture of China's development of corporate governance, it is necessary to examine the historical path of China's corporate governance regime from its starting point. Additionally, both Schools A and B fail to offer a satisfactory answer to the question of whether the formal convergence model has any advantages. The omission of this perspective is

⁵² R. Peerenboom (n 34) 217

⁵³ J. Farrar, 'A Brief Thematic History of Corporate Governance' (1999) 11 Bond Law Review 259, 259

particularly curious. School B focuses on one-side of the coin--the weaknesses of the formal convergence model, but ignores its benefits. By contrast, the explanations of School A are quite limited. The argument is for the purpose of "convenience" and "efficiency", Western legal rules are selectively transplanted into the Chinese legal system.⁵⁴ However, as the formal convergence model's advantages are not the principal concern of these studies, their answers do not undertake a comprehensive analysis. As a consequence, it is still unclear whether the convenient or efficient consideration is the only reason for transplanting Western legal rules into the Chinese legal system. Thirdly, where the advantages of the formal convergence model are not well exploited, the argument that policy-makers should adopt the functional convergence model by, for example, reforming the corporate governance system in accordance with Confucius's teachings, is also open to question. Such commentators assume that the functional convergence model would be a better choice only because the model which selectively transplants Western legal rules causes problems. They fail to provide any affirmative reasoning which evidences the competitive advantages of the model they support. The weakness of the formal convergence model cannot automatically prove the advantages of other models, because the possibility that the functional convergence model might have even worse performance in practice cannot be denied.

In light of the above analysis, two specific questions deserve further study in order to complete the scholarship on China's legal reform of corporate governance from a comparative perspective. Firstly, what are the technical advantages (if any) of transplanting Western legal rules into the Chinese legal system? Secondly, is the functional convergence model a more effective model, as some lawyers support? In addition to completing the scholarship on China's legal reform of corporate governance, the research on these two questions leads to the investigation of a series of further questions. Those questions have a great theoretical significance to general theories of comparative corporate governance. They are:

⁵⁴ R. Peerenboom (n 34) 217

(1) Whether the "agency-cost controlling strategies"⁵⁵ provided by the company law system are still important to China's unique regulatory environment?

(2) If the Western transplanted rules do not work well in China's context, why do Chinese legislators consistently borrow legal rules or institutions from Western jurisdictions for China's legal system? Is the decision irrational?

(3) In Western jurisdictions, lawyers and judges generally treasure their domestic legal traditions. Why then do Chinese commercial lawyers and judges, tend to take significant amounts of experience from Western jurisdictions, whilst deliberately keeping a distance from China's own cultural and legal tradition?

By solving these puzzles, this dissertation will make a theoretical contribution to the scholarship on comparative corporate governance in the context of the transitional economy. By and large, it will answer the question: "why can China, as representative of a transitional economy, not escape from the fate of legal transplant in its legal reform of corporate governance".

As mentioned above, one of the major driving forces for the theoretical exploration of comparative corporate governance is the practical demands of finding an efficient corporate governance model under the intensity of globalization. After addressing the above theoretical issues, this dissertation will make a contribution from a practical perspective. The theoretical research is expected to provide some important methodological insights for fulfilling a practical task, namely improving the legislative quality of "agency-controlling strategies". Many Chinese lawyers and Western scholars complain that Chinese company law is suffering deeply from the

⁵⁵ Agency-cost controlling strategies mean the formal or informal legal devices which can control the agency-cost between director and shareholder or the agency-cost between minority shareholder and majority shareholder. For this concept, see R. Kraakman and others (n 2) 37-44

problem of ambiguity.⁵⁶ Indeed, it is poorly and inconsistently drafted. There is, nevertheless, no systematic study on how to solve this problem in a pragmatic manner. In light of the proposed theoretical research, this dissertation will provide an important response on this issue. It rebuilds the director's fiduciary duties and the legal limitations on shareholder's voting power by inserting some workable legal rules from the UK into the existing legal regime in China.

1.3 Organization of this Dissertation and Chapter Synopses

The structure of this dissertation follows a "problem-solution" model. The first part (chapter II) maps out the problems of China's corporate governance regime. The second part (Chapters III & IV) sets up a theoretical framework of solving these problems, whilst providing some important theoretical insights into scholarship on China's legal reform of corporate governance. The third part (Chapter V), following on the theoretical study, provides some workable proposals for improving the "agency-cost controlling strategies" of the company law system.

China is usually labelled as being a transition economy with a number of unique characteristics. Therefore, in addition to illustrating the general background of China's corporate governance regime, chapter II, will compare China's corporate governance problems with those of Western jurisdictions.

Following this, chapter III will solve the first puzzle indicated above. It asks whether the company law system should play a dominant part in regulating corporate governance problems in a transition jurisdiction. This research is undertaken against a background of three arguments that cast doubt upon the suitability of the company law regime. Firstly, in order to solve corporate governance problems, some scholars

⁵⁶ K.Y. Zou, 'Towards the Rule of Law: An Overview of China's Legal Reform' In G.W. Wang and J. Wong (eds.), *China: Two Decades of Reform and Change*, (Singapore University Press, Singapore, 1999) 178, also see A. Young, G. Li & A. Lau (n 44) 204, and for more details of this point, see the discussion of chapter III (3.2) at 58 below and the discussion of Chapter V in general.

argue that the legal institution should be replaced by traditional Chinese ethnic standards, which is more suitable for China's cultural context.⁵⁷ Secondly, administrative regulation has already played a key role in regulating corporate governance in China. Finally, legal enforcement mechanisms in China are weak.

Chapter IV contributes some important theoretical insights. It begins with an in-depth analysis of two representative case studies. By investigating these two cases, it unveils the answers to the two questions ignored by the existing scholarship. Following that, it will shed some light on what determines these answers under the theoretical framework of path-dependence. Firstly, it puts the insights from the case studies into a political-cultural context. It locates the cultural and ideological determinants, which reject a total westernization of China's company law regime. Secondly, it further unpacks those insights through a perspective founded on "efficient-driven path-dependence".⁵⁸ By locating the starting point of China's company law regime and investigating it from a historical perspective, this chapter explains why the Western experience is essential to China's legal reform of corporate governance. Exploiting these determinants will ultimately lead to a more ambitious theoretical analysis. It solves two curious puzzles of China's legal reform of corporate governance, including why Chinese legislators adopt a reforming approach underpinned by legal transplant and why the Chinese traditional legal culture plays little role in China's modern company law.

In Chapter V, the focus will shift from generating theoretical implications to searching for practical solutions. Following the comparative method, it enhances the workability of the company law system by inserting a bundle of legal rules or standards into current regime. It makes a series of suggestions regarding the reform of director's duties and the legal limitations on shareholder's voting power in China's company law system. Chapter VI finally concludes with some thoughts on the

⁵⁷ See A. Young, G. Li & A. Lau (n 44)

⁵⁸ For the concept of "efficient-driven path-dependence" see 4.2.2. 2.2 below 122-123

scholarship of China's legal reform of corporate governance and the general theories of comparative corporate governance.

Chapter II. The Major Problems surrounding China's Corporate Governance Regime and The Legal Implications of the Problems

2.1. Introduction

Before discussing core research questions, this part introduces the major problems surrounding corporate governance in China. Indeed, mapping these problems is the first step to solving them. Moreover, it sheds some light on the crucial question of whether the problems of China's corporate governance regime are unique. More precisely, although most public companies retain several "Chinese characteristics", such as "strong state-shareholder", "over-concentrated ownership structure" and "powerful insider control", it is still unclear whether these characteristics cause major problems for China's corporate governance regime in nature, are distinctive from that of developed jurisdictions. If China's problems are idiosyncratic in nature, the law in developed jurisdictions would provide little valuable guidance on how to deal with China's problems. In short, the nature of the problem determines whether solutions can be found in comparative research. The next fundamental question is where the weaknesses of the legal regime that regulates these corporate governance problems are. The answer to this question will indicate what needs to be further improved in the current regulatory regime if a better corporate governance regime is to be formed.

This part firstly defines corporate governance. It then introduces the development of China's corporate governance regime. After that, it identifies the major problems of corporate governance regime in China's public companies. The following section will assess the legal implications of these problems.

2.2 Defining Corporate Governance

Traditionally, corporate governance has been concerned with one subject. It is about the "divergence of interest between the ownership and the management". This concept was first recognised by Berle and Means in 1932 when they stated,

the owners were distinguished primarily by the fact that they were in a position both to manage an enterprise or delegate its management and to receive any profits or benefits which may accrue. The managers on the other hand were distinguished primarily by the fact that they operated an enterprise, presumably in the interest of the owners.¹

Nonetheless, the interests of management could run directly counter to the interests of owners. The major function of corporate governance is to guarantee that directors act in the best interests of owners. Traditionally, in the UK, the corporate governance regime has essentially been about how to manage a company's business in the best interests of shareholders. The assets of a company should be used efficiently for this purpose only.²

By the 1970s to 1990s, on an ideological level, development of theories like "industrial democracy" and "stakeholder society" exerted a great impact on the definition of corporate governance³. Additionally the theory of "firm-specified human capital" fundamentally reformed the theoretical structure of corporate governance in an economic sense.⁴ This movement forced corporate governance to shift from the

¹ A. Berle and G. Means, *The Modern Corporation & Private Property* (Transaction Publishers 2002) 112-113

² For this point, see B. Cheffins, 'Corporate Governance Reform: Britain as an Exporter' in David Hume Institute in Corporate Governance and Reform of Company Law, Hume Papers on Public Policy: Volume 8 No.1 (Edinburgh University Press 2000) 10

³ B. Pettet, *Company Law* (2nd edn, Person Education Limited 2005) 58

⁴ See O. Williamson, 'Transaction Cost Economics', In R. Schmalensee and R. Willing, (eds.), *Handbook of Industrial Organization* (Amsterdam: Elsevier Science Pub 1989) 135, and see C. Chang & Y.J. Wang, 'A Framework for Understanding Differences in Labor Turnover and Human Capital Investment' (1995) 28 *Journal of Economic Behavior and Organization* 91

shareholder-oriented model to the stakeholder-oriented model. The stakeholder model which requires corporate governance to promote the interests of stakeholders has become a widely accepted international standard.⁵ Following this trend, corporate governance is oriented by the "enlightened shareholder value" in the UK. Here, the director is not only responsible to the shareholders, but also to the stakeholders and even to the community as a whole.

During 1980s to 1990s, a series of scandals triggered a widespread rethinking of the corporate governance regime in the UK. These re-assessments of corporate governance were fruitful. A series of reports concerning the regulation of corporate governance were published in this period, of which the *Cadbury Report* is arguably most influential. According to the *Cadbury Report*, corporate governance is "the system by which companies are directed and controlled".⁶ Compared to the traditional definition, it defines corporate governance from a functional perspective. It stresses that internal corporate powers should be properly allocated to different corporate organs. Arguably, this definition is the best-known definition in the academic world.

By contrast, there is no universally accepted definition of corporate governance in China's legal system. Generally speaking, the "system theory" is widely accepted in China's academic world. For example, one of the top Chinese corporate lawyers, T.S Shi defines corporate governance as "a system distributing the managing and supervising powers to different corporate organs".⁷ Similarly, a Western scholar points out that the "Corporate governance (gongsi zhili) is a concept whose time seems definitely to have come in China. Chinese definitions of corporate governance in the abstract tend to cover the system regulating relationships among all parties with interests in a business organization, usually spelling out shareholders as a particularly

⁵OECD Principles of Corporate Governance (April 2004) available at <<http://www.oecd.org/dataoecd/32/18/31557724.pdf>> accessed 20th July 2011

⁶ Cadbury Report (the Financial Aspect of Corporate Governance), available at <http://www.ecgi.org/codes/code.php?code_id=132> accessed 20th July 2011

⁷ T. Shi, *Shang Fa* [Commercial Law] (Falv Chuban She 2003) [Law Publisher 2003] 233

important group".⁸ The academic argument in this line has deeply influenced the legislation. In the *Company Law 2005*, the term "corporate governance" is replaced with "corporate organization and structure".⁹ This indicates that corporate governance is deemed to be an institution which regulates internal corporate arrangements and power distributions.

Similarly to the Western jurisdictions, corporate social responsibility (CSR) has been incorporated into the *Company Law 2005*. Article 5 says that "a company should accept the supervisions by government and the general public and assume social responsibilities". Additionally, according to the *Corporate Governance Guideline for Listed Corporations 2002 (Corporate Governance Guideline)*, a director must take the interests of creditors, employees, customers, suppliers and the local community into consideration.¹⁰ However, these legal principles are without detailed and intricate interpretations. Therefore, Articles on CSR and stakeholder protection in China are more likely to be a slogan rather than an enforceable legal principle.¹¹

We can view this issue from a different perspective. As MacNeil argues, the dominant value in China's corporate governance is "shareholder primacy" rather than "pluralism". Since the State is the major shareholder of most super-size corporations, the "shareholder primacy" approach is more likely to be consistent with the task of protecting State interests and property¹². Most Chinese scholars accept that the core problems of China's corporate governance regime still concern basic issues, such as

⁸ D. Clarke, 'Corporate governance in China: An Overview' (2003) 14 *China Economic Review* 496, 496

⁹ *Company Law 2005* Chapter 4

Available at: <<http://www.cpasz.com/xzfg/gongsifa2005.htm>>

¹⁰ Corporate Governance Guideline, Article 43 & Chapter 6 for a general introduction of Corporate Governance Guideline, see L. Lau, 'China: CSRC's Corporate Governance Guideline for Listed Companies' (2003) 24 *Company Lawyer* 125, 125-128

¹¹ In 2007, the Shen Zhen Stock Exchange issued a guidance of implementing CSR for all public companies which listed in Shen Zhen. However, it merely provided a few permissive provisions and the enforceability of these provisions are doubtful. and also see L.W. Lin 'Corporate Social Responsibility in China: Window Dressing or Structural Change' 2010 (28) *Berkeley Journal of International Law* 64

¹² I. MacNeil, 'Adaptation and Convergence in Corporate Governance: the Case of Chinese Listed Companies' (2002) 2 *Journal of Corporate Law Studies* 289, 335

building a practical corporate governance framework, restricting insider control, enhancing the protection of minority shareholders, and implementing sophisticated disclosure rules. After all, protecting stakeholders' interests is not the central issue for China's legal reform of corporate governance in the near future. Thus, it is not surprising that a Western lawyer concludes that "the definition [definition of corporate governance in China] seems to revolve around such components as transparency, accountability, management, board function and shareholder's rights and director's duties and responsibilities"¹³. All these components are in the sphere of the narrow definition.

In accordance with the above analysis, in this paper, "corporate governance" will be defined in a relatively narrow sense. This is not only because CSR is still an unclear concept in the Chinese context, but also because the major problems of Chinese corporate governance are still within the sphere of "shareholder primacy". Therefore, this dissertation adopts the Cadbury Report's definition-- the system by which companies are directed and controlled.

2.3. The Major problems of China's Corporate Governance

2.3.1. A Brief Historical Introduction

The historical development of China's corporate governance is important for understanding the current problems. In the planned economic period (1949-1979), after the civil war, the government's major task was to reinforce the dictatorship of the socialist regime. During the early days of Peoples Republic of China (PRC), China was economically backward following constant wars and the nationalist party had taken nearly all the top Chinese scientists and scholars to Taiwan.¹⁴ Under these

¹³ S. Shim, 'Corporate Governance Reform in China' (2005) 26(12) Company Lawyer 367

¹⁴ Y. Hua, Zoujin Taiwan [Approaching Tai Wan], Chapter 14 Rencai Jingji Fazhan De Zhongyao Yinsu [Human Resource and Economic Development], (Zhongguo Shehui Kexue Chubanshe 2003) [China's Social Science Press] 209

circumstances, Chairman Mao had a visionary analysis of the economic status of China. He pointed out the weaknesses of "bureaucratic capitalism". According to his theory, mid and small sized private enterprises did not have the ability to use resources efficiently.¹⁵ By contrast, a centrally planned economy and State-ownership could enhance economic efficiency by pooling available resources together.¹⁶ Article 6 of the *1950 Interim Regulation Concerning Private Enterprises*, says that

for the purpose of overcoming economic anarchy, adjusting the relationship between production and marketing, and developing toward a planned economy, if necessary, the government may make production and marketing plans in relation to certain important products, which should be complied with by both state-owned and private enterprises.¹⁷

This provision could be regarded as the starting point for transforming private enterprises into State-owned or collectively-owned enterprises. Following this, in 1956, a more fundamental movement was initiated by the government to nationalise all sorts of private enterprises. From 1949 to 1956, the government nationalised nearly 2800 private firms and 2400 financial institutes. In the same period, it also established 156 super-size State-owned enterprises (SOEs)¹⁸. State ownership was assumed to be the only safe mode by which to stabilise the socialist dictatorship.

¹⁵ J.N. Li, 'Mao Zedong Fangqi Xin Minzhu Shehui De Zhuyao Yuanyin' [The Fundamental Reasons for Mao Zedong to Abolish the New Democracy Socialism in China], (2005) 07 Beijing Dianzi Keji Daxue Xuebao [Journal of Beijing Electronic Science and Technology Institute] 62, 70 also see Z.D. Mao, *Mao Zedong Xuanji* [An Anthology of His Writings] (Renmin Chubanshe 1977 Diwujuan) [People's Publisher 1977 volume 5] 177

¹⁶ According to Marxism, the highly concentrated state-ownership and highly socialized production will ultimately replace capitalist system in which the development of productivity force will be damaged, see generally K. Marx, *Capital Volume One: A Critique of Political Economy* (Dover Publications, 2011)

¹⁷ Y.W. Wei, *Comparative Corporate Governance: A Chinese Perspective* (Kluwer Law International 2003) 92 and Guanyu Siyou Qiye de Rougan Guiding 1950 [1950 Interim Regulation Concerning Private Enterprises] article 3

¹⁸ C.Q. Ge, 'Zhongying Guanyu Gongyohua de Bijiao Yanjiu' [The Comparison of Nationalization in China and the UK] (1998) 3 Nankai Jingji Pinglun [NanKai University Economic Studies] 72

In respect of these newly developed SOEs, the government adopted a method of uniform ownership, but hierarchical control. Under such a regime, most super-size SOEs were directly controlled by central government. All medium and small size SOEs were owned by the central government on behalf of Chinese people as a whole, but controlled by local governments.¹⁹ In addition, the appointments and dismissals of corporate managers were also controlled by the government.²⁰ In order to protect the rights of the labour force and prove the superiority of socialism, market competition was rejected. Everyone received almost the same salary regardless of productivity. Managers of SOEs were not assessed on the basis of the SOEs' market performance, but by their ability to satisfy the plan set by government agencies.²¹ They would keep their jobs, even if they did not adequately fulfil their duties. This is the so-called "iron rice bowl". During this period, the government did not develop SOEs by building economic institutions or legislative frameworks. The stability of politics was the main target of economic structural reform. According to this policy, the corporate governance model was based on a strict socialist administrative decree rather than law and regulations.²² In short, from 1957 to 1965, China's SOE underwent dramatic upheavals, promoted by a number of movements.²³ During the subsequent "Ten Year Cultural Revolution" (from 1968-1978), the development of SOEs stagnated.

Nonetheless, after 1978, the Chinese government officially replaced the "planned economy" with the "socialist market economy". Indeed, there was a series of vigorous reforms of SOEs in 1980s. The government's *Decisions on Economic Structural*

¹⁹ Y.W. Wei (n 17) 95

²⁰ C. Shipani & J.H. Liu, 'Corporate Governance in China Then and Now' (2002) 2002 Columbia Business Law Review 1, 5

²¹ *ibid* 8, Y.H. Wei (n 17) 94, and also see

Y.H. Wei, 'Corporation and Privatization: A Chinese Perspective' (2001-2002) 22 Northwestern Journal of International Law & Business 219, 222

²² J. Farrar, 'Developing Corporate Governance in Greater China' (2002) 25 (2) University of New South Wales Law Journal 466, and also see J. H Farrar, 'Developing Appreciate Corporate Governance in China' (2001) 22 Company Lawyer 92

²³ C. Xi, 'Transforming Chinese Enterprise: Ideology, Efficiency and Instrumentalism in the Process of Reform' In J. Gillespie & P. Nicholson [eds.], *Asian Socialism A Legal Change* (Australian National University Press 2005) 91,93

Reform issued in 1984 formally declared that the "ownership and management in the SOEs should be appropriately separated". Additionally, a "contract responsibility system" was employed to tackle inefficiency problems within enterprises. Under this system, the manager of an enterprise signed a contract with the supervisory authorities to guarantee that the enterprise under his or her management would achieve a certain productivity target. However, it seems that these reforms, which remained superficial, failed to provide meaningful autonomy or incentives for enterprise efficiency.²⁴

A more fundamental shift from an ideology-orientation to an efficiency-orientation in reforming SOEs was initiated in the 1990s. In 1992, Mr Deng Xiaoping, then leader of the Party, declared that some "capitalist methods" can be used to build socialism.²⁵ This declaration paved the way for deeper reform of SOEs from an ideological perspective. According to this declaration, in order to build a "modern enterprise system", mid to large sized SOEs were gradually incorporated. Some practical methods were implemented to support this reform. For example, the first company code of the PRC, the Company Law 1993,²⁶ was enacted in this context. The key development manifested in the Company Law 1993 was its categorisation of enterprise in accordance with its liabilities rather than its identity. Before 1993 Company Law, companies were categorised in accordance with the attributes of its owner. For example, the state-owned company and foreign-investor owned company were governed by different laws.²⁷ By contrast, the 1993 company law has universal application to all companies incorporated under it.²⁸ Generally, companies were enabled to have an independent property right of a legal person. Modern corporate organs, including the shareholder meeting, the board of directors

²⁴ *ibid* 94

²⁵ See Decisions of the CPC Central Committee on Some issues Concerning the Establishment of a Socialist Market Economy System, adopted by the Third Plenary Session of the CPC Fourteenth National Congress on 14th November 1993, see C. Xi (n 23) 108

²⁶ The Company Law of People's Republic of China 1993, *Zhonghua Renmin Gongheguo Gongsifa* 1993, adopted by Fifth Session of the Standing Committee of the Eighth National People's Congress, 29th December 1993

²⁷ See 4.2.2.2.1 below at 129

²⁸ See C. Xi (n 23) 100 also see M. Nikkel, 'Chinese Characteristics in Corporate Clothing: Questions of Fiduciary Duty in China's Company Law' (1995) 80 *Minnesota Law Review* 524

and the board of supervisors were all introduced into China's corporate governance regime in accordance with this law. In addition to introducing a modern corporate structure, the government persuaded managers of SOEs to abandon out of date managerial methods and learn modern scientific methods of management.²⁹ The incorporation of SOEs, coupled with the introduction of an appropriate separation between ownership and management delivered a strong signal that the government had taken a substantial step to shift its role from setting out direct productivity plans for SOEs to providing them with indirect planning by authorizing a higher-level of autonomy to managers. In addition to this legislation, the Shenzhen and Shanghai stock markets were established in 1990. Although private companies could be authorised by the market regulator to list in the markets, the major function of the stock markets was to raise funds for SOEs and to facilitate their structural reform.³⁰ From this historical introduction, it seems that the most significant achievement of SOE reform in the post-planned economic period is the government's move to loosen the grip of state ownership over management.

However, the fundamentals of the economic infrastructure remained unaltered. As the *Constitution* states, "the basis of the economic system is socialist public ownership of the means of production".³¹ In order to retain the dominant position of State-ownership, the shares of Chinese listed corporations were divided into three tiers; namely, State shares, legal person shares and "A shares".³² Before the shareholding unification reform, State shares and legal person shares were not transferable to the general public.

It is not surprising that this "modern" corporate structure, which is transplanted from neo-classical economic systems, comes into conflict with the socialist orthodoxy

²⁹ Y.H. Wei (n 17) 110

³⁰ I. MacNeil (n 12) 339

³¹ Amendment 4 to the Constitution of the People's Republic of China (2004): Zhonghua Renmin Gongheguo Xianfa Xiuzhengan 2004 article 7 amended by 2nd Meeting of the Standing committee of tenth National People's Congress on 14th March, 2004 (hereinafter Constitution).

³² For details of the three tiers of shares see 4.1.2.2.1 below at 76

underpinned by State ownership. The mismatch between the form (management structure) of the enterprise and its substance (ownership structure) causes several complicated problems, including issues surrounding the "absent owner", "insider control" and the problem of majority shareholder tunnelling. In addition to that, the intrinsic socialist suspicion of the power of law led to a long-term legal nihilism in the planned-economy period. Indeed, a strong administrative regulatory approach negatively affected the independence and efficiency of the judicial system. The following sections will unpack these issues in further detail.

2.3.2 Mapping the Major Problems of China's Corporate Governance Regime

2.3.2. 1. Vertical Agency Cost: "Owner Absence" and "Insider Control"

On the Chinese stock markets, listed companies can be divided into two groups in terms of their identity. One group is State-owned listed companies. The other is private listed companies which have no State background. This part focuses on the former group. In 2009, there were 1600 listed companies on China's stock markets. Nearly 900 of these are controlled by the State. These companies occupy nearly 85 per cent of the total share value of all listed companies.³³ Listed SOEs are still the major forces on the Chinese stock markets and their problems are therefore important and representative.

As previously mentioned the government deems the separation of ownership and management to be a solution to problems rather than seeing them as an origin of uncontrolled problems. As Xi points out,

³³ 'Guo Zi Wei Dui Shangshi Gongsi Zuo de Buchong Guiding' [A Survey on Listed Companies by State-Owned Assets Supervision and Administration Commission of the State Council] at <<http://www.chinasoe.com.cn/gqxc/2009-11-27/404535.shtml>> accessed 20th July 2011

By corporatizing SOEs, the Chinese leadership intended to separate government administration from enterprise management, release the state from its unlimited responsibility for SOEs, raise funds to diversify SOE risks, and, consequently, improve enterprise efficiency.³⁴

Indeed, separating State-ownership from management is an important step, which enables SOEs to plan their productivity in accordance with market demand rather than a State mandate. Through the separation of ownership and management, bureaucratic interference from the State, experienced under the old system, was replaced by the share-voting power. This change worked to limit the State's power within a certain scope by making it subject to a series of rules of company law. Furthermore, this separation also creates a common ground for cooperation between State-shareholder and private shareholders, as both pursue the same interests; namely, distributable profits.³⁵ The system also enables managers with high levels of expertise and motivated by well-designed incentive schemes, to boost enterprise efficiency in a fully regulated market. However, it is easy for policy-makers to forget that the modern corporate structure cannot bring these benefits on its own. It needs the appropriate institutional support. Such structures trigger serious problems, when forced to manage concentrated State-ownership. Equally they cannot be efficient without an effective legal regime and market regulations. The following part will discuss the types of problem that the "modern" corporate structure causes in the Chinese context.

The separation between ownership and management of companies triggers conflict of interest problems. In economic terms, this is usually called the "agency-problem" or the "principal-agent problem". Some scholars argue that one of the major functions of company law is to regulate the "agency-problem."³⁶ When corporate governance is narrowly defined two agency problems typically arise. The

³⁴ C. Xi (n 23) 95

³⁵ D. Clarke, (n 8) 499

³⁶ R. Kraakman, J. Armour, P. Davies, L. Enriques, H. B. Hansmann, G. Hertig, K. J. Hopt, H. Kanda and E.B. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 35

first is the "vertical agency problem" between corporate owners and managers. This problem arises where a manager, whilst being an agent, nevertheless pursues his or her own interest at the expense of the principal's interests. The second agency problem is the "horizontal agency problem". This is between majority and minority shareholders. Here, majority shareholders may improperly use their overwhelming voting power to depress minority shareholders' interests by squeezing them out without fair compensation or tunnelling the company's assets to a special purpose entity.³⁷ Fortunately, although these two types of agency issues can coexist, they are usually mutually exclusive. Some studies indicate that the "agency cost" (i.e. the agency problem) between shareholders and executives is not a key issue in jurisdictions dominated by concentrated ownership³⁸. Majority shareholders hold the residual right to claim corporate property and the voting right to control the fundamental business decisions of the corporation. Therefore, they have both the incentive and ability to supervise the directors' performance.³⁹ By contrast, in jurisdictions with dispersed ownership not much focus may be placed on the agency cost between majority shareholder and minority shareholder, as fewer powerful block-holders exist in this type of market.⁴⁰

³⁷ *ibid* 307-309 also see M. Roe, 'The Institutions of Corporate Governance', In C. Menard & M. Shirley (eds.), *Handbook for New Institutional Economics* (Kluwer Academic Publishers, 2004) 95

³⁸ There is taxonomy between US and UK's widely-held shareholder system and European continental controlling shareholder system in the comparative corporate governance debate. In European continental jurisdictions, e.g. Germany, the ownership structure in most of public companies is concentrated. Therefore, the vertical agency cost is not a major problem in this jurisdiction. By contrast, in the UK and US where the ownership structure in most public companies is dispersed, the horizontal agency problem is hardly to be the major issue in these jurisdictions. See B. Cheffins, 'Minority Shareholder and Corporate Governance' (2000) 21(2) *Company Lawyer* 41 and also see B. Cheffins, 'Current Trends in Corporate Governance: Going from London to Milan via Toronto', (1999) 10 *Duke Journal of Comparative and International Law* 5, for a critical view toward the taxonomy between widely-held system and controlling shareholder system, see R. Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2005-2006) 119 *Harvard Law Review* 1641

³⁹ See R. La Porta, F. Lopez-De-Silanes A. Shleifer & R. Vishny 'Corporate Ownership around the World' (1999) 54 *Journal of Finance* 475, M. Aoki, 'Controlling Insider Control: Issues of Corporate Governance in Transition Economies' In Masabiko Aoki & Hyung-Ki Kim (eds.), *Corporate Governance in Transition economy, Insider Control and the Role of Bank* (EDI Development Studies 1996) 5, and Y.H. Wei (n 17) 24

⁴⁰ *ibid*

Nonetheless, the mismatch between the form and substance of China's SOE breaks this equilibrium in China. Although ownership in most Chinese companies is concentrated, both types of agency problem are equally serious. In the course of Chinese economic reform and in seeking the autonomous management of SOEs, the government tends to delegate independent decision-making power to the executives of SOEs.⁴¹ However, it has not developed an efficient system to supervise the conduct of those SOE managers.⁴² The control of SOEs is hierarchical in China. It can be divided into several tiers. These include the central governmental leadership, local State organs and central ministries who all supervise the State-owned parent companies. In accordance with Article 6 of the *Chinese Constitution*⁴³ and Article 12 of the *Interim Measures for the Supervision and Administration of State-Owned Assets of Enterprises*, central and local government must establish governmental agencies to control and supervise State-owned corporations on behalf of the Chinese people as a whole. Consequently, the State-owned Asset Supervision and Administration Commission (SASAC) was established in 2003. Its main function is to control and govern 152 centrally-controlled SOEs. It is entitled to appoint and dismiss directors and executives, assess directors' performance, assign supervisors to sit on supervisory boards in the super-size SOEs, and guide and facilitate the reform and restructure of SOEs. By contrast, listed SOEs are usually supervised and controlled by their parent companies rather than State agencies. In order to form a listed company, a promoter, usually a large SOE has to contribute its essential operating assets (factories, workshops, or production lines) to the listed company. A listed company is a legally separate enterprise from its State-owned parent company, though; in reality it usually

⁴¹ According to the Article 7 &10 of Interim Measures for the Supervision and Administration of State-Owned Assets of the Enterprises, the business decision should be independent from the administrative influence and clear separation between ownership and control should be established. It means in principle the governmental agencies will adopt a "hand-off" approach on the daily business of the state-owned corporations, and all state-owned corporations should make the "management decision by their own and take full responsibility for their profits and losses". e.g. C. Shipani & J.H. Liu (n 20) 28

⁴² D.L. Xu, G.J. Zhao & G.H. Li 'Guoyou Gongsi Zhili Moshi De Yanjiu' [The Study on the Corporate Governance Mode for State-owned enterprise] 2007 (4) Jingji Pinglun [The Study of Economy] 93 also see J.Z. Yang 'Comparative Corporate Governance: Reforming Chinese Corporate Governance' (2005) 16 International Company and Commercial Law Review 8

⁴³ Constitution of the People's Republic of China 2004

maintains a strong relationship with its parent company. Consequently, it is common for directors or managers in the listed company to also hold positions in the parent company.⁴⁴

The main reason behind the weak supervision of SOEs is the "absent owner problem". The State can only realise its shareholder's power through governmental agencies. These government agencies are ultimately organised by individuals. Nonetheless, the officials appointed to supervise the management of an SOE, unlike shareholders, do not enjoy residual rights or other interests directly linked to the performance of a SOE.⁴⁵ Moreover, they neither bear any economic risk of a corporate collapse nor benefit from the profits made by the SOE. They therefore lack strong incentives to supervise director and executive performance.⁴⁶ Additionally, even where officials are loyal to the State's interests, they are still in a difficult position. Such officials are generally appointed by local government, whilst serving the central government-owned enterprise. However, local government interests can occasionally conflict with those of the central government. Indeed, SOEs are usually major tax-contributors for local government revenue. For the sake of regional protectionism, the local government may require officials to loosen their supervision on SOEs.⁴⁷

State-owned parent companies encounter similar incentive problems. As majority shareholder, the parent company has a residual claim to the profits made by a listed company. However, State-owned parent companies, like State-agencies, are organised by individuals. The persons who are appointed to check and supervise listed SOEs do not have property rights in those companies. Rather, they are simply government

⁴⁴ J.Q. Liu, 'Corporate Governance in China: From the Protection of Minority Shareholders Perspective', (2006) 2 Corporate Governance Law Review 311, 316

⁴⁵ For this point see D. Clarke (n 8) 500

⁴⁶ Y.H. Wei (n 17) 24 and D. Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 Delaware Journal of Corporate Law 125, 147

⁴⁷ C. Xi, 'Case Note: Private Enforcement of Securities Law in China: Daqing Lianyi co v ZHONG Weida and Others Hei Longjiang High Court' (2006) 1:2 Journal of Comparative Law 492, 496 and also 4.2.2. 1 below Zijing Mining case at 116

officials who earn a salary based on the governmental hierarchy, that is, around three times that of an unskilled worker.⁴⁸ Wary of social unrest, the State does not want to pay SOE managers and also the supervisory officials in a manner that would make them too far detached from lower level workers.⁴⁹ Arguably, promoting a listed SOE's market performance could be beneficial to an officials' political fortune. However, even this incentive is suspicious. As mentioned above, a listed SOE that takes over its essential assets from its parent company is usually equipped with the best production line and the best trained employees. More importantly, the parent company has to bear all sorts of burdens (e.g. debts, redundant personnel etc.) that occurred before its separation from a listed subsidiary. These advantages guarantee listed SOE's strong productivity. Additionally, a massive number of preference policies are granted to listed SOEs by central and local government. Some large SOEs are even allowed to monopolise markets like telecommunications, oil and airlines. Finally, companies with State-backgrounds are much more successful in applying for loans from banks, compared to private companies.⁵⁰ Consequently, a listed SOE's market performance is easily maintained at a high level, even without close supervision. In other words, even if the managers make substantial profits through related party transactions or lack due diligence in their daily management, these negative effects may be not strong enough to ruin the overall performance of the listed SOE. In such conditions, there is little reason for the officials in the parent company to contribute significantly to secure a result that they can otherwise gain with little effort.

⁴⁸ L.H. Tang & J.Y. Wang 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy' (2007) 7 Journal of Corporate Law Studies 143, 179

⁴⁹ O. Rui, M. Firth & P. Fung, 'Corporate Governance and CEO Compensation in China' (September 2002). Available at SSRN: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=337841> 8 accessed 20th July 2011

⁵⁰ Y. Kang, L. Shi, E. Brown, 'Chinese Corporate Governance: History and Institutional Framework' Report in Centre of Corporate Ethics and Governance (Rand Corporation 2008) 1, 32 The authors argue that 'China's immature capital market is characterized by the Chinese bands' preferential treatment of state-owned enterprise.'

Gugler's research⁵¹ on the relationship between corporate governance and a company's economic performance, highlights that compared to other models,⁵² dispersed voting power under a concentrated ownership structure is the most disadvantageous. Gugler points out that this corporate structure shapes a pattern of "Strong Managers and Weak Owner", which provides little means for shareholder intervention. China's situation falls into the worst model in Gugler's study. This is because the absence of the ultimate owner (weak owner) directly leads to the insider control (strong management), which results in the situation where a firm falls under the *de facto* or *de jure* control of insiders without any external checks and balances.⁵³

In recent years, many cases have revealed that "owner absence" leads to ethically questionable activities amongst executives in listed SOEs. The China Aviation Oil Singapore (CAOS) scandal is a typical example. CAOS is a listed SOE in Singapore whose chief executive officer, Chen Jiulin, carried out speculative oil derivative trading from 2003, eventually causing the company to lose US\$550 million. From a legal perspective, speculative oil derivative trading is strictly prohibited by relevant regulations.⁵⁴ At an institutional level, CAOS had appointed Ernst & Young as consultants to draft Risk Management and Financial Management Manuals for its guidance. In practice, high-end risk management software, namely *Kiodex Risk Workbench*, was used by CAOS to assist in business decision-making.⁵⁵ In accordance with the risk management regime of CAOS, any transaction, causing a loss exceeding US\$200,000 should be appraised by the risk-management committee. Unfortunately, however, this rule was not obeyed by insiders. Indeed, even after Chen Jiulin had been engaging in oil derivative trading for nearly a year, by which time the

⁵¹ K. Gugler, *Corporate Governance and Economic Performance* (Oxford University Press 2001) 4

⁵² The other modes are 1. Dispersed Voting Power under Dispersed Ownership
2. Concentrated voting power under Dispersed Ownership 3. Concentrated Voting Power under Concentrated Ownership, *ibid* 4

⁵³ K. Lee & D. Hahn 'From Insider Control Collusion to Insider Control in China's SOEs' (2004) 40 (2) *Issues and Studies* 1, 3

⁵⁴ See Qihuo Guanli Zhanxing Ban Fa [Interim Measures for the Control of Futures] Article 4

⁵⁵ Q. Shao, 'Toushi Zhonghangyou Shijian: Chuanquan Buqing Daozhi Neiwei Fengxian Jiankong Quanshi' [The Scandal of CAOS: Absence of Supervision] available at <<http://gov.finance.sina.com.cn/zsy/z/2005-03-09/55247.html>> accessed 20th July 2011

company had suffered loss of 380 million USD, the risk management committee was not aware of the illegal business activity and substantial losses. As Mallin concluded, "the Chinese SOEs even including those operating abroad, CEO may be all-powerful and able to take decisions that are not in the best interests of the company and its shareholders and limited disclosure may exacerbate the situation."⁵⁶

It might be argued that the issue of "insider control" is exaggerated by this extreme case. However, similar cases are readily found.⁵⁷ Statistical research supports that the issue of "insider control" is widespread in China's public companies. A survey by the National Bureau of Statistics found that from 2002 to 2005, nearly 100 billion RMB had been misappropriated or misused for illegal purposes in 1290 SOEs. Approximately 70 per cent of these companies were suspected of being involved in forging financial reports.⁵⁸ In light of this, it can be concluded that although ownership is concentrated in most Chinese listed SOEs, the issue of vertical agency is severe amongst such companies as a result of "owner absence". Consequently, as State ownership of most Chinese listed companies is unlikely to be substituted for privatization in the short term, enhancing shareholder protection against executives by introducing a series of workable legal rules seem to be essential.

2.3.2.2. Horizontal Agency Cost between Majority and Minority

Another major concern regarding corporate governance in China is the fact that the board of directors is controlled by a dominant shareholder, who may take advantage of this control to undermine minority shareholders' interests by self-dealing

⁵⁶ C. Mallin, *Corporate Governance* (2nd edn, Oxford University Press 2006) 5

⁵⁷ For example, the scandal of China National Cotton Reserve Corporation (CNCRC) is a similar case. In this case, the CNCRC participated the cotton speculative trading. Finally it suffered a loss nearly 100 million USD. The relevant report also indicates that, the proposal of cotton speculative trading did not undergo a formal decision-making process before it was initialed. It was only decided by a few executives in CNCRC. See a series of detailed reports about this scandal, available at <<http://finance.news.tom.com/1327/2005114-145131.html>> accessed 20th July 2011

⁵⁸ Q. Shao (n 55)

or manipulating the share price.⁵⁹ Indeed, there has long been a serious issue with controlling shareholders engaging in "tunnelling activities". A number of cases in China have shown that the manipulation of a few insiders can trigger thousands of individual investors to suffer a loss of their investments. Reported cases show that shareholder "tunnelling activities" can be divided into three major types. Firstly, block-holders⁶⁰ can force listed companies to provide them with corporate loans or guarantees.⁶¹ Secondly, block-holders can exploit a listed company's assets through insider-trading.⁶² Thirdly, block-holders can appropriate a listed company's assets directly.⁶³ According to a study of 173 listed companies in China, samples in which block-holders had illegally appropriated company assets constituted 37 per cent of all samples. Most appropriations were engaged in through the above activities.⁶⁴

For listed SOEs, their interdependence with their controlling shareholders gives rise to "stealing" activities on wide range of fronts. Officials who control the parent SOE may move the listed SOE's assets to the specify propose entity owned by his or her related party (e.g. friends or relatives). However, more commonly cases relating to "tunnelling activities" do not involve appropriating a listed company's asset for

⁵⁹ D. Clarke (n 46) 148

⁶⁰ Block-holder means controlling shareholder with overwhelming controlling power on a company

⁶¹ See Shanghai Zhengquan Jiaoyi Suo [Shanghai Stock Exchange], 'Guanyu Dui Shanghai Lengguang Shiye Gufen Youxian Gongsi Gongkai Qianze de Gonggao' [Notice on Public Criticism on Shanghai Lengguang Shiye plc] (11th 6 1999); available at <<http://static.sse.com.cn/sseportal/ps/zhs/>> accessed 20th July 2011 Shenzhen Zhengquan Jiaoyi Suo [Shenzhen Stock Exchange], 'Guanyu dui Beijing Zhongguancun Keji Fazhan (Konggu) Gufen Youxian Gongsi Yuyi Gongkai Qianze de Gonggao' [Notice on Public Criticism on Beijing Zhongguancun Keji Fazhan plc] (28th 9 2001) available at: <<http://www.szse.cn/>> accessed 20th July 2011 also see G.H. Jiang, C.M. Lee & H. Yue, 'Tunneling in China: The Surprisingly Pervasive Use of Corporate Loan to Extract Funds from Chinese Listed Companies' Johnson School Research Paper Series 31-06 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=861445> accessed 20th July 2011

⁶² See Shanghai Zhengquan Jiaoyi Suo, [Shanghai Stock Exchange] 'Guanyu Dui Hubei Xingfu Shiye Gufen Youxian Gongsi Gongkai Qianze de Gonggao' [Notice on Public Criticism on Hubei Xingfu Shiye plc] (23rd 2 2001) available at <<http://static.sse.com.cn/sseportal/ps/zhs/>> accessed 20th July 2011

⁶³ Zhongguo Zhengjianhui [CSRC] 'Guanyu dui Hubei Meiyerya Gufen Youxian Gongsi Ji Yougian Renyuan Yuyi Gongkai Piping de Gonggao' [Notice on Public Criticism on Hubei Meiyerya Gufen Youxian plc] (12th 9 2001) available at <<http://www.csrc.gov.cn/pub>> accessed 20th July 2011 Zhongguo Zhengjianhui [CSRC] 'Guanyu dui Ningxia He Minzu Huagong Gufen Youxian Gongsi Ji Yougian Renyuan Yuyi Gongkai Piping de Gonggao' [Notice on Public Criticism on Ningxia He Minzu Huagong plc] (31st 10 2001) <<http://www.csrc.gov.cn/pub>> accessed 20th July 2011

⁶⁴ H. Zhang & Z.D. Wu, 'Woguo Shangshi Gongsi Zijin Zhanyong de Xianzhuang Ji Tezheng Yanjiu' [The Characteristics of Appropriation of Public Companies' assets in China] (2003) 5 Shangshi Gongsi [Journal of Public Companies] 17, 24

personal benefit. As already highlighted, parent SOEs contribute their best-equipped facilities to subsidiaries in order to list them. However, maximizing profits is not the only demand made of an SOE by the government. The government usually expects SOEs bring multiple benefits—for example stabilizing society by providing full employment, or providing strategic control of a particular industry where this cannot be achieved through regulation.⁶⁵ A parent SOE cannot fulfil all these tasks by itself. It may therefore sometimes need to strengthen other entities of the group by distributing the profits of its listed subsidiary between these entities. As some scholars point out, "many SOEs are debt-ridden enterprises 'repackaged' for listing and continue to be controlled by their parent companies who, having successfully seen to their IPO, look towards them as cash cows for ready milking."⁶⁶

For private listed companies, the horizontal agency problem is less complicated. Some leading Chinese entrepreneurs have been shown to have a strong interest in expanding their business empire by owning several listed companies and a number of other business entities. However, such a super-size business network does not always bring benefits and can, in fact, sometimes be a troublesome burden. According to statistics, within the last three years, the market regulator investigated nearly 40 corporate groups, relating to more than 200 listed companies. Most cases investigated involved illegal loans between members of a corporate group or undisclosed related party-transactions.⁶⁷ The main reason for these corporate scandals is that corporate groups are overloaded with a large number of business entities. Some corporate group owners have overestimated their capacity and recklessly become involved in several different business sectors. Business failure in one sector may easily trigger pressure from lenders or local government, which has granted preference policy (e.g. a licence which authorises a corporate group to use a certain kind of natural resource during a certain period). Related party transactions, illegal guarantees and other types of

⁶⁵ D. Clarke (n 46) 150

⁶⁶ L.H. Tang & J.Y. Wang (n 48) 151

⁶⁷ R. Cai, 'You Shangshi Gongsi Zaoxi Yundong Yinfa De Sikao' [Some Thoughts Concerning Listed Company's Profit Making System] (2005) 2 Shenyang Nongye Daxue Xuebao [Journal of Shenyang Agricultural University] 98, 105

financial manipulations are effective ways to conceal temporarily the effects of business failure, though they do not help to overcome such failure permanently. In fact, such manipulations usually worsen the problems and causes huge losses to most members of the group. This phenomenon seriously threatens minority shareholder interests and even their confidence in the stock markets.

Having provided a brief history of corporate governance issues, the above sections have clarified the major problems of China's corporate governance regime; namely, the vertical agency problem and horizontal agency problem. Both problems are severe and widespread. These problems are not only the result of ideological influence or concentrated ownership structures, but also because agency cost control strategies are poorly designed. The following part will analyse the relationship between these major problems and the law.

2.4. Weak Agency Cost Control Strategies

2.4.1 Administrative Regulation

Administrative authorities and regulations play an important role in regulating China's public companies. Notably, even until 1988, no formal legislation had been enacted to govern SOEs. The functions of the formal legislation, for example, protection of creditors and accountability of managers, were managed through the State administrative procedure.⁶⁸ This culture of strong administrative regulation has been inherited by the current regulatory regime.

Unlike the UK's Financial Services Authority,⁶⁹ which is a QUANGO, the China Securities Regulatory Commission (CSRC) is a wholly government controlled

⁶⁸ Clarke (n 8) 496

⁶⁹ In June 2010, the UK Coalition Government announced proposals to abolish the FSA and reform the UK financial services regulatory regime. The Treasury has now published a formal consultation paper with further details of the proposed new regulatory structure, due to be in place by 2012, see Herbert Smith, Corporate E-bulletin issue. No. 2010/24

administrative authority. In accordance with the *Securities Law 2005*,⁷⁰ the CSRC's powers are divided into three parts: (1) formulating regulation; (2) investigation and supervision; and (3) legal enforcement.⁷¹ Its powers range from proactive to reactive and it plays an important role in promoting compliance with regulations in the stock markets. Firstly, the CSRC contributes considerably to increasing legal certainty surrounding the corporate governance regime. It does so by enacting quasi-legislations, including regulations and guidelines,⁷² to implement the principles of the *Company Law 2005* and *Securities Law 2005*. In general, these regulations and guidelines are legally binding and all listed companies must comply with them. Secondly, the CSRC actively performs its supervisory and legal enforcement powers. From a proactive perspective, the CSRC is entitled to verify the Articles of Association for companies seeking to gain listed position in mainland China.⁷³ The CSRC has responsibility for ensuring that all the companies gaining access to the stock markets, meet the required corporate governance standards. From a reactive perspective, the CSRC has investigated more than 1000 illegal activities engaged in by market participants within the last ten years.⁷⁴ It has issued sanctions against 581 companies and approximately 1200 individuals.⁷⁵ Between 1999 and 2003, the CSRC investigated misconduct amongst 12 per cent of all listed companies and brought

⁷⁰ China first passed a Securities Law in 1998. See Zhonghua Renmin Gongheguo Zhengquan Fa [Securities Law of the People's Republic of China], adopted by Ninth Session of the Standing Committee of the Sixth National People's Congress, December 29th, 1998, effective July 1st, 1999 (hereinafter Securities Law 1999). The Securities Law of People's Public of China 2005, Zhonghua Renmin Gongheguo Zhengquanfa 2005 by 18th Meeting of the Standing committee of tenth National People's Congress 27 October, 2005 effective 1st January 2006 (hereinafter Securities Law 2005).

⁷¹ Securities Law 2005 Article 179

⁷² Zhongguo Shangshi Gongsi Zhili Zhunze 2002 [Corporate Governance Guideline 2002] issued by the CSRC on 7th January 2002, Guanyu Jiaqiang Shehui Gongzhong Gudong Quanyi Baohu De Rougan Guiding [Minority Shareholder Protection Provisions 2004] issued by the CSRC on 8th December 2004, Guanyu Shangshi Gongsi Jianli Duli Dongshi Zhidu De Zhidao Yijian [Independent Director Guideline 2001] issued by the CSRC on 16th August 2001, Shangshi Gongsi Zhangcheng Zhiyin 2006 [Guidelines on Article of Association for Listed Companies 2006] issued by the CSRC on 16th March 2006

⁷³ Securities Law 2005 Article 12

⁷⁴ 'Zhengjian Hui Zhifa Xiaolv Tigao' [Promoting of CSRC's Enforcing Efficiency] 12th Feb 2007, Fazhi Ribao [Daily Law] electronic version available at <http://www.china.com.cn/zhuanti2005/txt/2007-02/12/content_7793281.htm> accessed 20th July 2011

⁷⁵ *ibid*

enforcement action against those companies⁷⁶. Its enforcement seems to work well in most cases. Clarke points out that the sanction of a CSRC's reprimand or filing rejection remains powerful, as the executives of most listed companies are government bureaucrats, who are sensitive to anything that might blot their record or affect their chances of promotion.⁷⁷ Moreover, the CSRC's investigation and enforcement procedures can also give rise to a criminal liability.⁷⁸

Nonetheless, the above figures may not precisely reflect the position on the ground. According to Pistor's survey, CSRC's sanctions are often benign. In 2003, only 22 per cent of all enforcement actions resulted in fines.⁷⁹ Some reported cases also reveal that CSRC's sanctions exist merely on paper, which means they have not been enforced. For example, in the case of Yi An Technology, the CSRC issued a fine of 880 million RMB against the wrongdoers. However, because of the CSRC's slow reaction to the misconduct, the moment for proper investigation and enforcement was missed and the wrongdoers could not be located.⁸⁰

Some research shows that regulatory compliance among market participants is often prompted under the CSRC's administrative supervision. However, corporate governance practice in listed companies is not substantially improved by complying with CSRC's regulations. Instead of implementing CSRC standards into practice, market participants passively accept these standards and then try to achieve them at

⁷⁶ C.X. Shi 'Protecting Investors of China Through Multiple Regulatory Mechanism and Effective Enforcement' (2007) 24 (2) Arizona Journal of International & Comparative Law 451, 485

⁷⁷ D. Clarke (n 46) 198

⁷⁸ In practice, CSRC will deliver the relevant materials which could be the evidences of criminal offence to the public security, e.g. see Report of Gu ChuJun and KE LONG's case, available at <<http://stock.jrj.com.cn/news/2006-07-16/000001551926.html>> accessed 20th July 2011

⁷⁹ C.G. Xu & K. Pistor, 'Governing Stock Markets in Transition Economies: Lessons from China' (2005) 7 (1) American Law and Economics Review 184

⁸⁰ A case report available at <<http://www.southcn.com/finance/zhengquan/tb/200203260140.htm>> accessed 20th July 2011

minimum cost.⁸¹ For example, according to CSRC regulations, all listed companies must have independent directors on their board. However, many surveys indicate that most independent directors play a far more passive role than the CSRC expects. For example, Li's recent research points out that more than 90 per cent of independent directors assess corporate performance on the basis of the materials circulated by listed corporations voluntarily. Only a small percentage communicates with the company's customers, suppliers, employees and other executives on a regular basis. Moreover, Li's research reveals that a striking 75 per cent of independent directors never use or prepare to use their power to recommend that the board hold extraordinary general meetings or appoint independent auditing firms to investigate the financial situation of the company. Nearly 90 per cent of them acknowledge that they will never recommend the board to dismiss an auditing firm already appointed by the corporation.⁸² Therefore, implementing CSRC's corporate governance standards is merely a window-dressing exercise for most listed companies. The effectiveness of the CSRC's administrative enforcement has also been brought into question because of resource constraints. The number of listed companies in China is increasing dramatically and the CSRC with a relatively small group of staff may not have adequate human resource to supervise the conduct of all the listed companies regularly.⁸³

⁸¹ 'Dui Zhongguo Gongsi Zhili De Pingjia' [Assessing Chinese Corporate Governance, An interview of Li Weian] 11th, May 2007, Tian Jing Daily, Li is a Professor of NanKai University (China), and also the director of Corporate Governance Research Center, NanKai University. This conclusion is based on an empirical research on 1249 Chinese listed companies. A detailed report is available at 8th May 2007 Zhongguo Zhengquan Zazhi [China Securities Journal]

⁸² L.M. Li, 'Zhongguo Shangshi Gongsi Duli Dongshi Zhidu Bianyuanhua Wenti Yanjiu' [Independent Director, Only a Decoration?] In B.S. Wang (eds.), *Zhuan Xing Shiqi Gongsi Fa De Xiandai Hua* [Modernizing Company Law in Transition Context] (China Social Science Press 2003) 131

⁸³ W. Hutchens 'Private Securities Litigation in China: Material Disclosure About China's Legal System' (2003) 24:3 University of Pennsylvania Journal of International Economic Law 638 The recent survey shows that nearly 2000 companies listed in Chinese stock markets. In contrast, CSRC has 1812 employees whose average age is 35, and more than 40 per cent of them hold a master degree or higher. Information available at <http://www.gov.cn/banshi/2006-11/28/content_455561.htm> accessed 20th July 2011

Finally, as S.G. Tu, the vice-president of the CSRC, recently said, the "Government will intervene in the development of stock markets, if necessary."⁸⁴ The CSRC is widely suspected to be a governmental body, which may facilitate State intervention. Its independence as a regulator is therefore always questionable.⁸⁵

2.4.2 Problems of the Legal Regime

Aside from administrative regulation, legislation is playing an increasingly important role in regulating public companies. However, legislation in China is usually incomplete, inconsistent, not-consecutive, lacks co-ordination, and is not sufficiently detailed or accurate.⁸⁶ Furthermore, the enforcement of legislation is also not efficient. This part will elaborate on the problems relating to the substance and enforcement of legislation in more detail.

2.4.2.1 Incompleteness of Law

According to Pistor, there are two types of incomplete law. Type I is the law that broadly circumscribes outcomes without identifying particular actions, or by specifying only a few actions. Type II is law that specifies the actions that must be prevented, but fails to enumerate all relevant prohibitions.⁸⁷ In most cases, the law in this field falls under type I in terms of its incompleteness. A large number of legal provisions in Chinese company law are drafted in an obscure fashion.⁸⁸ Nevertheless, China, as a civil law jurisdiction is not an appropriate jurisdiction for type I incompleteness as this type of incompleteness is a particular characteristic of common

⁸⁴ X. Cheng, 'Wuxian Tongqing Zhengjian Hui' [Embarrassed CSRC] 19th Oct. 2007, Dongfang Daily available at <<http://finance.sina.com.cn/g/20071019/00394076147.shtml>> accessed 20th July 2011

⁸⁵ See 4.2.2.1 below 117-118

⁸⁶ K.Y. Zou, 'Towards the Rule of Law: An Overview of China's Legal Reform', In G.W. Wang and J. Wong (eds.), *China: Two Decades of Reform and Change* (Singapore University Press, Singapore 1999) 62

⁸⁷ K. Pistor & C.G. Xu, 'Incomplete Law A Conceptual and Analytical Framework And its Application to the Evolution of Financial Market Regulation' (2003) 35(4) *Journal of International Law and Politics* 931, 942

⁸⁸ For details, see Chapter V below

law jurisdictions in which the court system holds a strong residual law making power.⁸⁹ Additionally, catch-all provisions generally require the enforcer to have strong ability to exercise discretion and deal with a matter as they see fit on case by case basis.⁹⁰ Inexperienced judges in transition economies are unlikely to fulfil this task. Thus, the nature of the Chinese legal system and the weak court system in China make it a jurisdiction for which the catch-all provisions in Chinese company law seem obviously misplaced.

It is important to explain why Chinese company law is drafted in this particular style. Firstly, it is a reflection of Chinese legislators' limited legislative skill. According to Liu's research, it is usual for the legal provisions of Chinese commercial law to be drafted in an open-ended manner. The reason is simply that legislators are inexperienced in that they are unable to foresee the effects of certain legal provisions in practice. Therefore, the open-ended standard is an optimal choice for the legislator, as it leaves greater room for China's Supreme Court to further interpret and revise these provisions on the basis of their practical implications.⁹¹ This approach, however, is unlikely to be efficient. It is difficult to collect feedbacks from practice, when a legal rule is too vague to be implemented in practice. In China, the lower courts usually decline to hear a litigant's case standing on vague legal provisions. Therefore, many rules live only on paper. Additionally, this approach potentially damages the consistency and stability of the legislation, as different individuals can interpret the law in different ways. Frequent revision of law not only causes confusion, but also damages its authority.

⁸⁹ K. Pistor & C.G. Xu (n 87) 120

⁹⁰ B. Cheffins, *Company Law Theory Structure and Operation* (Clarendon Press Oxford 2004) 282, for more information, see Chapter III 3.2 below

⁹¹ J.H. Liu, 'Gongsifa de Xiugai yu Jieshi: Yisifaquan de Shidu Ganyu Wei Zhongxin' [Reforming Company Law: A Centralism of Judiciary Intervention] (2005) 3 *Falv Shiyong* [Journal of Legal Application] 4. The China's Supreme Court is entitled with a power of making interpretations on laws in according to the practical need. See *Zhonghua Renmin Gonghe Guo Fayuan Zuzhi Fa 2006* article 33 [People's Republic of China Law of Organization of People's Court 2006]

Secondly, open-ended legal provisions are sometimes political instruments. Where a particular legal provision could result in sensitive consequences, such as opportunistic litigations, excessive free-rider problems, or even political instability, but the government needs to enact that provision to reduce pressure on it from the general public, this provision will be drafted with great caution. On the one hand, such a provision may be introduced in the company law to appease a particular interest group. On the other hand, it will be drafted as a principle without any further interpretation to reduce its enforceability. As some Western lawyers argue, "rather than existing to provide clear notice to private parties of legal rights and duties, PRC legal enactments exist to facilitate management of a complex society by an administrative state."⁹²

Additionally, laws are not always properly disclosed by the Supreme Court, which holds residual law-making power. An example is in cases of private enforcement against insider-trading and market manipulation, which were banned by the courts. Before the *Securities Law 2005* came into effect⁹³, some reports revealed the Supreme Court had lifted the ban on private enforcement on insider-trading and market manipulation.⁹⁴ Nevertheless, this decision was merely treated as an internal directive circulated in the court system and no formal interpretation was officially disclosed to the general public.

2.4.2.2 Problematic Legal Enforcement: The Example of Securities Litigation⁹⁵

⁹² W. Hutchens (n 83) 625

⁹³ Securities Law 2005 Article 76 & 77

⁹⁴ X.M. Xi, the Vice-Principal of the Chinese Supreme Court gave a conference speech in which he confirmed that the private securities litigation against insider-trading and market manipulation will be accepted by lower court. For details, see 'Zhengquan Minshi Peichang Quanmian Jiejin' [No Ban on Civil Securities Litigation], *Caijing* [Finance] Electronic version available at <<http://stock.jrj.com.cn/news/2007-09-03/000002626614.html>> accessed 20th July 2011

⁹⁵ In respect of company law litigation, there is no report case of the shareholder derivative action against director or executives on the basis of breach fiduciary duties in Chinese listed companies in China. Therefore, this part uses the security law cases to illustrate the problems.

Private securities litigation generally serves two functions. Firstly, it offers investors a means of recovering their losses. Secondly, it enhances incentives for market participant compliance with regulations.⁹⁶ In China, the first function is partially fulfilled by private securities litigation. However, such litigation plays a very limited role in incentivising regulation compliance.

Private securities litigation cases were not accepted by any level of the courts in China until 2002. An important case was the Hong Guang Industry scandal. In seeking to successfully obtain a listed position, Hong Guang Industry falsely reported its annual profit as being 54 million RMB, while in fact it was suffering a 103 million RMB loss. After becoming listed, the company forged the financial data of an interim report by concealing its substantial losses and disclosing fabricated profits to general public. After being investigated by the CSRC, an administrative fine and criminal sanction were imposed on Hong Guang Industry and its executives. However, the civil litigations raised by portfolio investors were declined before the courts on the basis that "there is no cause-effect relationship between the listed company's wrongful conduct and the loss suffered by the investors."⁹⁷ In 2001, the Supreme Court issued a Notice⁹⁸ to put a ban on all types of private securities enforcements. The securities litigation was a highly sensitive issue in China. The Chinese Supreme Court was reluctant to expose State-owned listed companies to a flood of securities litigations. In the meantime, as S.H. Cao, director of the Research Centre of the Supreme Court, stated "the law and regulations on securities litigation need to be further interpreted and most Chinese judges in lower courts also lack knowledge and experience of handling it."⁹⁹

⁹⁶ W. Hutchens (n 83) 603

⁹⁷ F. Liu, A Case Note of HONG GUANG Industry available at <http://www.51lw.com/article/audit/953.htm> accessed 20th July 2011

⁹⁸ The Notice on Temporarily not Accepting Securities Related Civil Compensation Case

⁹⁹ An interview of Cao Shouhua available at <http://news.southcn.com/hotpersue/.%5C200110110824.htm> accessed 20th July 2011

During the period from 2002 to 2003, in order to ease the tension between aggrieved investors and State-owned listed companies, the Supreme Court issued an ice-breaking Notice.¹⁰⁰ It confirmed that local intermediate courts would hear private securities litigations against fraudulent misrepresentation. The Notice provided a practical legal regime for the enforcement of securities litigations.¹⁰¹ In some respects, it was enacted in a plaintiff-friendly way. For example, it gives plaintiffs an autonomous position from which to choose which eligible parties they would like to sue. This means plaintiffs could pursue their interests by bringing litigation action against a "deep pocket" defendant.¹⁰² Additionally, the provision applied a statute of limitations of two years to private securities litigations rather than the standard one year special statute of limitations.¹⁰³ From 2003 to 2007, the lower courts accepted large numbers of private securities litigations based upon misrepresentation. The claims of these litigations were valued at approximately 700 million RMB to 800 million RMB. Nearly 10 thousand investors brought private litigations against more than 30 listed companies and other eligible parties. Until 2007, 80 per cent of litigations have been properly settled.¹⁰⁴ In several reported cases, most plaintiffs were successful in obtaining the compensation they were claiming.¹⁰⁵

Although the private securities litigations have improved the standard of legal enforcement, it does not solve the issue of administrative intervention. In accordance with the Supreme Court's Notice, private securities litigations are subject to

¹⁰⁰ Zuigao Renmin Fayuan Guanyu Shouli Zhengquan Shichang Yin Sujia Chengshu Yinfade Minshi Qinquan Jiufen Anjian Youguan Wenti De Tongzhi [The Notice on Relevant Issues Concerning Accepting Civil Tort Dispute Cases Caused by False Statement on Securities and Several Provisions on Hearing Civil Compensation Caused by False Statement on the Securities Market] (herein after Notice) issued by China's Supreme Court on 15th January 2002

¹⁰¹ W. Hutchens (n 83) 604

¹⁰² C. Xi (n 47) 495 also see Provisions on Private Securities Litigation Article 28, listed companies bear a joint and several liabilities with the directors, supervisors, underwriters who fraudulently disclose the information.

¹⁰³ W Hutchens (n 83) 258

¹⁰⁴ Y.X. Song, 'Zhongguo Minshi Zhengquan Susong' [Private Securities Litigation in China] working paper, available at <<http://songyixin.blog.cnstock.com/archives/2007/189194.html>>, accessed 20th July 2011 Song is a leading securities lawyer in China.

¹⁰⁵ Y.X. Song, 'a Case Note of Dong Fang Electronic', available at <<http://songyixin.blog.cnstock.com/archives/2007/176670.html#539098>> accessed 20th July 2011 also see C. Xi (n 47) 492-496

administration and criminal sanction. In other words, aggrieved investors can only file a litigation action against a party who has received an administrative fine from the CSRC or another administrative organ like the Ministry of Finance on the basis of fraudulent disclosure, or who has been convicted for misrepresentation by a court. Arguably these preliminary requirements reduce the cost of evidence collecting for private investors whilst also preventing the opening of the floodgates to litigations. Some economic studies also indicate that, the market regulator outperforms courts as a law enforcer, where the "costs of verifying the circumstance of specified cases and interpreting statutes are high".¹⁰⁶ However, these preliminary eligibility requirements directly conflict with the general principles of the Civil Procedure Act 2007.¹⁰⁷ Furthermore, an individual investor's civil right of claim is partially controlled by administrative authorities. In practice, the enforcement of an investor's private claim is tightly restricted by the attitude of the administrative organs toward the fault disclosed. It can also be argued that the CSRC as an administrative regulatory body would adopt different standards to justify whether a disclosure is fraudulent compared to tests used by a court in a civil litigation action.

In addition to undermining the independence of the court system, this administrative oriented approach weakens the role of private securities litigation in mitigating the "agency cost problem". In most cases, fraudulent disclosure is organised by a few insiders within listed companies. In deliberately disclosing wrongful information to the general public such persons can foresee that they may face administrative or criminal sanctions in the future if caught. However, as plaintiffs

¹⁰⁶ G. Edward, S. Johnson & A Shleifer. 'Coase v. Coasians' (2001) 116 (3) Quarterly Journal of Economics 853

¹⁰⁷ The Civil Procedure Law of People's Public of China 2007, Zhonghua Renmin Gongheguo Minshi Susongfa 2007, adopted by 30th Meeting of the Standing committee of tenth National People's Congress 28th October, 2007 effective 1st April 2008

This pre-trial demands conflict with the general principles of Civil Procedure Law 2007, according to Article 108 of the Act, a suit can be filed, where the following conditions are met:

- (1) the plaintiff must be an individual, legal person or any other organization that has a direct interest in the case;
- (2) there must be a specific defendant;
- (3) there must be a concrete claim, a factual basis, and a cause for the suit; and
- (4) the suit must be within the scope of acceptance for civil lawsuits of the people s courts and within the specific jurisdiction of the people s court where it is filed.

will generally sue the eligible defendant with the greatest payment capacity, these insiders can easily externalise the loss to the listed company. In *Dong Fang Electronic Plc v Cao Xiaomei and others*, more than 6500 aggrieved investors raised litigation actions against listed companies founded on their joint and several liabilities, on the basis of administrative and criminal sanctions imposed on insiders, who directly had engaged in fraudulent misrepresentation.¹⁰⁸ Dong Fang Electronic plc eventually freely allocated its shares to plaintiffs as compensation.¹⁰⁹ In such conditions, a reasonable assumption is that the potential loss triggered by private securities litigation could enhance a shareholder's incentive to supervise a company's management. However, most super-size listed companies are dominated by State ownership, which generally suffers from the issue of "owner absence". It means both of governmental agencies and management team of SOEs will not suffer from the loss of the state asset. Thus, if State assets are the main source of compensation for a plaintiffs' loss, private securities litigations are unlikely to enhance the governmental officials' incentive in supervising the management in SOEs. The preliminary requirements for such actions to be brought further compound this situation, since it constrains private investors, especially institutional investors, in playing a more active role in supervising market participants' conduct.

2.5. Concluding Remarks

The analysis in this chapter shows that the major problem in China's corporate governance regime, similar to the problems in Western jurisdictions, is the "agency cost problem". However, as a result of socio-economic differences the "agency cost problem" bears some distinctive Chinese characteristics. Unlike in other jurisdictions, "horizontal agency cost" and "vertical agency cost" are equally intense in China. In

¹⁰⁸ A detailed case note of Dong Fang Electronic available at <http://www.qingdaonews.com/gb/content/2003-02/20/content_1003459.htm> accessed 20th July 2011

¹⁰⁹ In the case of Ying GuangXia, the approach of free share-allocation was also adopted by the defendant to compensate the plaintiffs' loss See 'Yin Guangxia Min Shi Peichang Jijiang Shouwei' [The End of the Civil Litigation Against Ying Guangxia] available at <<http://stock.jrj.com.cn/news/2007-05-28/000002273550.html>> accessed 20th July 2011

listed SOEs, the vertical agency cost is triggered by the "absent owner problem". Concentrated ownership without ultimate owners weakens a majority shareholder's supervisory power. It thus results in the "insider control" problem. In the meantime, the concentrated ownership structure gives rise to majority shareholders undermining minority shareholder's interests. In short, the two-tiers of agency cost are the core problems faced by China's corporate governance regime. In order to respond effectively to these problems, legal and administrative control strategies must be carefully structured.

Nonetheless, existing control strategies in China are suffering from a number of weaknesses. Although the market regulator is empowered to exercise a full-range of regulatory powers, it cannot efficiently control agency-cost problems. The underperformance of administrative regulations is partly because market participants have few incentives to substantially comply with administrative regulations, and partly because the enforcement strategy adopted by the market regulator is inefficient. Similarly, the functions of formal legislation are curbed by a variety of constraints. Firstly, legislation is usually poorly drafted. The legal provisions are vague and ambiguous. Secondly, enforcement of legislation is not always effective under the current legal framework. The analysis shows that socialist scepticism towards the "rule of law" together with a strong administrative regulatory approach limits the role of the judicial system. The above analysis, allows two conclusions to be made regarding China's legal reform of corporate governance. Firstly, in essence, the major problems experienced in China's corporate governance are similar to those experienced in Western jurisdictions. This observation is a key pre-condition to solving China's problems using a comparative approach. Secondly, improving poor existing agency-cost control strategies is the major means of improving corporate governance standards in China's listed companies. Bearing all these findings in mind, the next two chapters will set out a methodology for China's legal reform of corporate governance.

Chapter III Legal Reform of Corporate Governance in China: Does Company Law Matter?

Chapter II has revealed that Chinese corporate governance is suffering from a series of problems. Although these problems seem to be complicated, they share some similarities. One of the main sources of the problems is that the Chinese legal regime fails to provide adequate protection to shareholders against incumbent managers, and to minority shareholders against majority shareholder abuses. On this basis, it can be concluded that "agency cost control devices" should be further improved in China. The analysis in chapter II has already indicated that Chinese company law is not effective from either a legislative or practical perspective. This chapter will answer the first question posed in chapter I; namely, does company law really matter in controlling agency cost in the Chinese context?

3.1. The Priorities of the Company Law in the Chinese Context

The "law matters" thesis has been developed by law and finance scholars. Following empirical research, La Porta *et al* have concluded that law which effectively protects shareholders' interests is the foundation for a strong and secure securities market, as it increases investor confidence and motivates investors to invest their money into stock markets.¹ Although this argument is influential, it is nevertheless criticised by many company lawyers. They cast doubt on the "law matters" thesis in two respects. Firstly, law is only one element of an institutional framework. In many developed jurisdictions, non-law components play a more

¹ R. La Porta, F Lopez-De-Silanes, A. Shleifer and R. Vishny 'Investor Protection and Corporate Governance' (2000) 58 *Journal of Financial Economics* 1

important role in promoting the good corporate governance of public companies.² Secondly, even if law is an important force in regulating corporate governance, its effectiveness largely depends on the enforcement regime. In other words, the function of good legislation is limited, if it is without the support of an effective judicial system.³ These drawbacks to the law matters thesis warn us that it would be inappropriate to apply the thesis directly to a specific context without careful analysis. This part will therefore explore the questions of (1) on what basis company law has an objective to mitigate China's corporate governance problems, and (2) why good legislation is still important in a context where the legal enforcement is relatively weak.

Some commentators challenge the law matters thesis by arguing that company law is not the only device for regulating corporate governance. From research into the UK corporate governance regime, Cheffins argues:

On balance, developments in the UK suggest that a highly specific set of laws governing companies and financial market do not need to be in place for the American version of corporate governance to become pre-dominant. Instead, alternative institutional structures can perform the function "law matters" advocates say the legal system needs to play.⁴

Coffee makes a similar point in his research into UK and US corporate governance regimes. He concludes that "the principal weakness of the LLS&V thesis is its narrow focus on enforceable legal right.... the minority right could in principle come from

² J. Coffee, 'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control' (2001) 111 Yale Law Journal 1, B. Cheffins, 'Does Law Matters? The Separation of Ownership and Control in the United Kingdom' (2001) 30 Journal of Legal Studies 459, B. Cheffins, 'Law Economics and the UK's System of Corporate Governance: Lessons from History' (2001) 90 Journal of Corporate Law Studies 71, and B. Cheffins, 'Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies' (2003) 23 Oxford Journal of Legal Studies 1

³ M. Siems 'Shareholder Protection Around the World ('Leximetric II')' 33 (2008) Delaware Journal of Corporate Law 111 and J. Coffee, 'Law and the Market: The Impact of Enforcement' (2007) 156 University of Pennsylvania Law Review 229

⁴ B. Cheffins 'Does Law Matters?' (n 2) 461

any source".⁵ Indeed, the agency cost between shareholder and director is controlled by many other regulatory mechanisms in developed economies, including competitive product markets, reasonable efficient capital markets and an active market in corporate control incentive compensation for managers, sophisticated professional accountancy and effective financial disclosure.⁶ In fact, these multiple non-legal mechanisms shoulder the main burden of regulating corporate governance. Consequently, some lawyers even argue that the company law regime merely plays a "trivial" or "limited" part in promoting good corporate governance in the developed economies.⁷

Nonetheless, the situation in China is different. Under the current regulatory regime, the CSRC, as the sole market regulator, serves an important function in controlling insider abuse through the enforcement of market regulations and Securities Law. However, as demonstrated, much evidence has already shown that a one tier regulatory regime is inadequate to effectively control the serious agency cost problems in China.⁸ Therefore, developing a multi-level regulatory regime is essential for the legal reform of corporate governance. The company law regime and non-legal forces, both of which are the core agency cost controlling devices, are the crucial complementary components of administrative regulation. However, unlike in Western jurisdictions, company law must play a more important part in this regulatory regime for the following reasons.

Firstly, protection provided by the non-legal forces might be too lax to shield minority shareholder interests from insider abuse. Admittedly, non-legal regulatory

⁵ J. Coffee (n 2) 71

⁶ B. Black 'The Legal and Institutional Preconditions for Strong Securities Market' (2001) 48 UCLA Law Review 781

⁷ B. Black 'Is Corporate Law Trivial? A Political and Economic Analysis' (1990) 84 NorthWestern University Law Review 542, M. Klausner, 'The Limits of Corporate Law in Promoting Good Corporate Governance' (December 17th, 2004). Stanford Law and Economics Olin Working Paper No. 300. Available at SSRN: <<http://ssrn.com/abstract=637021>> accessed 20th July 2011 and also see M. Roe, 'Corporate Law limits' (2002) 31 Journal of Legal Studies 233

⁸ C.X. Shi, 'Protecting Investors in China through Multiple Regulatory Mechanisms and Effective Enforcement' (2007) 24 Arizona Journal of International & Comparative Law 452

regimes can exert pressures on managers and block-holders. However, the control exerted by non-legal forces is generally loose, rather than firm.⁹ One of the standard claims of law and economics literature is that competitive pressure may rule out inefficient structures through a "survival of the fittest" selection process. However, it may take time for selection pressures to act on firms operating sub-optimally especially at a time when no inefficient structure can be observed.¹⁰ In developed economies, loose pressures from non-legal components can secure individual shareholder's property rights, while preserving the management's discretion in the decision-making process. However, as stated in chapter II, both horizontal and vertical agency cost¹¹ poses serious risks to minority shareholder interests. As a result, compared with shareholders in developed economies, the shareholders in China face a much higher risk.¹² Consequently, the sanctions offered by non-legal regulatory regimes are not strong enough to control insider misconduct. Arguably, they hardly even cause any direct loss to insiders. Most non-legal forces are capable only of imposing a reputational sanction on companies and insiders. For example, as the stock exchanges in China lack any independent authority, the sanction issued by the exchanges is limited to the public criticism of companies and individuals.¹³ However, Chinese market participants are not really sensitive to reputational sanctions. Mutual trust between market participants and non-legal regulatory regimes has not been well established, nor has an effective communication trajectory between non-legal regimes and investors been formed. Under these circumstances, investors have to face the question of the extent to which the message sent by non-legal sanctions is accurate and reliable.¹⁴ By contrast, the company law regime has a stronger deterrence effect in controlling insider abuse. The function of the company law system is based on the heavy hand of the State. This is more demanding than the enforcement regime of

⁹ D. Clarke, 'The Ecology of Corporate Governance in China', GWU Legal Studies Research Paper No. 433 available at SSRN: <<http://ssrn.com/abstract=1245803>> 15 accessed 20th July 2011

¹⁰ *ibid* 15

¹¹ For the definition of these two types of agency cost, see chapter II (2.3.2.1) above

¹² See Chapter II (2.3.2.1 & 2.3.2.2) above

¹³ B. Liebman & C. Milhaupt 'Reputational Sanction in China's Security Market', (2008) 108 Columbia Law Review 929

¹⁴ *ibid*

non-legal forces. The sanctions under the company law regime can impose fines on wrongdoers and even disqualify them from again being a business manager.¹⁵ A clear mandatory rule can send a strong signal to directors and block-holders that any behaviour which violates minority shareholder property right is subject to serious legal sanctions.¹⁶ Furthermore, decisions made through court procedures need to be supported by solid evidence and to undergo complicated legal processes, rendering the result more reliable. Consequently, sound corporate governance practice is more likely to be integrated into manager and block-holder behaviours by strict liability rules provided through formal legislation.

Secondly, introducing multiple non-legal mechanisms into the regulatory regime would conflict with the local regulatory culture. The Chinese administrative culture is oriented around a hierarchical model. The government prefers a hands on approach under which most regulatory agencies are controlled by the State. In such a context, there is little room for developing a set of complicated non-legal regulatory mechanisms. For example, both Chinese stock exchanges are under the tight control of the CSRC. The CSRC nominates the chairman and deputy chairman of these exchanges and also appoints and dismisses their general managers and deputy general managers. The CSRC alone has already placed substantial control on the stock exchanges, allowing them only to have a limited range of powers.¹⁷ Clarke makes an insightful comment on this phenomenon,

market monitoring, is disfavoured by the state. The Chinese state prefers direct regulation by government agencies first, and indirect regulation by private litigation in the state's courts next. Regulation by the uncontrolled institutions of the market comes a distant third, and indeed it is hard to find such institutions in

¹⁵ Company Law 2005 art.147

¹⁶ T. Paredes, 'A Systems Approach to Corporate Governance Reform: Why Importing U.S Corporate Law isn't the Answer' (2004) 45 William and Marry Law Review 1136

¹⁷ C.X Shi (n 8) 466

China.¹⁸

In line with Clarke's argument, the Chinese government is more likely to employ formal legislation rather than non-law forces in reforming the corporate governance regime, as the former in general is easier to control. The securities litigation mentioned in chapter II is further supporting evidence on this point¹⁹.

Thirdly, good corporate governance underpinned by non-legal forces cannot be achieved in a short time. The development of institutions can take decades. In North's words, institutions are the "product of a long gestation" and the "process of [institutional] change is overwhelmingly incremental."²⁰ There are many uncertainties surrounding the development of institutional supports. It is a time-consuming project for policy-makers in developing jurisdictions to understand why institutions work the way they do and to ascertain the complementary relationships among institutions in each setting.²¹ Compared to complicated non-legal components, a good company law regime is more accessible. Black makes the following conclusion from the experience of corporate governance reform in Russia:

Writing good laws can take years and building good institutions takes decades... they chose to privatize immediately, and hope that the laws and institutions would follow later. The law did indeed follow... but the privatizers hoped for more than just decent laws. They hoped that broad private ownership would create a constituency for strengthening and enforcing those laws. That did not happen.²²

Although Chinese corporate governance reform adopts a gradualist approach compared to Russian style "shock therapy", the urgency of calling for good legal and

¹⁸ D. Clarke (n 9) 57

¹⁹ See chapter II 2.4.2.2 above

²⁰ D. North, *Institutions, Institutional Change and Economic Performance* (Cambridge University Press 1990), 192

²¹ T. Paredes (n 16) 1125

²² B. Black, R. Kraakman & A. Tarassova, 'Russian Privatization and Corporate Governance: What Went Wrong' (2000) 52 *Stanford Law Review* 1731, 1753

institutional supports in reform is very similar to conditions in Russia. Every transition economy preparing to transfer State-owned shares to the general public must face the problem of how to promote private investor confidence to secure the benefits of privatization.²³ Much experience has indicated that private investors are reluctant to purchase privatised shares in conditions where legal and institutional supports for the stock market are weak.²⁴ In China, with the recent share-unification regime, the government has begun to transfer State-owned shares to general public.²⁵ Accordingly, policy-makers also need to promote private investor confidence by introducing legal or institutional supports, which can generate immediate effects by way of a regulatory regime. For the purposes of time-saving, formulating sound company law is better than building a complex set of non-legal institutions.

Finally, this part does not attempt to deny the benefits of developing non-legal forces in Chinese corporate governance reform. Rather, it uses these arguments to highlight the advantages of employing a company law regime to promote good corporate governance in China. There is no doubt that company law, as a regulatory regime, has some important features which meet the demands of the reform of corporate governance in China. These include exerting strict control over insider misconduct, having a better level of coherence with the local regulatory culture and a better level of accessibility for policy-makers. Furthermore, good company law is an excellent proxy for the development of non-legal institutions. As Coffee states: "Indeed, where legal forces exists to protect the minority shareholder, an institutional and cultural infrastructure—composed of such important actors as security analyst, rating agencies, and business journalist—soon follows."²⁶ Consequently, the "law matters" thesis is valid in the Chinese context. The company law regime can play a

²³ J. Coffee, 'Privatization and Corporate Governance: The Lessons from Securities Market Failure' (2000) 25 *Journal of Corporate Law* 1, 20-21

²⁴ *ibid* 21 and B. Black (n 22)

²⁵ For details, see C.X. Shi 'Recent Ownership Reform and Control of Central State-Owned Enterprises in China: Taking One Step at a Time' 2007 (30) *University of New South Wales Law Journal* 855

²⁶ J. Coffee 'The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications' (1999) 93 *Northwest University Law Review* 696

crucial role in the legal reform of corporate governance in China.

3.2. Company Law under Weak Legal Enforcement

A current debate on the role of company law in transitional economies centres on the issue of the significant gap between "law on paper" and "law in practice". The criticism is that "legal rules which are not enforced and do not influence an individual's behaviours are not even regarded as a part of an institution."²⁷ Indeed, if no competent authority can enforce the legal regime, it would be pointless to claim that company law is a reliable device. As shown in chapter II, the securities litigation suffers from weak legal enforcement.²⁸ As a result, they serve a limited function in changing the behaviour of market participants. It is therefore necessary to explore why company law is still important, even where legal enforcement is not efficient.

Many commentators attribute the gap between "law on paper" and "law in practice" to a weak court system. As Clarke argues, "the Chinese judiciary, with its low level of education and vulnerability to corruption and political pressure... [might be not capable of having] ... an important role to play in the development of Chinese corporate governance norms".²⁹ Admittedly, Clarke's argument highlights some of the weaknesses of the Chinese judicial system. The court system even today is subject to strict administrative controls. Its efficiency significantly lags behind that of the developed jurisdictions. However, the weaknesses of the judicial system may be overstated.

Firstly, the independence of the Chinese court system has long been questionable. Nonetheless, some recent research indicates that the Chinese court system has begun

²⁷ S. Opper & S. Schwaag-Serger 'Institutional Analysis of Legal Change: The Case of Corporate Governance in China' (2008) 245 *Journal of Law and Policy* 247 for a general argument of the divergence between "law on paper" and "law in practice", see A. Seidman & R. Seidman, 'Drafting Legislation for Development: Lessons from a Chinese Project' (1996) 44 *American Journal of Comparative Law* 1

²⁸ See Chapter 2 (2.4.2.2) above at 45-49

²⁹ D. Clarke (n 9) 44-45

to take an independent judicial position. Howson's research on the court system in Shanghai finds that,

there is evidence of Shanghai courts ruling against political actors – case where private litigants do battle against both government department and SOEs or apparently commercial actors/investors with substantial political backing. In fact, in all of the more than 200 full opinions reviewed, where there is a discernable political interest the Shanghai court supported the non-state/Party interest... the courts seem empowered to disregard formal corporate structures when they are offered as a defence against "state" or Party cadre misfeasance.³⁰

It could be argued that, in an economic sense, Shanghai is the most developed city in China. Its judicial system might therefore be much more effective than in under-developed areas. As a result, the performance of the Shanghai courts may not represent the judicial system in China as a whole. However, Liebman also observes a trend in which the Chinese courts have become to be more independent:

China's courts have at times appeared to signal that they are no longer solely political tools for the state. Court rhetoric has changed over the past decade, reflecting a modest attempt by the courts to shift from being a tool for enforcing Party policy to being neutral forum for dispute resolution...the new education requirements for judges represent a shift away from primary reliance on political background in selecting members of the judiciary.³¹

In addition to Western commentators' findings, a more vivid example demonstrating the increasing independence of the Chinese courts is the Hainan Kaili case. Hainan Kaili (Kaili) is a private limited liability company seated in Southeast

³⁰ N. Howson, 'Judicial Independence and the Company Law in the Shanghai Courts', University of Michigan Law & Economics, Olin Working Paper No. 09-023. Available at SSRN: <http://ssrn.com/abstract=1340566> 8 10

³¹ Liebman, 'China's Courts: Restricted Reform' (2007) 21 Columbia Journal of Asian Law 1, 18

China. In 1998, Kaili sought a listed position on the Chinese securities market. However, the CSRC rejected its application because there were some financial misrepresentations in Kaili's application. In response to the CSRC' rejection, Kaili filed an administrative petition to the Beijing Secondary Court. The court upheld Kaili's petition. The judge held:

the key standard for judging whether a financial report includes substantial misrepresentations is whether it is inconsistent with the accounting standards set out by laws and regulations. In this case, the CSRC should appoint a competent accounting authority to review Kaili's application materials and point out the illegal components. However, the CSRC failed to fulfil this responsibility. Therefore, the CSRC' does not have a solid stand to reject Kaili's application, and accordingly it has a responsibility to re-evaluate Kali's application within 60 days.³²

This judicial decision was not accepted by the CSRC, because it significantly damages its authority and reputation as a market regulator. As a result, a CSRC representative even announced that the Beijing Secondary Court's decision was "unreasonable" and "impracticable".³³ Unsurprisingly, the CSRC brought the case before the Beijing High Court. At the second hearing, the High Court upheld both of the Secondary Court's reasoning and decision. The judge held:

the CSRC's clerical office is an inappropriate organ to reject Kaili's application. It is inconsistent with the relevant laws, regulations, and the approval procedure which is set out by the CSRC itself...the decision made by the Beijing Secondary Court is fair and just. The CSRC must re-evaluate Kaili's application in

³² Shenpanzhang Xishuo Zhengjianhui Baisu Yinyuo [An Interview of the Chief Judge of Kaili Case: Why Did CSRC Lose its Lawsuit?] Beijing Qingnian Bao [Beijing Youth Daily] 6th July 2001

³³ Hainan Kailian: Zhengjianhui Shangsuo Neirong Shouci Duiwai Gongkai [Hainan Kaili Case: the Reasons for CSRC's Appeal] Zhongguo Qingnian Bao [China Youth Daily] 17th January 2001 available at <<http://mil.eastday.com/epublish/gb/paper250/613/class025000004/hwz310896.htm>> accessed 20th July 2011

accordance with the relevant laws and regulations within 60 days.³⁴

Kaili, as the plaintiff in this case, was in a far more disadvantaged litigious position than the CSRC. From a political perspective, Kaili is a wholly private company without any State backing. By contrast, the CSRC is a high-level administrative organ which is directly controlled by the State Council. In such a situation, if the courts considered political factors or were influenced by political forces, Kaili's petition would have been dismissed at the first hearing. Indeed, even in a technical sense, it would not have been difficult for the Beijing courts to achieve a judicial decision, which favoured the CSRC. This is because when Kaili filed its petition to the Beijing Secondary Court, the *Securities Law 1998* had merely been in force for a year, and the CSRC had just revised its approval procedure according to the new securities law. Thus, during Kaili's petition, many provisions of the newly-issued law and regulations were still untested. The court could have interpreted them in a way that was in favour of the defendant rather than the plaintiff. However, the Beijing courts did not do so. Instead, they protected the private party's legal rights from the administrative regulator's abuse. Furthermore, Kaili is seated in Hainan province, which is far from Beijing. It is therefore nearly impossible for Kaili to have engaged in any form of nepotism with the judges in the Beijing Courts. Other than pure legal considerations, the Beijing Courts had no additional incentive to protect this private company.

This example coupled with the Western commentators' findings cannot constitute a solid ground on which to conclude that the Chinese court system is now wholly independent of political influence. However, the Chinese courts are entitled to have some degree of independence where they deal with less politically sensitive cases. Compared to public law cases, company law cases in general are less sensitive from a political point of view. Furthermore, with the government conversion of State-owned shares into private shares, the political sensitivity of corporate governance cases in

³⁴ (n 32)

large public company would be further reduced. It is therefore reasonable to expect the courts to act more independently in company law cases in the future.

Secondly, many commentators claim that the Chinese courts lack sophistication in good judicial decision making. Nonetheless, the quality of judges in China has significantly improved in last decade. According to *Judges Law 2001*,³⁵ judges must have at least two years' working experience in law and a bachelor degree in law or a joint law degree. Judges must also undergo more intensive legal and professional training that previously.³⁶ Moreover, according to a recent official strategy, by 2008 more than 80 per cent of Chinese judges had a bachelor degree and nearly 4 per cent had a master or doctoral degree.³⁷ Additionally, the Supreme People's Court also requires judges under the age of 40 who do not hold a bachelor's degree to obtain this qualification within five years. Judges above the age of 40 have to undertake a special legal training course lasting between 6 months to one year.³⁸ In respect of company law judges, there is some rudimentary evidence illustrating their ability to make sound judicial decisions using logical reasoning. According to Xi's research on the security litigation, even the judges in local courts have shown "a considerable level of judicial competence and innovation in handling unprecedented private securities litigation cases."³⁹ Additionally, Howson's research tells us that in many Shanghai company law cases, the courts rightly support the "self-order" of Articles of Association in opposition to mandatory business regulation. This suggests that company law judges in Shanghai have the awareness and the competence to protect "some area of

³⁵ Judges Law of People's Republic of China 2001, *Zhonghua Renmin Gonghegou Fguanfa 2001*, amended by 9th Meeting of the Standing committee of 22nd National People's Congress 30th June, 2001 (herein after *Judges Law 2001*)

³⁶ Article 9 of *Judges Law 2001*

³⁷ D.D Wang, 'Shidai Guanjianci Jianzheng Faguanduiwu 30 Nian Bianqian' [The Changes of the Chinese Judges in Last 30 Years: Some Keywords] *Fazhi Ribao* [Law Daily] 7th December 2008

³⁸ Wenping Shangqu Shuiping Tigao, Fuaguan Peixun Buneng Zhi Benzhe Wenping Qu [An Advance Degree Does not Equal Enhanced Ability, Judges' Training Should not Solely Aim at Degree] *Xinhua Wang* [Xin Hua web] 11th March 2004

³⁹ C. Xi, 'Case Note: Private Enforcement of Securities Law in China: Daqing Lianyi co v ZHONG Weida and Others Hei Longjiang High Court' (2006) 2 *Journal of Comparative Law* 496 in China, both of company law cases and securities law cases are handled by commercial law court.

semi-autonomous activities against direct state-regulation."⁴⁰

In addition to the dramatic improvement of in the educational level of judges, recent technological innovation is also widely employed to promote judicial sophistication. Traditionally, Chinese judges worked in a relatively isolated environment under which they could only find materials in court libraries and discuss demanding cases with senior judges or legal scholars. It was difficult for them to access information on how similarly-situated courts do their job. However, according to Liebman's recent research, the problem of limited access to information is largely mitigated by using internet. Most Chinese judges interviewed by Liebman overwhelmingly commented that now they were able to use the internet to conduct research to assist them in handling cases, especially hard and novel cases.⁴¹ For example, the research showed that in the central Chinese city of Xian, judges use the internet to consult cases decided by the Supreme People's Court and the Shanxi Provincial High People's Court.⁴² The internet can effectively enlarge judges' horizons by enhancing their communication with judges in different areas. Moreover, technological innovation is also used to promote the court's working efficiency. For example, in a securities law case heard by the Qingdao Intermediate Court, approximately 3000 eligible plaintiffs filed actions against Dong Fang Electronic Co. on the basis of misrepresentation in the security market. After the Qingdao Court upheld the plaintiff's claims, a demanding technical problem emerged. The judges found that calculating the compensation to be awarded to investors was extremely difficult because the compensation for each investor varied according to two variables: (1) the amount of shares the investor bought, and (2) the date on which they brought the shares. In order to make a quick settlement, the court employed several computer engineers to design software, capable of automatically calculating the precise amount

⁴⁰ N. Howson (n 30) 10

⁴¹ B. Liebman & T. Wu, 'China's Network Justice' (2007) 257 *Chicago Journal of International Law* 257, 290

⁴² *ibid* 291, Chinese judges use internet or other method to consult cases or doing legal researches cannot constitute a solid base upon which we can conclude that a doctrine of judicial precedent/state decisis is emerging in China. The reason is the legal research or case consultations with the high courts are judges' personal behaviours without any institutional support.

of compensation for each individual shareholder. More importantly, the software could also produce a document, which detailed how the compensation was calculated.⁴³ This case illustrates that using technological innovation in judicial practice not only promotes the court's working efficiency, but also strengthens the transparency of judicial decision-making.

Consequently, whilst compared to the court systems of developed economies, the Chinese judicial system might be less independent and sophisticated, it is nevertheless far from collapse. Evidence reveals that Chinese judges have an increasing level of independence in judicial decision making, and their expertise is boosted by better education and more intensive practical training. Generally speaking, judges have the ability to achieve sound decisions in relatively simple cases by applying the relevant legal rules. Moreover, with the integration of technology into the judicial practice, the efficiency and transparency of judicial practice are further promoted. By and large, the Chinese judicial system has the potential to play a more important role in shaping the corporate governance regime by effectively enforcing well-designed legal rules.

In light of the foregoing discussion, it is unfair to attribute weak legal enforcement solely to the court system. If the substantive legal rules available to the court are ill-defined, even the most sophisticated and honest judge cannot ensure that these laws are properly enforced on a case by case basis.⁴⁴ Thus, legal enforcement is influenced by quality of legislation. As noted in the previous chapter, Chinese company law has already transplanted a number of general principles and doctrines from Western jurisdictions into its own legal system but failed to provide

⁴³ C.G. Yan, 'Zhongguo Gushi Xujia Chenshu Diyi An: Quanmian Tiaojie Jian' [The Settlement of the First Misrepresentation Case in China's Judiciary Practice] (2008) 4 Zhongguo Shenpan [China Trial] 39, 41-42

⁴⁴ B. Black & R. Kraakman, 'A Self-Enforcing Model of Corporate Law' (1996) 109 Harvard Law Review 1911, 1925

supplementary explanations and interpretations.⁴⁵ Without detailed interpretations, these principles and doctrines are naturally unworkable. Furthermore, Chinese judges do not customarily interpret legislation on a case by case basis. Thus, in many cases, they do not have a concrete basis from which to enforce effectively laws, so weak legal enforcement is partly caused by ill-drafted company law.

Having concluded that bad legislation deters enforcement, the next question is whether well-drafted legislation can facilitate legal enforcement. If so, there is a solid basis from which to claim that it is meaningful to focus on "law on paper", even in a relatively weak enforcement regime. From a typological point of view, there is a distinction between a rule and a standard in legislation. According to Hart, a rule reflects a social need, which requires "over great areas of conduct, safely be applied by private individuals by themselves without fresh official guidance or weighing up of social issues".⁴⁶ A standard represents a different social need, which requires the legal provision to "leave open for later settlement by an informed, official choice, issues, which can only be properly appreciated and settled when they arise in a concrete case."⁴⁷ The legal provisions of company law are more complicated than this general classification. They can be divided into three groups, namely permissive rules also known as enabling rules, presumptive rules and mandatory rules. In short, both permissive rules and presumptive rules leave space for the autonomy of parties. The former functions as a default rule which is not applied to parties, unless they choose to opt in. The latter rule works using a gap-filling approach which is automatically applied to the parties, unless they choose to opt out. A mandatory rule is more strict and rigid. Like the presumptive rule, it is applied to company affairs without the need for affected parties' affirmation. However, the parties cannot choose to opt out like

⁴⁵ H. Huang & B.S. Wang argues, "indeed, the reform has introduced a number of important regimes, but their workability is in serious doubt due to the lack of detailed and functional provision". See H. Huang & B.S. Wang 'China's New Company Law and Securities Law: An Overall and Assessment' 2006 (19) Australian Journal of Corporate Law 243, see Chapter 2 (2.4.2.1) above and Chapter V below

⁴⁶ For a general conceptual difference between rule and standard, see H.L.A Hart, *The Concept of Law* (2nd edn, Oxford University Press 1994) 130-131

⁴⁷ *ibid*

they can do under the presumptive rule.⁴⁸ In most developed economies, a company law regime is mainly constructed by permissive rules and presumptive rules. Mandatory rules are not favoured by policy-makers, as they easily suffer from the problem of over-inclusiveness, which could potentially damage the efficient conduct of private parties.⁴⁹ However, research suggests that although the bright-line mandatory rule has largely been abolished in developed economies, it still facilitates enforcement in developing economies. Paredes's research shows that easily administered bright-line rules have comparative advantages where courts generally lack the sophistication to apply open-ended company law standards.⁵⁰ Similarly, Black in his research on Russian company law reform also suggests that,

Whenever possible, use of bright-line rules, rather than standards, to define proper and improper behaviour. Bright-line rules can be understood by those who must comply with them and have a better chance of being enforced. Standards, in contrast, require judicial interpretation, which is often unavailable in emerging markets, and presume a shared cultural understanding of the regulatory policy that underlies the standards, which may also be absent⁵¹

Furthermore, a positive relationship does not only exist between mandatory rules and legal enforcement. The efficiency of legal enforcement can be upgraded by precisely defined standards as well. Cheffins argues that precise and intricate legislation can reduce the negative influence of unsophisticated judicial systems. He finds that, as English judges generally have less expertise than US judges, compared to US law, UK company legislation is drafted in a more detailed fashion. In order to achieve this, open-ended terms are constructed in a restrictive, narrow or technical manner by precise and detailed guidelines.⁵² Obviously, the sophistication of the

⁴⁸ B. Cheffins, *Company Law Theory Structure and Operation* (Clarendon Press Oxford 2004), 218-220

⁴⁹ *ibid* 237

⁵⁰ Paredes (n 16) 1134

⁵¹ B. Black & R. Kraakman (n 44) 1916

⁵² B. Cheffins (n 48) 362

Chinese courts is not comparable with that of the UK courts. The latter are far more professional than the former. However, the legislative experience of the UK still provides profound insights for China's reform. It tells us that even open-textured standards can be re-drafted into a clear and workable form which can be appropriately managed by judges with less expertise. Consequently, both rules and standards can be transferred into a detailed form that facilitates legal enforcement.

Moreover, bright-line rules and detailed standards would improve the quality of legal enforcement by increasing judicial accountability. Generally speaking, they have a high level of transparency, since policy-makers use "words with well-defined and universally accepted meaning within the relevant community" in the drafting process.⁵³ As a result, rules and standards drafted in this way are easier for private parties to understand. Furthermore, bright-line rules and detailed standards naturally leave a little room for judges to use their discretion. It is therefore cheaper and easier for parties and the media to detect when a judge misapplies these kinds of rules and standards. Thus, greater accountability will force judges to make greater effort to apply laws correctly as well as prevent them from becoming corrupt or giving unfair treatment to certain parties.⁵⁴

To conclude, the interaction between law and enforcement is complicated. On the one hand, weak legal enforcement is not only attributable to an unsophisticated judicial system but also to ill-defined legislation. On the other hand, although well drafted legislation with detailed guidance is not a necessary pre-condition for effective legal enforcement in all jurisdictions, it does have a positive relationship with legal enforcement in jurisdictions where courts lack expertise. In short, the gap between "law on paper" and "law in practice" in China can be partly bridged by precise legislation with a greater level of transparency. Accordingly, in the Chinese context, it is instructive to focus on "law on paper" despite the weak legal enforcement regime.

⁵³ C. Diver, 'The Optimal Precision of Administrative Rules' (1983) 93 The Yale Law Journal 67

⁵⁴ Paredes (n 16) 1136

Finally, weak legal enforcement is not a sufficient reason to shift our focus away from the importance of good legislation in China. As already mentioned, beyond the administrative regulator, the legal regime and non-legal forces are two core agency cost controlling devices. This means that if policy makers decide not to regulate agency cost using the company law regime, they have to resort to non-legal forces to achieve an identical function. However, non-legal forces also demand sophisticated institutional support. The performance of non-legal components is highly dependent on professional lawyers and accountants. In developed economies, accountants takes the responsibility to catch an insider's false and misleading disclosure and securities lawyers should ensure that company's providing documents comply with the relevant disclosure requirements.⁵⁵ However, in China, both professional accountants and securities lawyers are not well qualified to play an effective role in this regard. Some research has illustrated that the major features of Chinese audit market include lack of audit independence, a shortage of well-qualified auditors, and an environment of massive corruption.⁵⁶ In order to ensure the reliability and accuracy of the financial reports provided by the public companies, the CSRC in 2001 issued a document, which required all companies to engage in an initial public offering. All current listed A-shares companies that conducted a secondary offering in China had to have their Annual Reports audited by a "world renowned accounting firm."⁵⁷ In practice, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick and PricewaterhouseCoppers (the *Big Four*) are dominant in the provision of accounting services for public companies.⁵⁸ However, according to empirical research, the auditing quality of the *Big Four* is no better than that of local firms and there is also no firm data to support that the *Big Four* are more independent than their local

⁵⁵ B. Black (n 6) 796

⁵⁶ X. Zhang & Xie 'Zhongou De Duli Kuaiji Biaozhun' [The Independent Auditing Standards in China], (2000) 14 *Kuaiji Shiye* [Accounting Horizons] 69

⁵⁷ Gongkai Faxing Zhengquan de Gongsi Pilubianbao Guizhe di 16 Gao – A Gu Gongsi Shixing Buchong Shengji de Zhanxingguiding [Temporary Measure Regarding Additional Auditing Requirement for Listed A Share Companies] (December 2001) issued by CSRC

⁵⁸ H. Cai, 'Bonding, Law Enforcement and Corporate Governance in China' (2007) 13 *Stanford Journal of Law, Business & Finance* 82, 94

counterparts.⁵⁹ Furthermore, as some reported cases indicate, foreign accounting firms may also easily to suffer from ethical digressions when operating in China. This is indicated in the scandal of Keloon group. Keloon, a domestic listed Chinese company, appointed Deloitte & Touche as its external auditor in 2002. During the period from 2002 to 2004, Deloitte & Touche issued several unreserved opinions, which declared that Kelong's financial statements objectively reflect its financial status. Later, the CSRC found that Kelong's financial reports had made serious misrepresentations. It also found that as Kelong's auditor, Deloitte & Touche, not only failed to perform due diligence, but facilitated Kelong's misrepresentation.⁶⁰ Arguably, reputable overseas auditor firms should be more independent and competent than local Chinese firms, as they have better expertise as well as fewer connections with their Chinese clients. However, it is not always the case. Clarke points out those Chinese laws merely impose limited liability on the misconduct of lawyers and accountants. Although the CSRC occasionally issues administrative fines to auditing firms and law firms, the absence of private litigation regarding the misconduct of auditors and lawyers means that these intermediates assume less risk when they are involved in fraudulent activities. Therefore, ethical transgressions have come to be a serious problem among professional gatekeepers in this under-regulated market.⁶¹

In fact, there is no solid evidence to suggest that the institutions supporting non-legal components are more honest or effective than the judicial system. Therefore, aside from the contribution which good company law could make to the reason of weak judicial system, whether it means developing non-legal constraints are also meaningless in China? The reason is the professional gatekeepers are incapable as

⁵⁹ F. Liu & F.Y. Zhou, 'Gupjisida Yiweizhe Gaoshenji Zhiliang Ma—Lai Zhi Woguo A Gu Shichang de Chubu Zhengju' [Does the Big Four Mean Higher Auditing Quality: Preliminary Evidence from China's A Share Market] 3 2006 Asia and China Corporate Governance International Conference, Group C Working Paper

⁶⁰ Z.W. Yu 'Kelongan Zhong Deqin de Juesefenxi' [The Role of Deloitte & Touche in Kelong case] (2007) 50 Hezuo Jingji Yu Keji [Journal of Cooperative Economy] 50

⁶¹ D. Clarke (n 9) 26-31 for an empirical research indicates a similar result in a cultural perspective, see J. Liu, Y. Wang & L.S. Wu, 'The Effect of Guanxi on Audit Quality in China' (2001) Journal of Business Ethics the authors suggest that, "State ownership and management affiliations with the external auditor both increase the probability of receiving a clean audit opinion in China."

well in China. This line of reasoning could simply lead China's legal reform of shareholder protection into a deadlock. Consequently, it is necessary to discuss legal reform in the context of a second best world in China. Institutional support is not quite reliable in most sectors. As a result, carefully drafted law, which can minimise the negative influence of unsophisticated institutions and judicial systems, is particularly important in China.

To conclude, this part has tried to explain why company law matters in Chinese corporate governance reform. In seeking to offer an insightful answer to this important question, it has firstly mapped out the advantages of developing a company law regime in reforming corporate governance in China. Secondly, it has shed some light on why company law regimes still deserve attention in jurisdictions where legal enforcement is weak. Using the associated arguments, this chapter has highlighted the importance of company law and re-defined its role in the context of China's legal reform of corporate governance. Indeed, company law does have its limitations. Even a perfect legal regime cannot spell everything out.⁶² Nonetheless, having well-drafted company law in place would be the first important step toward an effective multiple-level agency-cost controlling regime in a second-best world where institutional supports are weak or absent.

⁶² D. Clarke (n 9) 14

Chapter IV. Reforming the Company Law Regime: A Theoretical Perspective

The importance of the company law regime in promoting good corporate governance has been demonstrated in previous chapters. However, an adequate and complete theoretical framework through which it is practically feasible to affect the legal reform of corporate governance using company law is still to be developed. This is because Chinese company law still contains a large number of ill-defined and vague rules or standards, which are incapable of fulfilling this task. Refining these legal rules into a precise and intricate form will encounter many methodological and technical barriers. Among these barriers, the most fundamental one is how Chinese company law can be converted into the efficient model. Transitional jurisdictions, including China, have already tried to provide an answer to this question by attempting to achieve the goals of legal reform through "legal transplant". However, this answer is not as simple as it seems to be. As indicated in chapter I, many studies show that a mismatch between the political cultural context in a receiving jurisdiction and the rules being transplanted can cause serious unexpected problems.¹ The following sections will therefore answer the fundamental question posed in Chapter I; namely, why China cannot divert from the course of legal transplant in its legal reform of corporate governance? To answer this broad theoretical question, this part begins by answering two specific questions. Firstly, what are the technical advantages (if any) of selectively inputting Western legal rules into the Chinese legal system? Secondly, is functional convergence a more effective model than legal transplant, as some lawyers would suggest? In seeking to provide convincing answers to these questions, a direct comparison between the formal convergence model and the

¹ See D. Berkowitz, K. Pistor & J. Richard, 'The Transplant Effect' (2003) 51 American Journal of Comparative Law 163 and D. Berkowitz, K. Pistor & J. Richard, 'Economic Development, Legality, and the Transplant Effect' (2003) 1 European Economic Review 47 see also B. Tabalujan, 'Why Indonesian Corporate Governance Failed - Conjectures Concerning Legal Culture' (2002) 15 Columbia Journal of Asian Law 141; J. Gillespie, 'Transplanted Company Law: An Ideological and Cultural Analysis of Market-Entry in Vietnam' (2002) 51 International and Comparative Law Quarterly 641 and the scholarship of School B as cited above in section 1.2.2, at 11-12.

functional convergence model is necessary. Through this comparison we can firstly generalise the advantages (if any) of the formal convergence model and secondly, test which model is more effective for China's legal reform of corporate governance.

4.1 Comparing Formal Convergence with Functional Convergence: Case Studies

4.1.1 Defining the Formal Convergence and Functional Convergence Models

The traditional concept of legal transplant, proposes that a rule undergoes no change between the host jurisdiction and the receiving jurisdiction is too narrow to interpret the phenomenon of legal borrowing. As Twining states, "no transportation without transformation"² and "single importer from multiple sources"³ are currently important characteristics of legal borrowing. Indeed, the concept of formal convergence has enough flexibility to embrace the phenomenon of some local elements merging into the transplanted rules. By contrast, the concept of functional convergence is more straightforward. It refers to one jurisdiction employing legal institutions or rules, which are different to the rules or institutions used by other jurisdictions in fulfilling the same task. In other words, it uses a different approach to achieve an effect of functional equivalence with other jurisdictions.

Towards this classification, it might be argued that it is difficult to draw a clear boundary between formal and functional convergence. The difference between these two forms of convergence may only be a matter of degree if formal convergence is broadly defined. Both forms of convergence include some adoptions of local characteristics, which make it difficult to distinguish one from the other. Indeed, an inappropriate definition may lead to misleading conclusions. Defining "formal

² W. Twining, 'Diffusion and Globalization Discourse (2006) 47 Harvard International Law Journal 510

³ *ibid*, 510

convergence" broadly may entail a high level of flexibility with this model. In contrast, functional convergence is narrowly defined and the rigidity of such a definition may lead this model to lose some of its advantages.

Nonetheless, on a theoretical level, there is a long-standing debate on the evolving path of company law among different jurisdictions. Both theories of "functional convergence" and "formal convergence" have been well developed in the domain of comparative corporate governance. Within this theoretical debate, China's legal reform of corporate governance is often presented as a counterexample to rebut the formal convergence model. The definition of formal convergence has been provided by existing studies relating specifically to China in this context. It refers to the legal rules or institutions, which are transplanted from Western jurisdictions into China's legal system. Indeed, although these legal rules and institutions have been credited with some Chinese characteristics, scholars have categorised the transplanted rules as falling under the formal convergence model. For example, Clarke argues that director's duties under China's *Company Law 1993* are "legal borrowings", though he notes that the transplanted duties are similar rather than the same as Anglo-American fiduciary duties.⁴ Functional convergence, by contrast, has not been clearly defined by scholars. However, the mixture of Western experience and Chinese characteristics has been excluded from the functional convergence model by virtue of the definition of "formal convergence". The legal rules adopted through functional convergence in China's context are expected to be completely different to the Western legal rules. Some scholars argue that the functional convergence should be dominated by the Chinese ethical values.⁵ Consequently, the difference between "formal convergence" and "functional convergence" and the definition of these two forms of convergence are not the products of this piece of research. They have been already expressly or implicitly stated by the existing studies on China's legal reform of corporate

⁴ See D. Clarke, 'Lost in Translation? Corporate Legal Transplants in China' (July 3rd 2006). George Washington University (GWU) Law School Public Law Research Paper No. 213; GWU Legal Studies Research Paper No. 213, SSRN: <<http://ssrn.com/abstract=91378414-15>>, accessed 20th July 2011

⁵ See section 1.2.2 above at 12

governance. The task of the current research, as mentioned, is to provide evidence to test the conclusions reached by these studies.

Another conceptual issue, namely the difference between functional convergence and functional equivalence, should be clarified. According to Coffee, "functional convergence recognises the availability of substitutes; for example, a legal system that faced doctrinal or political obstacles to the adoption of a particular legal rule might fashion a functional substitute that achieved similar results."⁶ Therefore, functional convergence emphasizes a complete process. Its scope is larger than functional equivalence, which is the outcome of the convergence process.

4.1.2 Case Study I: Class-voting Regime

4.1.2.1 Introducing the Case Study

This part tries to generalise the advantages (if any) of the formal convergence model by undertaking a comparative analysis. This is a difficult task as the results generated through a comparison of random samples may not be accurate if the samples lack a reasonable level of comparability. Different rules or institutions may be constrained or facilitated by different external factors, made up of different groups of market participants, and enforced by different authorities. Under such circumstances, the efficiency of one rule over another not might be because of the way it is adopted, but because of the extent to which it is enforced or the manner in which it interacts with the local context. All these variables complicate a proposed comparison. In order to make the comparison meaningful therefore, it is necessary to reduce the complexity to an acceptable degree.

The class voting scheme, implemented in two different contexts in China, is a

⁶ J. Coffee, 'The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control' (2001) 111 Yale Law Journal 5

suitable example. On the one hand, similar to its role in other jurisdictions, the class-voting scheme works as a complementary regime for shareholder class meetings, which are held in conditions where a class of shareholders' rights has been removed. The scheme takes a similar form to that in other legal regimes whilst also containing detailed differences. The class-voting regime can therefore be regarded as a formal convergence. On the other hand, it is employed to fulfil the function of minority protection. It therefore becomes a regime by which the minority shareholders can block majority shareholders' decisions on some of the companies' business affairs. A similar function in other jurisdictions is discharged by a general meeting with a super-majority approval. From this vantage, class-voting is implemented for the purpose of functional convergence. The nature of the class-voting regime alters between a sample of formal convergence and a sample of functional convergence in accordance with the different contexts in which it is applied. Additionally, no matter in which identity, its political, cultural and regulatory surroundings do not have any significant change. In both situations, the class-voting regime is enforced by the CSRC and courts, applied to the public company shareholders, and surrounded by same political and economic infrastructure. The only significant difference which can be identified is that the legal rules are proposed to have different function in a different context. This can be largely (if not completely) attributed to the approach by which the regime is introduced into the Chinese legal system.

The following parts will first introduce the general background against which the class voting scheme has been introduced. They will then provide more detail to clarify the situations in which the class-voting scheme constitutes a formal convergence, and those in which represents functional convergence. By comparing its practical effects in different situations, this part will go on to form the competitive advantages (if any) of the formal convergence in the Chinese context.

4.1.2.2 General Background

4.1.2.2.1 Split Shareholding under Concentrated Ownership Structure

Chapter II has highlighted that concentrated State-ownership in China triggers several serious problems.⁷ As such, reducing the State-ownership would be an effective way to mitigate existing problems. However, this reduction must overcome an institutional barrier; namely, the split shareholding structure. Up to 2005, the shareholding structure in the Chinese stock markets had been mixed. All shares are divided into three tiers, namely, State, legal person and A-table shares. Only A-table shares could be transferred to the general public. Generally, State shares are held by central and local governments, and State investment companies. Legal person shares are held by domestic companies, such as industrial enterprises, securities companies, trust and investment companies, banks, construction companies, transportation and power companies and research institutions.⁸ A-table shares are held by the individuals. Furthermore, State and legal person shares occupied nearly 70 per cent of all shareholdings of public companies before 2005. This meant that merely one-third of shares in Chinese publicly-held companies were transferable.⁹

4.1.2.2.2 Share-Trading Reform

In order to remove the institutional barrier to reducing State-ownership and to upgrade the liquidity of the Chinese stock markets, some steps have been taken by central government. In 2005, the CSRC and the other regulatory authorities published the *Notes on the Split Share Structure Reform of Listed Companies*, which formally launched a reform terminating the institutional restrictions on share trading.¹⁰

⁷ See section 2.3.2 above at 29-39

⁸ C.X. Shi 'Recent Ownership Reform and Control of Central State-owned Enterprises in China: Taking One Step At a Time' (2007) 30 University of New South Wales Law Journal 855

⁹ For a detailed introduction, see C. Jian, *Corporate Governance in China* (RoutledgeCurzon 2005) 28; J. Yang, 'Comparative Corporate Governance: Reforming Chinese Corporate Governance' (2005) 16(1) International Commercial and Company Law Review 12 and also C. Law and P. Wong, 'A Comparative Analysis of Corporate Governance between the UK and China' (2006) 16(9) International Commercial and Company Law Review 35

¹⁰ *Guanyu Shangshi Gongsi Guquan Fenzhi Shidian Gaige Youguan Wenti Tongzhi* [Notes on the Split Share Structure Reform of Listed Companies] issued by the CSRC on 29th April 2005

According to this regulation, both State shares and shares held by legal person are now transferable. However, unlike the rapid privatization approach adopted by Russia, China has undertaken a far more cautious approach. In order to protect the stability of its stock markets, State shareholdings authorised for transfer to the general public are limited by a mandatory freeze-out period.¹¹

4.1.2.3 Class Voting Scheme

4.1.2.3.1 Class Voting Scheme: A Theoretical Perspective

In order to clarify whether the class voting scheme is a formal convergence or a functional convergence in this situation, it is necessary to look at how the class voting regime works in most other jurisdictions. Maug and Yilmaz find that two-class voting is usually used where different classes of voters have significant conflicts of interest and where certain considerations mean that the voting power of one-class voters needs to be significantly strengthened.¹² In the context of company law, the application of class-voting is relatively narrow. As Davies illustrates,

Under the company's constitution the approval of a class of shareholders may be required to make a decision binding on the company, normally in addition to a decision of the shareholders generally... the principle of separate consent is well-established in relation to proposed alterations of the Articles where these alterations may affect the "rights" of a class of members.¹³

We can use an example to further unpack the rationale behind the class voting scheme. For example, shareholders who hold preference shares do not generally have

¹¹ *Shangshi Gongsu Jiechu Xianshou Cunliang Gufen Zhidao Yijian* [Guidance on Transferring the Converted Shares of the Listed Companies] issued by the CSRC on 20th April 2008

¹² E. Maug & B. Yilmaz, 'Two-class Voting: A Mechanism for Conflict Resolution' (2002) 92 *American Economic Review* 1448

¹³ P. Davies, *Gower and Davies's Principles of Modern Company Law* (8th edn, Sweet & Maxwell 2008) 664

voting rights. Instead, they often have a right to obtain a higher level of dividends. Here, if the class-voting scheme is absent, the alteration of non-voting shareholder rights would be a matter entirely for the voting shareholders.¹⁴ Obviously it would be unjust for voting shareholders to nullify non-voting shareholders' preference rights. Thus, it is necessary to entitle preference shareholders to veto a proposed change.¹⁵ Consequently the essence of the class-voting regime is to prevent an unjust arrangement between different classes of shareholders. In accordance with this normative analysis the following parts will explore the class voting scheme in the Chinese legal system.

4.1.2.3.2 Class voting as a Functional Convergence

Before the share trading reform is formally carried out, insider control continues to be a particularly serious problem amongst in the Chinese listed companies because of the concentrated ownership structure and the split share-transfer regime. Minority shareholder interests are under a serious threat of exploitation by controlling shareholders and incumbent managers.¹⁶ In 2004 the CSRC published the *Shareholder Protection Provisions*, which enabled transferable shareholders who hold A-table shares to have a stronger voice in the corporate decision-making process through a class voting regime. Under this regime, the shareholders who hold A-table shares are entitled to hold approval from several important corporate decisions as a separate class. The affairs which are subject to their approval include substantial corporate transactions, cash offers, right offers, convertible bond issues, substantial asset reorganization, subsidiaries which seek overseas listing and issues which have a

¹⁴ *ibid*

¹⁵ *ibid*

¹⁶ On this point see J.Q. Jun, 'Corporate Governance in China: From the Protection of Minority Shareholder Prospective' (2006) 2 Corporate Governance Law Review 312, as well as chapter II (section 2.3.2).

considerable bearing on public shareholder interests.¹⁷ The above corporate activities must be approved by at least two-thirds of all shareholders present at the meeting and at least two-thirds of A-table share vote holders participating in the vote, either by attending the shareholder's meeting or via an internet voting system.¹⁸ Additionally, in order to protect the fairness of the voting process, a disclosure requirement is imposed on listed companies. The decisions made by the top 10 transferable shareholders (by the amount of shareholding) on major corporate transactions must be disclosed.¹⁹

The purpose of this whole arrangement is to protect the interests of the holders of transferable shares. The split shareholding structure causes a conflict of interests between transferable shareholders and non-transferable shareholders. In particular, whilst non-transferable shareholders pay more attention to the companies' growth in a long term, transferable shareholders are more likely to focus on the price that their shares can realise in the short term. As a result, one group of shareholders will prefer corporate activities which promote the company's value on the balance sheet in the long run, whilst the other group would prefer those which can increase the share's market price immediately. The most likely result of this conflict is that different classes of shareholder will make different business decisions on the same corporate activity. Additionally, the concentrated ownership structure adds further complexity to this issue. Controlling shareholders (usually non-transferable shareholders) are generally the ultimate decision-makers at a general meeting, even in cases where a special resolution is applied. The split shareholding structure makes minority shareholder (usually holder of transferable shares) interests rarely convergent with that of the majority shareholders (usually holder of non-transferable shares). Furthermore, concentrated State-ownership means minority shareholders have little room to make

¹⁷ *Guanyu Jiaqiang Shehui Gongzhong Gudong Quanyi Baohu De Rougan Guiding* [Minority Shareholder Protection Provisions 2004] issued by the CSRC on 8th December 2004, art 1; see also, C. Xi, "Institutional Shareholder Activism in China: Law and Practice" (2006) 9 *International Company and Commercial Law Review* 251, 285

¹⁸ *Minority Shareholder Protection Provisions* (n16) art 1

¹⁹ *ibid*

their voices heard. Taking all these considerations into account, legislators appear to have attempted to change the imbalance in decision-making powers between transferable and non-transferable shareholders, through the introduction of class-voting regime.

Before examining the practical effects of the class-voting scheme, it will be necessary to address the reason why the class-voting regime can be regarded as an functional convergence. Research by a group of leading corporate lawyers and economists concludes that "all of our core jurisdictions fortify minority decision rights over fundamental corporate decisions by imposing supermajority approval requirements".²⁰ Taking the UK as an example, a general meeting with a special resolution will be applied for the purpose of protecting minority shareholders' voice. As Davies concludes,

Overall, the higher majority required for special resolutions obviously constitutes a form of minority protection...it means, for example, that a person with more than 25 per cent of the votes, and in practice often with many fewer votes, can block the adoption of a special resolution.²¹

However, Chinese policy-makers may consider a special resolution not to be strong enough to allow a shareholding minority to block majority shareholder decisions that threaten their interests. Thus, they employ the more powerful class voting scheme to guarantee that the minority shareholder voice will be strongly represented in the general meeting. In this context, unlike the class voting regime which will be triggered where a particular group of shareholder's right is negatively affected by a corporate decision in Western jurisdictions²², the minority shareholders in China can block majority shareholders' decision on key corporate affairs, even

²⁰ On this point, see R. R. Kraakman, and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 93

²¹ See P. Davies(n 13) 438

²² See 4.1.2.3.1 above

where their rights as holders of transferable shares are not or will not, be affected or prejudiced by the decision which the majority propose to take. It might therefore be evident why the class voting scheme can be categorised as functional convergence in this context. The next issue to be resolved therefore is whether this regime effectively solves or mitigates these problems when it works as a functional convergence.

Shou Lv Holding Co. (Shou Lv) was the first Chinese public company to hold a class-meeting to approve corporate affairs. In 2004, Shou Lv proposed the launch of a share-allocation scheme, which was an activity that had an "important bearing on minority shareholders' interest".²³ In accordance with the CSRC's regulations, a class-meeting was held. Additionally, an internet voting system was available to the minority shareholders. However, the holders of transferable shares who participated in the class meeting constituted only a 6 per cent holding of the nominal value of transferable shares. In another reported case, the participation ratio only achieved 5.6 per cent.²⁴ It is therefore difficult to conclude whether the results of class voting represent the transferable shareholders' interests as a whole. Theoretically, this phenomenon is understandable. Individual shareholders may have little incentive to participate in the decision-making process, as they generally own shares in several companies, and participating in the affairs of one will not typically be worthwhile.²⁵

Secondly, provided that policy-makers realise that issues of "rationale apathy" and "collective choice" may lead individual shareholders to take little part in the corporate decision-making process,²⁶ the main purpose of this rule is to encourage institutional shareholders, as the majority holders of transferable shares, to check and balance an insider's controlling power. However, there is much evidence to indicate that institutional shareholders are reluctant to protect transferable shareholder interests

²³ Y.L. Cheng 'Fenlei Biaoju v. Zhengji Daili Toupiao Quan' [Class Voting v. Proxy Voting] (2005) 2 Xin Caijing [The Investors] 88

²⁴ *ibid*

²⁵ See B. Cheffins, *Company Law Theory Structure and Operation* (Clarendon Press Oxford 2004) 62

²⁶ F. Easterbrook & D. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 66

as a whole by challenging a powerful majority's decision. For example, Chong Qing Bai Hou is a listed company seated in south-west China. In 2004, it proposed issuing additional shares to the general public. In accordance with the CSRC's regulations, such a proposal must be approved by the holders of transferable shares as a separate group. According to Chong Qing Bai Hou's announcement, a shareholder meeting was held. Among those shareholders who actually attended the meeting, non-transferable shareholders held 38 per cent of the company's total shareholdings and transferable shareholders held merely 1.4 per cent. Although those shareholders whose holdings occupied 98 per cent of the active shareholdings in the voting process cast their votes in support of the proposal, it was ultimately dismissed by the remaining 2 per cent of shareholders involved in the voting process. Worse; according to the statistics, most individual shareholders were in favour of the proposal because of the fact that it would have provided them with a pre-emptive right. Indeed, the proposal was ultimately rejected because of a veto cast by an investment company, which held 56 per cent of transferable shares in the company.²⁷ In other words, under the regulations, no matter what other shareholder preferences are, a proposal will be dismissed only if the majority shareholder of transferable shareholdings disapproves it. As such, the class voting regime can, in practice, worsen problems of majority shareholder control. Ironically, it attempts to control block-holder abuse by creating another block-holder. Whilst the policy-makers' intention was to protect minority shareholders, in effect the regime encourages institutional shareholders (usually the majority of the transferable shareholders) to act opportunistically, enabling them to become involved in the rent-seeking activities. Thus, in order to obtain extra benefits from controlling shareholders, they block corporate decisions that are in the best interests of shareholders as a whole.²⁸

The lack of *ex post* protection exacerbates this situation. Weak legal enforcement

²⁷ See X.N. Li, 'Chongqin Baihuo Fenlei Biaoju Zengfa Zao Foujue' [Chongqin Baihuo's Proposal of Issuing Additional Shares Has Been Dismissed by Class-voting] *Nanjing Ribao* [Nanjing Daily] (29th December 2004)

²⁸ E.g. Y.Q. Yin, 'Fenlei Biaoju: Ruhe Fangzhi Xinde Yigu Duda' [Class Voting: How to Control the New Version of 'Blockholder-Control'] *Zhengquan Shibao* [Securities Times] (5th December 2005)

enables block-holders to ignore individual and institutional shareholder voices, which might threaten their interests. There are several reports, which indicate that block-holders implement business decisions rejected by the institutional or individual shareholders in the class meeting.²⁹ Additionally, some of them even refuse to carry out class voting procedures in order to block transferable shareholders from having a voice. Consequently, class-voting is passive. It does not provide minority shareholders a voice as proposed but rather further complicates problems by creating a series of unexpected issues.

4.1.2.3.3. Class Voting as a Formal Convergence

As mentioned earlier, the CSRC launched the share trading reform in 2005. However, this reform encounters a technical problem. Individual shareholders, in stock markets with low liquidity, have to pay an extra premium in order to obtain transferable shares, because such shares are a resource of scarcity.³⁰ Following the share trading reform, the scarcity of transferable shares will be significantly diluted. In other words, lifting the ban on transferring non-transferable shares will dramatically increase the amount of transferable shares on the stock market. This will water down the price of shares (pre-reform A-table shares) held by individual shareholders and destroy the market confidence. For example, the state had sold off part of its non-transferable shares in listing companies in 2001. As a response to the government's plan to sell off its non-transferable shares at the market price, the Shanghai Composite Stock Index dropped dramatically by 32% within four months, which forced the CSRC to drop the plan.³¹ Furthermore, a contractual relationship between investors and companies can be traced back to their initial public offering. However, the terms/conditions of the prospectus indicate that State and legal person

²⁹ C. Xi (n 17) 258

³⁰ Recall that nearly 70 per cent of shares were not transferable to the general public in Chinese stock markets.

³¹ C. Xi, 'In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China' 2006 (22) Connecticut Journal of International Law 31

shares are not transferable.³²

Consequently, it is understandable that non-transferable shareholders should pay compensation to transferable shareholders in exchange for the transferability of their shares. In such circumstances, the class voting scheme plays a very important role in achieving a workable compromise between transferable and non-transferable shareholders. Under the CSRC's regulation, the board of directors should propose a compensation scheme and submit it to the general meeting. The proposed compensation scheme must be approved by at least two-thirds of all shareholders present at the meeting and at least two-thirds of A-table shareholders who participated in the vote, either by attending the shareholder's meeting or via the internet voting system.³³

In order to establish that this class voting scheme is a formal convergence, containing substantial components borrowed from Western legislation, it is necessary to map the core points of share trading reform:

- When individual shareholders paid higher premiums to purchase transferable shares from either public companies or other individuals, they entered an agreement with non-transferable shareholders, under which only shareholders holding A-table shares are entitled to transfer their shares freely.
- Several years later, non-transferable shareholders proposed an alteration of this agreement with transferable shareholders to enable their share to benefit from a full range of transferability.
- The bargaining power of A-table shareholders is far weaker than that of State

³² See F. Liu, M. Balatbat & R. Czernkowski, 'The Role of Consideration in China's Split Share Structure Reform', (10th October 2008) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1284067>, accessed 20th July 2011

³³ Minority Shareholder Protection Provisions (n 17) art.3 and 5

shareholders and legal person shareholders. They are unable to negotiate the terms/conditions of the prospectus with holders of non-transferable shares, when they enter into this contractual relationship.

The question of how a developed jurisdiction would proceed under these circumstances is raised. UK law's reaction may be illustrative on this point. Suppose a UK company has 100 shareholders. One of its shareholders pays 100 pounds to buy a preference share and 99 shareholders pay 1 pound per person to buy 99 ordinary shares. The company therefore consists of 99 ordinary shares valued 99 pounds and 1 preference share valued 100 pounds. It is assumed that the only difference between the preference share and the ordinary shares is that according to the Articles of Association, only the shareholder who holds preference shares can freely transfer his share to the general public, whilst the shareholders who hold ordinary shares have no right to do so. Later, the ordinary shareholders propose lifting the restriction on their shares by altering the Articles of Association. A dispute between preference shareholder and ordinary shareholders is very likely to arise here. The ordinary shareholder may argue that a special resolution should be applied, in accordance with s.21 (1) of the *Companies Act 2006*, which expressly states that a company may amend its Articles by special resolution. Moreover, the variation of ordinary shareholders' class right is not being altered in a manner adverse to them. Therefore, a variation of class right is not involved in this case and class voting is not therefore needed. If this argument is accepted, the proposed alteration will surely be approved by the ordinary shareholders who hold 99 per cent of voting rights. This makes the high premium paid for the preference right become meaningless. By contrast, the opinion of the preference shareholder will be different. He or she may argue that, although the preference right is not modified or abrogated by the proposed alternation, the economic value attached to the right is indeed adversely affected. They will surely request the convening of a class meeting under the s.630 of the *Companies Act 2006*. This section requires the consent of 75 per cent of shareholders who hold preference shares, at a separate class meeting, or consent in written form from the holders of at

least three quarters in nominal value of the issued shares of that class.

In UK common law, there are two cases similar to this hypothetical scenario; namely *White v Bristol Aeroplane Co*³⁴ and *Re: John Smith's Tadcaster Brewery Co.*³⁵ In both cases, ordinary shareholders wanted to issue themselves a bonus. However, the preference shareholder felt their right was "affected" by this proposal, as their voting power would be diluted, whilst the ordinary shareholder's power would be increased. A clause in the Articles of Association stated that a class meeting should convene where a class right is affected, modified, dealt with or abrogated. The Court of Appeal dismissed this claim. It held that the preference shareholder's right was not affected. This is because the right to one vote per share in certain circumstances remained as before and the subject being affected was the holder's enjoyment of the share. Therefore, the court would only uphold a preference shareholder's claim in conditions where more explicit wording is used, clarifying that the intention of the clause is to protect the right as well as the attached economic interests.³⁶ The situation in these two cases holds some similarities with the hypothetical case outlined above. Although the preference right is not modified or removed, the interests or powers attached to the right are affected. Overall, under UK case law, the decision of the court largely depends on the terms of the Article of Association. In the hypothetical case, therefore a preference shareholder's claim could be upheld by the UK court, if the clause in the Articles use precise wording to state that the alteration has to be approved by the class meeting where either the class right or the attached economic interests are adversely affected.

The above highlights additional conditions that can be taken into consideration in the Chinese context. Unlike the above UK cases, in the context of Chinese share-unification reform, the bargaining power between parties is not equal. Individual shareholders are unable to amend the terms/conditions of the prospectus of

³⁴ [1953] Ch.65, (Court of Appeal)

³⁵ [1953] Ch.308, (Court of Appeal)

³⁶ P. Davies (n 13) 670

listed companies. Therefore, even if the holders of non-transferable shares have a strong desire to add a clause protecting their class rights and the attached economic interests, they do not have power to do so. Furthermore, in an economic sense, an A-table shareholder is the weaker party, compared to the State and legal person shareholders. Thus, it seems fair for the CSRC to interpret the contractual relationship between transferable shareholders and non-transferable shareholders in favour of the former.

In essence, there is no significant difference between the class voting regime in Chinese share trading reform and its counterpart in UK common law and statute. Both regimes entitle shareholders with preference shares to protect their interests by bargaining with the other class of shareholders, when their class rights or the interests attached to those rights are subject to variation. However, the shareholder class voting regime adopted by the CSRC contains some detailed differences from that in UK law. Firstly, the variation of a class right in China is defined in a broader sense, including the affected right and attached economic interests. UK common law, by contrast, defines it narrowly. Secondly, in order to enhance transparency, majority shareholders are subject to stricter disclosure requirements in China.³⁷ Thirdly, the class-voting regime can be applied to both public and private companies under UK company law. However, in China, this regime is mainly designed for public companies involved in the share reform project. All in all, in the context of share-trading reform, the class-voting regime can be categorised as an example of the formal convergence model.

With regard to its practical effects, according to empirical research, the average participation ratio of the holders of transferable shares is 33.49 per cent and with standard deviation 12.12 per cent. The participation ratio and support rates from the

³⁷ Under the CSRC's regulation, shareholders who hold more than 5 per cent of non-transferable shares bear special disclosure duties. They have a responsibility to disclose the precise amount of their shareholding in the prospectus of share-trading reform. See *Shangshi Gongsi Guquan Fenzhi Gaige Guanli Banfa* [Regulation of Public Companies' Share-trading Reform] art. 32 (2005)

holders of freely traded shares rationally increase with the size of compensations which indicates the wealth effect of the proposal. This empirical research is based on the official data issued by CCER (China Center for Economic Research). These data consist of 1326 firms which were undergoing the process of unification of shareholding reform in 2008. In 1231 firms, the compensation has been paid to holders of transferable shares. 40 firms have approved the compensation proposal in ballots. Compensation proposals from 9 firms were rejected.³⁸

This ratio is significantly higher than the ratio of participation where class-voting is adopted as a functional convergence.³⁹ It seems that transferable shareholders have a stronger incentive to participate in class-voting in share-trading reform. Additionally, the performance of institutional shareholders is more competent in this context. According to a recent study, in share-trading reform, compensation value tends to be higher when institutional shareholders hold a large percentage of tradable shares.⁴⁰ This suggests that the voting results are more likely to represent minority shareholders' interests as a whole. More importantly, the class-voting regime fulfils its task by providing crucial technical support to share trading reform. As Lu, Balatbat & Czernkowski state,

in particular, our results indicate that individual company arrangements for implementing the reform were (at worst) not harmful of the interests of minority shareholders. This may enhance the confidence of market participants that the Chinese authorities will not lightly make changes which disadvantage public investors.⁴¹

³⁸ W.X. Hou 'Two Class Shareholder Voting in the Split Share Structure Reform' (ESRC Corporate Governance Seminar, Queen's University, Belfast, April 2008) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1328445>, accessed 20th July 2011

³⁹ Y.L. Cheng (n 23)

⁴⁰ L. Liao, M. J. Shi & H. Wang, 'The Value of Shareholder Activism: New Evidence from the Split-share Structure Reform in China' (December 15th 2008) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1316214> accessed 20th July 2011

⁴¹ F. Liu, M. Balatbat & R. Czernkowski (n 32) 2

Until April 2007, over 1290 public companies had either completed or were within the process of share-trading reform. These figures were comprised of over 98 per cent of the market capital of the combined Shanghai and Shengzhen Stock Exchanges.⁴² This is by no means to say that the class voting scheme works perfectly in share trading reform. Indeed, it actually means that some institutional shareholders engage in rent-seeking during the class-voting process.⁴³ It has nevertheless worked as expected in eliminating a core institutional barrier that has thus far served to block public companies from dispersing their over-concentrated ownership structure.

To conclude, the class voting is a competent regime, when it combines Western legal rules and local resources. In contrast, it does not fulfil the task intended by legislators, when it is implemented for the purpose of functional convergence. This conclusion significantly diverges from the assumption that functional convergence is the better model for the legal reform of the Chinese corporate governance.

4.1.3. Case Study II: Limitation on Company's Investment Ability

Another important example which illustrates the problematic aspects of functional convergence is the limitation imposed on a company's ability to invest in another corporate entity, as part of the legal doctrine enshrined in China's 1993 Company Law. This provision bears a function of protecting minority shareholder and creditor in China. This example is weaker than the one above. It does not provide a comprehensive comparative investigation between formal convergence and functional convergence. Therefore, it is not able to illustrate the competing advantages of the formal convergence model. However, it nevertheless highlights the drawbacks of functional convergence, illustrated in the first case study.

⁴² 'Hushen Liangshi Wancheng Huo Jinru Gugai Chengxu Gongsi Shizhi Yida 98%' [Companies Involved in the Share-trading Reform Occupy 98 per cent of the Market Capitalization of Shanghai and Shenzheng Stock-exchanges] *Sohu Caijing* [Sohu Finance] (27th April 2007) <<http://business.sohu.com/20070427/n249727979.shtml>> accessed 20th July 2011

⁴³ J.Z. Huang 'Jijin Zai Gugai Zhong De Xunzu Zhi Shou' [The Rent-Seeking Activities of Institutional Shareholders] (2006) 6 Jinji [Economy] 62, 67

A developed jurisdiction which is oriented around a market economy does not protect minority shareholder and creditor interests by restricting a company's ability to invest in another corporate entity. This is because this approach is not only awkward but harmful. It deters the expansion of corporate groups and stifles the effective allocation of economic resources among companies. Large-scale corporate groups play an important role in the national economy and even in people's lives in developed countries. As one US commentator states:

huge concentrations of private capital continue to wield extraordinary power over decisions crucial to the lives of all Americans, decisions on rates and directions of investment, the harvest and use of resources, the development and deployment of technology, and the control and management of work and workplaces, to name a few.⁴⁴

Except in some extreme conditions, developed jurisdictions rarely set out a compulsory limitation on a company's ability to invest in other corporate entities.⁴⁵ Instead of using this clumsy approach, the court can lift the "veil" between a parent company and its subsidiary to protect creditor's right in appropriate circumstances. This places more demanding duties on both corporate groups and their decision-makers.

In the UK, "limited liability" and "separate personality" are two fundamental principles of the company law system. However, like many other developed jurisdictions, the corporate veil can be lifted in appropriate circumstances. "Lifting the corporate veil" refers to "the possibility of looking behind the company framework to make the members liable, as an exception to the rule that they are normally shielded

⁴⁴ M. Harper, 'Bodies Politic: The Progressive History of Organizational Real Entity Theory' (1989) 50 University of Pittsburg Law Review 639

⁴⁵ S. 136 of the UK Companies Act 2006 prohibits cross-holding, a phenomenon in which a company holds shares in its holding company.

by the corporate shell".⁴⁶ According to Davies, there are at least four tests for lifting corporate veil in the common law system. These include the "sham or facade test", the "single economic unit test", "interests of justice test" and "impropriety test".⁴⁷ In respect of the corporate group, there is a general principle that if it can be shown that a subsidiary acts as the agent of its parent, then, on ordinary agency principles, liability will attach to the parent as principal.⁴⁸ For example, in *Re FG (Films) Ltd*⁴⁹, the applicant company sought to register the film "Monsoon" as a British film, and made a declaration that it was the maker of the film. The application was refused by the Board of Trade on the grounds that the film had been made by a large American Company. Under the contract between the applicant and the American company, finance and all the necessary facilities were provided by the American company. In this case, Vaisey J case found that "their participation in any such undertaking was so small as to be practically negligible, and that they acted, in so far as they acted at all in the manner merely as the nominee of and agent for an American company called Film Group Incorporated..."

Furthermore, if the only intention behind an individual or a company forming a subsidiary is to use it as a device to perpetrate fraud, the UK court can deny the independent personality of the subsidiary. Case law confirms that the corporate veil can be lifted, where the corporate entity is merely a device or mask. In *Jones v. Lipman*,⁵⁰ the defendant entered into a contract to sell a land to the plaintiff. However, in order to avoid the contractual obligations owed to the plaintiff, the defendant sold the land to a company rather than the plaintiff. The company which obtained the land was substantially controlled by the defendant. The Court of Appeal held that "the creature of the first defendant, a device and a sham, a mask which he holds before his

⁴⁶ L. Sealy & S. Worthington, *Sealy's Cases and Materials in Company Law* (9th edn, Oxford University Press 2010) 53

⁴⁷ P. Davies (n 13) 203-206

⁴⁸ E. Ferran, *Principles of Corporate Finance Law* (2nd edn, Oxford University Press 2008) 37

⁴⁹ [1953] 1 WLR 483

⁵⁰ [1962] 1WLR 832

face in an attempt to avoid recognition by the eye of equity."⁵¹ However, this doctrine becomes more complicated in the context of corporate groups. Davies makes following comments on *Adams v Cape Industries Plc*

the court felt that it was "left with rather sparse guidance as to the principles which should guide the court in determining whether or not the arrangements of a corporate group involve a facade..." but, unfortunately, it declined to "attempt a comprehensive definition of those principles."⁵²

In addition to the doctrine of "lifting the corporate veil", the corporate group bears demanding disclosure duties in the UK. The principle is that "the parent company must present group financial statements as well as its own individual statement, thus avoiding the misleading impression which the latter alone might give."⁵³ The corporate group's financial report must present a "fair and true" view. Section 399 of the *Companies Act 2006* imposes a duty to the directors of the parent company. The parent company is responsible for presenting a consolidated balance sheet and profit and loss account to general public, in order to avoid the misleading information. Furthermore, the directors of a parent company are also responsible for preparing individual financial reports for the parent company. Similarly, the directors of subsidiaries must also prepare individual financial reports.⁵⁴ In order to protecting creditors, the individual and consolidated accounts in the same group must be presented within same financial reporting framework.

By contrast, China's 1993 Company Law does not adopt the doctrines of "lifting

⁵¹ *ibid*

⁵² P. Davies (n 13) 204 and also see *Adams v Cape Industries Plc* [1990] Ch 433, (Court of Appeal)

⁵³ P. Davies (n 13) 233

⁵⁴ P. Davies (n 13) 709

corporate veil" or use a consolidated financial reporting regime.⁵⁵ Instead, it launches a mandatory limitation on a corporate group's expansion, which can be regarded as a low-cost substitute for these advanced corporate law doctrines. Article 12 of the law says that where a company which invests in other corporate entity, the amount of its investment shall not exceed 50 per cent of its net assets. Furthermore, this rule is not applicable to investment companies and holding companies listed by the State Council.

China's 1993 Company Law inherits this doctrine from its 1929 company law, which was issued by the government of the former republic. Its provisions come from China's local knowledge. Article 11 of the 1929 company law states that a limited liability company's investment in another corporate entity should not exceed 25 per cent of its registered capital. This limitation on a company's investment ability manifests ideological considerations. In 1911, the Qing Dynasty was replaced by a republican nation. Sun Zhongshan, the leader of the revolutionaries, believed that private capital should not play an important role in key sectors of the national industry. One of the important components of his political programme was called "controlling the development of private capital" (*jie zhi zi ben*).⁵⁶ He once said that "Bank, railway and land, all the key sources of productivity should be owned and controlled by the government for the purpose of prohibiting private capital manipulating the national welfare and people's livelihood."⁵⁷ In Sun's political utopia, by limiting private capital and expanding public ownership, the working class will gain an equal opportunity of obtaining wealth. This belief was also written into the Nationalist Party's Manifesto issued in 1924. Here, it was written that

⁵⁵ A consolidated financial reporting regime was introduced into the legal system by the Ministry of Finance in 1995; see *'Bebing Kuaiji Baobiao Zhanxing Guiding'* [Provisions regarding Consolidating Financial Reports]. This administrative regulation was updated in 2005; see *'Qiyee Kuaiji Zhunze 33 Bao: Hebing Caiwu Baobiao'* [Provision regarding Company Accounting Standard No.33: Consolidating Financial Reports] issued by the Ministry of Finance

⁵⁶ J.H. Liu, *Xin Gongsi Fa De Zhidu Chuangxin: Lifu Zhengdian Yu Jieshi Nandian* [Institutional Innovation of New Corporate Law: Legislative and Judicial Controversies] (Falv Chuban She 2006) [Law Press China 2006] 37

⁵⁷ See Z.S. Sun, *Jianguo Fanglue* [The Way of Establishing a Republic Nation] (Huawen Chubanshe 1919) [Huawen Press 1919] 103

all large-scale of national industries, which belong to the Chinese people as a whole, should be run by the government...this can balance the interests between the class of capitalist and the class of industry workers...and achieving a harmonious economic development.⁵⁸

Following Sun's political beliefs, it is understandable that the limitations on a company's ability to invest were instigated by a desire to control the expansion of private capitalism.

However, this doctrine was misunderstood by PRC legislators, when drafting the 1993 Company Law. They wrongfully assumed that the limitation on a company's investment in another corporate entity was a "capital maintenance" principle, aimed at protecting company minority shareholders' and creditors' interests.⁵⁹ The logic behind this assumption is that, a company's net assets on its balance sheet are an important criterion by which a creditor can assess a company's ability to perform. By investing in other corporate entities, a company can reduce the transparency of its capitalization by blurring the lines between the assets of group members.⁶⁰ As a result, through this kind of investment, it can show a strong financial ability to perform contracts, which does not match its capitalization. For example, the registered capital of company A is 300,000 RMB. Company A and then invests 200,000 RMB in forming two subsidiaries, namely company B and company C. Each of these subsidiaries has 100,000 RMB. Through these investments, company A's capital on the consolidated balance sheet increases to 500,000 RMB (company A's registered capital 300,000 RMB plus company B's registered capital 100,000 RMB plus company C's registered capital 100,000 RMB), despite the fact that there is no substantial change in company A's structure of capitalization. Without proper disclosure, the manipulation of

⁵⁸ Nationalist Party's Manifesto 1924 <<http://www.hoplite.cn/templates/smzywsg0021.html>> accessed 20th July 2011

⁵⁹ J.H. Liu, (n 56) 39

⁶⁰ E. Bicker, 'Creditor Protection in the Corporate Group', Working Paper Series, (July 2006) <<http://ssrn.com/abstract=920472>> 2 accessed 20th July 2011

financial reports may lead a party who intends to enter into a contractual relationship with this company to misjudge the company's ability for contract performance. A company's investment in another corporate entity also increases transaction costs for the creditors.⁶¹ Furthermore, a company's investment in another corporate entity, especially when forming a wholly-controlled subsidiary, enables the company to use that subsidiary as a device to circumvent law, avoid contractual obligations or externalise commercial risks. Moreover, the limitation on investment is also deemed to be a key instrument in preventing officials from misappropriating State assets. For example, a government-appointed corporate officer could appropriate State-assets by investing the capital of a SOE to a special purpose entity run by himself or his relatives.⁶² The above problems are controlled by the 1993 Company Law through a legal arrangement, which constrains the expansion of the corporate group. However, similar problems are dealt with by more sophisticated legal rules in other developed jurisdictions. The manipulation of company's balance sheet or the committal of other fraud by setting up a "façade subsidiary" can be constrained by the doctrine of "lifting the corporate veil" and the "consolidated disclosure requirement". Furthermore, well-designed director's duties can tackle the problem of corporate officer misappropriation.

Now that Chinese companies are deeply involved in the global competitive market, the limitation on company investment ability set out by Article 12 of the 1993 Company Law places these companies at a disadvantage. The experience of developed economies shows that the organization and accumulation of private capital is important for economic development. It is therefore unwise for Chinese company law to adhere to a legal rule which makes domestic companies lose their international competitiveness. Unsurprisingly, this limitation on a company's ability to invest in another corporate entity was abolished by the 2005 Company Law. It seems the newly-implemented legal rules have adopted the experience of Western legal systems.

⁶¹ J.H. Liu (n 56) 40

⁶² *ibid*

The doctrine of "lifting corporate veil" has been implemented in order to prohibit the fraudulent raising of capital.⁶³ Additionally, refined director's duties of loyalty serve to prevent directors from misappropriating companies' assets through improper investment. Article 20 of the Company Law 2005 states that

The shareholders of a company shall exercise their shareholders' rights in compliance with laws, administrative rules and regulations as well as the articles of association of the company; shall not abuse their shareholders' rights to injure the interests of the company or other shareholders, or take advantage of the company's independent personality or the limited liability of shareholders to injure the interests of the company's creditors. Where the abuse of shareholders' rights causes any loss to the company or other shareholders, the shareholder shall be liable for compensation in accordance with the law. Where shareholders of a company take advantage of the company's independent personality or the limited liability of shareholders to disregard debts and seriously injure the interests of the company's creditors, such shareholders shall bear joint and several liability for the debts of the company.

In addition to the "piercing the corporate veil" doctrine, Article 149 of the company law imposes more demanding duties on corporate directors.⁶⁴ Consequently, the legal rule based on functional convergence is replaced by a set of more refined formal convergence rules.

4.1.4 Generalizing the Competitive Advantages of the Formal Convergence Model

4.1.4.1 Support from Western Experience

⁶³ For a general introduction to the doctrine of "piercing the corporate veil" in company law in 2005, see M. Wu, 'Piercing China's Corporate Veil: Open Questions from the New Company Law' (2007) 117 Yale Law Journal 329

⁶⁴ For the reform of director's duty of loyalty, see Chapter V below.

Why does the Western experience bear such a level of importance for the legal reform of corporate governance in China? The answer is two-fold. Firstly, at least in the field of company law reform, rules or institutions without the support of Western legislative guidance might be of a nature that has difficulty in fitting in with the Chinese context. At the first glance, this argument seems counter-intuitive. This is because the standard claim is that the mismatch between Chinese characteristics and Western experience is usually caused by transplanted rules. The following part will further explore this argument through the insights provided by two case studies. In the first case study, the ownership structure of Chinese public companies is split and over-concentrated. Policy-makers attempt to enact rules, which meet the demand of minority shareholders under a distorted ownership structure. The principal problem of this approach is that it has a one-sided focus on Chinese characteristics, whilst ignoring general features, which China's local context shares with Western jurisdictions. The ownership structure of Chinese public companies has idiosyncrasies, but an individual shareholder's behavioural philosophy is not idiosyncratic in China. As Anabtawi & Stout argue, "from an economic perspective, the cost of trying to influence corporate policy has typically outweighed the individual value of any single shareholder's interest, leaving dispersed shareholders in public companies 'rationally apathetic'."⁶⁵ The Chinese minority shareholders, similar to investors in developed jurisdictions, rationally invest their time and effort into the projects which have great potential to maximise the profits of their investment.⁶⁶ Corporate activities such as related-party transactions and the substantial asset reorganization which are likely to have uncertain results will find it difficult to attract the participation of transferable shareholders (usually portfolio shareholders). Thus, the class voting regime may meet the regulatory demands made by an over-concentrated ownership structure in the stock market, but conflicts with individual shareholders' behavioural philosophy.

⁶⁵ I. Anabtawi & L. Stout, 'Fiduciary Duties for Activist Shareholders' (2008) 60 Stanford Law Review 1255, 1257

⁶⁶ As Jensen & Meckling state, "whether they are politicians, managers, academics, professionals, philanthropist, or factory worker, individuals are resourceful, evaluative maximizers"; Jensen & Meckling, 'The Nature of Man' (1994) 7 Journal of Applied Corporate Finance 4

Since the main purpose of this regime is to protect minority property rights by enhancing their voice in the decision-making process, failing to motivate minority participation makes this regime meaningless.

Additionally, "shareholder democracy" in modern company law requires shareholder voting and cash-flow rights to be proportionate. According to this rule, a majority shareholder enters into a company with the expectation that his or her voting power should be stronger than that of minority shareholders. It is undeniable that the former owns a larger per cent of residual interests in a company than the latter. Majority shareholders are therefore having greater incentives to maximise company profit. Davies points out that where voting and cash-flow rights are not proportionate, there is a risk that

controlling shareholders (controlling in terms of votes rather than capital committed to the company) will take excessive risks with the company's business at the expense of non-controlling shareholders, who may be the majority contributors to the company's capital. This is because controlling shareholders do not bear a proportionate part of the risks if a strategy is unsuccessful.⁶⁷

As with public companies in Western jurisdictions, the capital of Chinese public companies is mainly contributed by majority shareholders rather than minority shareholders. Under such conditions, giving overwhelming voting power to minority shareholders gives rise to the risks associated with a disproportion between voting right and cash-flow right. Majority capital investors face excessive challenges and undertake unreasonable costs when trying to maximise their investments by engaging in certain business activities. This includes the risk that the minority uses its power to block the majority from undertaking reasonable and justified measures unless they are

⁶⁷ P. Davies (n 13) 413

paid off.⁶⁸ As a result, controlling shareholders have strong incentives to avoid the class-voting regime. Moreover, there has long been argued that the direct participation of minority shareholders in corporate decision-making reduces shareholder value. This is because minority shareholders lack either the requisite knowledge or expertise to make effective decisions.⁶⁹ Finally, over-concentrated ownership and the split shareholding structure of many corporate entities are of a nature that is characteristic of a strong planned economy. As mentioned above, some steps have been taken to disperse ownership and unify the split shareholding structure.⁷⁰ Therefore, there is little point in introducing rules or institutions to meet the special needs arising out of these economic characteristics, which will be significantly altered, if not wholly removed by such reform efforts.

By contrast, a class voting regime under a share-trading reform is more suitable to the local context. By adopting Western legal rules, it sets out good incentives, which motivate market participant compliance. Indeed, it is understandable that the individual and even institutional shareholders would have greater incentives to participate in class voting under share trading reform. This is because compared with other corporate activities, the compensation schemes which usually propose a free share-allocation to the holders of transferable shares are very likely to bring direct benefits to them.⁷¹

The second case study also illustrates the mismatch between the local context and the functional convergence rule. The functional convergence rule places a mandatory limitation on a company's investment ability, which does not provide institutional support for the development of large corporate groups. Unlike the

⁶⁸ D. Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 Delaware Journal of Corporate Law 125, 144

⁶⁹ S. Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2005) 118 Harvard Law Review 1735

⁷⁰ See above at section 4.1.2.2.2, 76-77

⁷¹ As empirical research has indicated, the participation ratio and the support rates from holders of transferable shares rationally increase with the size of compensation. See L. Xiao, 'Guquan Fenzhi Gaige De Jingjixue Yanjiu' [Shareholding Reform in China: An Economic Analysis], (2008) 10 Shanghai Jingji Yanjiu [Shanghai Journal of Economic Study] 98

mismatch in the first case study, this one is a result of an under-developed legislative methodology. It is driven by the belief that the best way of solving problems is through the application of a mandatory rule, and that the primary purpose of company law is to control corporate behaviour rather than to facilitate it. As Clarke argues, "the [Chinese] Company Law is clearly concerned more with regulating and suppressing than with fostering and nurturing."⁷²

Furthermore, it deliberately ensures unfair treatment as between a private company and large-scale State company. The law states that the limitation cannot be applied to companies on a list provided by the State Council. Both the mandatory limitation on company's investment and the bias against companies without a State background manifest planned economy characteristics. These characteristics mean that this legal rule cannot provide adequate support for a market economy system. In particular, whilst preventing a corporate entity from manipulating its financial report by creating a façade subsidiary is essential, it is economically inefficient to achieve this purpose at the expense of the development of private corporate groups. The functional convergence rule thus seems to be incapable of supporting China's domestic companies to survive in the face of intensive international competition. Although the newly-adopted rules through formal convergence (e.g. lifting the corporate veil and director's duties) have not undergone much testing to prove their effectiveness, they show a significant methodological movement from planned economy based legislation towards market economy based legislation.

Consequently, we should accept that the insights provided by the two case studies are limited. As many studies have indicated, rules or institutions that are transplanted have a strong tension with the existing institutional infrastructure. These two case studies are not adequate to prove that the formal convergence model is a better choice than the functional convergence model in relation to every aspect of China's legal reform of corporate governance. Rather, the results warn us that

⁷² D. Clarke, 'Corporate Governance in China: An overview' (2003) 14 China Economic Review 496

although the socio-economic context and the legal infrastructure surrounding corporate governance in China have their unique characteristics, they do share some important generalities with their Western counterparts.

Secondly, as noted above, Chinese legislation generally suffers from a problem of ambiguity. In light of this, guidance from Western legislation is an important resource, which can help to bridge the gap between "law on paper" and "law in practice" in China. However, when such guidance is absent, the poorly drafted rules can become unworkable in a technical sense. In the case of the class-voting regime, its ambiguous wording is widely criticised by lawyers.⁷³ For example, it contains a catch-all provision, which states that "all activities which have important bearing on the minority shareholders' interests should be subject to the approval by transferable shareholders". However, the law does not define the meaning of "important bearing" or provide any workable standard by which it can be assessed.⁷⁴ The same problem is well illustrated by the second case study. Many Chinese lawyers argue that the limitation on a company's ability to invest is technically implausible.⁷⁵ Firstly, it is unclear that how the term "investment" should be defined. Generally, a company can invest in another corporate entity by lending money or acquiring shares. Investment by lending is less harmful than investment through share-holding in respect of protecting minority shareholder and creditor interests, especially where the borrower provides a guarantee to the lender. It is therefore problematic to place same limitation on investment through lending. Secondly, a company's net assets are continuously changing. Consequently, the law should clarify how to calculate a company's net assets, when it makes an investment in another corporate entity. For example, company A's net asset in July is 300,000 yuan. It invests 160,000 yuan in company B. Several months later, company A invests another 100,000 yuan in company B, and A's net assets at that time increase to 800,000 yuan through doing other business activities. This scenario presents an interesting issue regarding how to define "net assets" in this

⁷³ C. Xi (n 17) 285

⁷⁴ *ibid*

⁷⁵ J.H Liu (n 56) 42

legal doctrine. According to the 1993 Company Law, company A's initial investment would be illegal, as it exceeds 50 per cent of the company's net assets. However, the parent company's net assets are damastically increased with the development of the corporate group at the time that it makes the second investment. In this case, whether the company's investment behaviour is illegal depends on which net asset value on the balance sheet is investigated by the authority. More percisely, the law should clarify whether when a company makes multiple-investments during a certain period, the "net assets" in the legal provsion indicate the "net assets" of company's initial investment, or that of company's subsequent investment, or indeed the average amount of "net assets" in company's total investments in the other corporate entity during this period. Without clarifying this concept, this provison is not workable in complex cases. Thirdly, the law stays silent on what sanctions will be placed on a company that breaks this rule. The 1993 law confirms that companies have independent personality.⁷⁶ According to this doctrine, when a subsidiary is formed through a parent company's investment which exceeds the 50 per cent net asset limtation, there is no solid basis on which to suspend the subsidiary's corporate identity, as the parent company's legal liability does not extend to its subsidiary.

It might be argued that, many rules which are transplanted from Western jurisdictions are poorly drafted and lack supportive interpretations. Therefore, poor legislative quality is a universal problem in China's legislation rather than a problem specific only to rules that are adopted through functional convergence. However, we should note that there is a considerable difference in evolution between functional convergence rules and formal convergence rules in China. Although legal rules adopted through the formal convergence model suffers from problems of ambiguity, there is still room for improvement. Firstly, such rules can be developed from bottom to top. If a rule or institution is transplanted from Western jurisdictions and poorly drafted, legal end-users, including judges, lawyers and market participants could

⁷⁶ See Company Law of the People's Republic of China, article 3 (1993) <<http://www.cpasz.net/xzfg/3xzfggsf01.htm>> accessed 20th July 2011

engage in self-help. They can formulate a general understanding of such legal provisions by researching relevant Western legislation in this area. Take institution of independent director as an example. In CNKI⁷⁷ database, a search of the journal articles which include the term of "independent director" in their titles hits 2542 results (during 2002 to 2008).⁷⁸ In the same database, a search of the journal articles which include both of "independent director" and a major foreign jurisdiction⁷⁹ in their titles hits 1736 results totally (during 2002 to 2008).⁸⁰ The number of each jurisdiction mentioned by the titles of articles is as follows:

Jurisdictions mentioned by articles' title	Number of results
The US (Mei Guo)	1241
The UK (Ying Guo)	245
German (De Guo)	187
Japan (Ri Ben)	63

These figures illustrate that the Chinese scholars and legal end-users made great efforts in localizing the institution of independent director through researching useful guidance from foreign experience. The policy-maker in practice has made responses to legal end-users' claims from the bottom by consistently updating the regulations.

Years	The Complementary Administrative Regulation	Rules related to Independent Director
2004	<i>Shareholder Protection Provisions 2004</i>	6 articles related to independent director

⁷⁷ China Knowledge Resource Integrated Database (CNKI) is the largest Chinese academic electronic database. It includes articles published in leading Chinese academic journals, newspapers and conferences presentations. For English introduction, see <<http://eng.cnki.net/grid2008/index.htm>>, accessed 20th July 2011

⁷⁸ This search is premised on the reasonable assumption that articles those titles include reference to "independent director" predominantly discuss the institution of independent directors in their content.

⁷⁹ Four major jurisdictions were used in testing the bottom to top reform of "independent director". These are US, UK, Germany and Japan.

⁸⁰ This search is premised on the reasonable assumption that articles those titles include reference to both the term "independent director" and a foreign jurisdiction discuss the independent director from a comparative perspective.

2006	<i>Corporate Governance Guidance 2006</i>	3 articles related to independent directors
2007	<i>Independent Directors Provisions</i> ⁸¹ (still in the drafting process)	48 articles related to independent directors

Furthermore, Liebman's recent empirical research has already shows that when Chinese judges hear difficult cases, they routinely research how similar such case has been dealt with in developed jurisdictions for guidance.⁸² In practice, Western law and jurisprudence assists judges and lawyers to localise transplanted legal rules. For example, the experience of US securities litigation plays a vital role in the Chinese judicial practice. In *Basic v. Levinson*,⁸³ the US Supreme Court adopted the "fraud-on-the-market" theory to deal with the "systemic risk defence" in litigation relating to corporate misrepresentation.⁸⁴ This US approach is appropriately used by Chinese local courts to solve problems in Chinese securities litigation.

Secondly, a "top to bottom" evolution might also be expected where Western experience is accessible. The Chinese Supreme Court encourages judges to widen their horizons by learning from foreign legal theory. For example, the Supreme Court recently issued a series of Official Interpretations (hereinafter *Interpretations*) of the 2005 company law.⁸⁵ It also published guidance to assist judges in understanding and applying these *Interpretations*. This guidance explores every article of the *Interpretations* through three dimensions; namely background, relevant foreign legal

⁸¹ *Shangshi Gongsu Duli Dongshi Tiaoli Zhengzai Zhiding* [Independent Directors Provisions Is in Drafting Process] *Zhongguo Zhengquan Bao* [China Securities News] 11th December 2006

⁸² B. Liebman & T. Wu, 'China's Network Justice' (2007) 257 *Chicago Journal of International Law* 257, 290

⁸³ 485 U.S. 224 (1988) (Supreme Court of the United States)

⁸⁴ See C. Xi, 'Case Note: Private Enforcement of Securities Law in China: Daqing Lianyi co v ZHONG Weida and Others Hei Longjiang High Court' (2006) 1:2 *Journal of Comparative Law* 492, 496 and C.G. Yan, '*Zhongguo Gushi Xujia Chenshu Diyi An: Quanmian Tiaojie Jian*' [The Settlement of the First Misrepresentation Case in China's Judiciary Practice] (2008) 4 *Zhongguo Shenpan* [China Trial] 39

⁸⁵ *Zuigao Renming Fayuan Guanyu Shiyong Zhonghuarenminggongheguo Gongsifa Rougan Wenti de Guiding (I&II)* [Supreme Court's Judicial Interpretations on China's Company Law 2005 I & II] Chinese text is available at <http://www.chinacourt.org/flwk/show1.php?file_id=109879> accessed 20th July 2011

theories and judicial practice. In relation to the first two dimensions, many important Anglo-American legal theories and legislative provisions are employed to explain the rationale behind the articles of the *Interpretations*. For example, in the chapter entitled "Deadlocked Companies", a substantial amount of Western legal theory including relevant legislation and legal concepts from the UK *Company Act 1985*, Delaware corporate law and the Japanese Commercial Code are introduced to Chinese judges.⁸⁶ Although the Supreme Court does not explicitly declare that Chinese judges can directly use these foreign legal doctrines in their daily practice, it expects that advanced foreign jurisprudence to provoke judicial thought so as to develop a feasible solution to demanding cases in practice.

By contrast, rules adopted as functional convergence do not usually undergo a "bottom to top" or "top to bottom" process of evolution. As a result of under-developed legislative skill, both of case studies indicate that the rules are difficult to apply in practice. In turn, the unworkable rules neither provide much practical feedback to legislators, nor are they supported by Western experience. Thus two major channels precipitating improvement are blocked. Unsurprisingly, they are eventually replaced by more sophisticated transplanted rules, when the law is reformed. Consequently, at least in the field of company law, the guidance of Western jurisprudence and law provides important support to legal end-users in understanding and to localizing the ambiguous legal rules of Chinese company law.

4.1.4.2 Complementarities

Many argue that the cross-reference of corporate governance rules from different systems encounters structural problems. As Gilson notes in his literature:

Changing the form of an institution, in order to enhance its own efficiency in response to changing economic conditions, initially may result in a reduction, not

⁸⁶ *ibid* 109-117

an increase, in overall system productivity.... The new form may not be complementary to the other institutions that make up the system, which can result in a reduction in the performance of even those institutions whose form remains unchanged.⁸⁷

A large number of Western legal rules have already been transplanted into the Chinese legal system through legislation.⁸⁸ Arguably, legal transplants in the context of company law no longer follow a "piece-meal" approach. There is therefore an advantage to using a transplanted rule in that it would be complemented by other rules or institutions of the same legal origin. For example, the 2005 Securities Act transplanted the concept of "sponsor" into the Chinese legal system. Art.11 states that,

An issuer which files an application for public issuance of shares or convertible corporate bonds by means of underwriting according to law or for public issuance of any other securities, to which a recommendation system is applied, as is prescribed by laws and administrative regulations, shall employ an institution with the qualification of recommendation as its "sponsor". A sponsor shall abide by operational rules and industrial norms and, on the basis of the principles of honesty, diligence and accountability, carry out a prudent examination of application documents and information disclosure materials of its issuers as well as supervise and urge its issuers to operate in a regulated manner.

The institution of "sponsor" is also applied in the share trading reform.⁸⁹ In accordance with the CSRC's regulations, public companies must employ a sponsor to assist in drafting the documents relating to compensation schemes.⁹⁰ The sponsors, who are sophisticated financial intermediaries, bring important expertise in the

⁸⁷ R. Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function', (2001) 49 American Journal of Comparative Law 329, 339

⁸⁸ See H. Huang & B.S. Wang 'China's New Company Law and Securities Law: An Overall and Assessment' 2006 (19) Australian Journal of Corporate Law 229

⁸⁹ Notes on the Split Share Structure Reform of Listed Companies (n 9) art.1

⁹⁰ *ibid* art.2(2)

drafting process of such compensation schemes. Furthermore, they also engage a responsibility to work as a "gatekeeper" by supervising the drafting process of the compensation scheme, and preventing any unlawful activities.⁹¹ Consequently, the involvement of security lawyers and auditors should improve the quality of compensation schemes. Well-designed compensation schemes create a good starting point for procedures that follow, including the application of a class voting regime. To sum up, the emerging complementary system would facilitate the practical effects of transplanted legal rules.

By contrast, a class voting regime as a functional convergence does not integrate into the existing legal regime well. As the first case study shows, there is no complementary institution to encourage minority shareholders to participate in a class meeting. Secondly, when majority shareholders circumvent the class meeting, no means of relief is available to minority shareholders. Finally, no rule or standard can prevent institutional shareholders from engaging in rent-seeking activities during class voting. A similar problem can also be found in the second case study. The lack of complementary strategies, such as an effective enforcement mechanism, means that there is no help for minority shareholders or creditors when they become aware of an unlawful investment made by the company. There is also no properly authorised institution to investigate a company's investments in any given period. This shortage of complementary strategies means that the functional convergence rules become difficult apply.

4.1.4.3 Time-saving

The "convenience" thesis, already supported by existing studies, is further supported by the above case studies. In 2004, as the performance of the Chinese stock markets was approaching a bottom-line, the central government decided to promote

⁹¹ X. Tang 'Protecting Minority Shareholder in China: A task for Both Legislation and Enforcement' In H. Kanda, K. Kim & C. J. Milhaupt (eds.), *Transforming Corporate Governance in East Asia* (Routledge 2008) 150

this performance by unifying the split shareholding structure. In order to respond quickly to the stock market calamity, this reform was initialled without adequate preparation. The CSRC, as the executor of the reform, needed to design a workable reform proposal in a short space of time. At this time of urgency, the time-consuming procedure of developing new rules risked delaying the reforming process. Introducing well-developed Western rules by way of reform therefore presented itself as a reasonable solution. As Chinese economic development in the last three decades has been dramatic, legislators have had to continuously update legislation to mitigate newly-emerging problems and support further economic development. Furthermore, as the second case study indicates, Chinese companies are increasingly facing fierce competition on the global market. In order to survive in this competition, legislators have also had to have quick responses to prompt the competitiveness of Chinese companies. Thus, adopting Western legal rules and institutions seems to have been a viable option as it is the most convenient way for legislators to make an immediate response to changing circumstances.

4.1.5. Conclusion

This part has attempted to fill a gap in the research on legal reform of corporate governance in China by answering two important questions: (1) what are the technical advantages (if any) of selectively inputting Western legal rules into the Chinese legal system? (2) Is functional convergence a more effective model than legal transplant, as some lawyers have suggested. The case studies have shown that it is undeniable that the formal convergence model possesses some overwhelming advantages when compared with the functional convergence model. Firstly, introducing Western experience into the Chinese legal system does not always cause conflict. At least the first case study shows that China's public companies and its domestic market, share some important features with their Western counterparts. In contrast, the functional convergence model which places a one-sided focus on Chinese characteristics may be difficult to apply in meeting the demands of the generalities between China's domestic

market and its Western counterparts. More importantly, so-called Chinese characteristics in the field of corporate governance, including State control, over-concentrated ownership, and split shareholding structure are the main objects of economic reform. Consequently, there is little point in drafting legal rules to fit in with economic components that are in any case due to be reformed. Moreover, the Western experience provides the technical support, which is helpful to activate the legal rules in practice. In contrast, rules adopted through a functional convergence model usually suffer from the problem of ambiguity. Legal end-users generally receive little guidance on how to use these rules and standards. Moreover, transplanting rules and legal institutions from Western legal systems is more efficient. Some indications have shown that transplanted rules have come to constitute a complementary system. The individual transplanted rule can promote the productivity of a whole system through its complementary effect. Thirdly, transplanting rules from Western jurisdictions is more time-saving. It can provide a fast response to the newly-emerging problems arising out of economic transition and the competitive global market. Finally, in relation to the second question, the results of this case study indicate that the formal convergence model is a better choice than the functional adoption model for China's legal reform of corporate governance.

Nevertheless, the above case studies do have their limitations. Their results may be not accurate or representative in all conditions. As micro-studies, they do not shed much light on the rationale behind the reasons for finding the formal convergence model to be the better model. In order to overcome these limitations, the next part will go one step further by discussing what determines the important role taken by formal convergence model in China's legal reform of corporate governance.

4.2. What Determines the Role of the Formal Convergence Model in China's Legal Reform of Corporate Governance?

This part will deal with the limitations of the above case studies by exploring the

determinants of the formal convergence model. It argues that there is juxtaposition between path-dependent trajectories in China's legal reform of corporate governance. Moreover, the two path-dependent trajectories have different effects on the reform. Additionally, law not only reacts but also shapes its economic and cultural context. The economic and cultural components influenced by the transplanted law are also therefore important determinants.

4.2. 1. "Path Dependence" in Comparative Corporate Governance

The essence of the path-dependence theory⁹² is to emphasise the "lock-in" effect and "self-reinforcing" consequences of the development of a system. In an economic sense, path-dependence results in "lock in" and "self-enforcement" effects through positive feedbacks and increasing returns.⁹³ The cost of switching to a previously discarded alternative accumulates over time, rendering whole change less and less likely.⁹⁴ Economic considerations, such as "fixed cost", "learning effects", "network effects", and "adaptive expectation" make an existing institution "extremely difficult to abolish."⁹⁵ Furthermore, a well-established institution is usually protected by an elite group. The path dependence theory plays an important role in moving the discussion of institutional stability beyond the unassailable notion that "history matters".⁹⁶ In respect of comparative corporate governance, as mentioned in Chapter I, path dependence theory is used to explain the persistent differences between the corporate governance regimes of dispersed ownership systems and block-holder systems.⁹⁷

After briefly introducing the general concepts of the path-dependence theory, in

⁹² For a general conceptual discussion of path-dependence in the context of corporate governance, see M. Roe, 'Chaos and Evolution in Law and Economics' (1996) 109 Harvard Law Review 641

⁹³ T. Boas, 'Conceptualizing Continuity and Change: The Composite-Standard Model of Path-dependence' (2007) 19 Journal of Theoretical Politics 33, 37

⁹⁴ *ibid*

⁹⁵ J. Mahoney, 'Path-Dependence in Historical Sociology' (2000) 29 Theory and Society 507, 515

⁹⁶ T. Boas (n 93) 34

⁹⁷ See Chapter I (n 5)

the following parts, this paper will place the Chinese experience within this theoretical framework. It will divide the path-dependence effects of China's corporate governance reform into two levels. One level is "rent-protection path-dependence", which refers to a strong combination of "clientelism" and "corporatism" in China's political-cultural context. The other level is "efficiency-driven path-dependence", which refers to "comparability" between a newly-enacted rule and the existing legal regime in China.

4.2.2. Dual-levels of Path Dependence in the Context of Chinese Corporate Governance Regime

4.2.2. 1. Level one: Rent-Protection Path-Dependence

Bebchuk & Roe find that players who enjoy rents under an initial structure might have both the incentive and the power to impede changes under this structure.⁹⁸ Although this part focuses on the evolution of the company law regime rather than the corporate governance system, the "interest group" argument still has robust explanatory power. Some Western commentators have pointed out that China's dramatic economic development in last three decades is regarded as an exception to the "right hypothesis".⁹⁹ The assumption made by the "right hypothesis" is that economic growth requires a legal system, which offers stable and predictable property and contractual rights.¹⁰⁰ However, even today China does not possess an efficient legal system, comparable to its phenomenal economic development. Thus, there must be some alternatives or partial substitutes for the "rule of law" in China. The argument provided by Jones offers a widely accepted explanation for this phenomenon. She argues that "clientelism" and "corporatism" are substitutes for the legal regime in

⁹⁸ L. Bebchuk & M. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' 1999 (52) Stanford Law Review 127

⁹⁹ D. Clarke, 'Economic Development and the Rights Hypothesis: the China Problem', (2003) 51 American Journal of Comparative Law 89

¹⁰⁰ *ibid*

"Chinese capitalism", which underlie China's remarkable economic development.¹⁰¹ Although Jones argues that these alternative trajectories are even more effective than a formal legal system in promoting economic development in China, some commentators assert that the strong tie of "clientelism" and "corporatism" hinders the transplant of corporate governance rules from the "rule of law" system.¹⁰² The following parts will further apply Jones's argument in China's legal reform of corporate governance.

"Clientelism"¹⁰³ refers to a close-knit society, which is highly reliant on personal relationships, and networks of familial, personal and social connection.¹⁰⁴ The network which facilitates exchange of personal and knowledge based resources, for mutual protection and for aid can be traced back to the traditional nepotism of Chinese emperors, as well as the corruption and particularism of Chinese dynastic bureaucracy.¹⁰⁵ Peerenboom divides clientelism into two groups. "Horizontal clientelism" refers to the relationships between equal parties. By contrast, "vertical clientelism" refers to the patron-client relationship between supervisors and subordinates.¹⁰⁶ On the one hand, it can be argued that the transaction cost between parties is reduced by a business model in which personal relationships play an important role. This is not only because parties who do business with their familiar partners will suffer less from the costs of asymmetric information, but also because strong networks of social connection facilitate the flow of information between

¹⁰¹ See J. Carol, 'Capitalism, Globalization and Rule of Law: An Alternative Trajectory of Legal Change in China' (1994) 3 *Social and Legal Studies* 195

¹⁰² C.W. Huang, 'Worldwide Corporate Convergence Within A Pluralistic Business Legal Order: Company Law and the Independent Director System in Contemporary China' (2008) 31 *Hasting International Comparative Law Review* 361, 433-434

¹⁰³ For a general introduction of China's culture of Clientelism (also known as *Guanxi*) in the commercial realm, see Heidi von Hoivik, 'East Meets West: Tacit Messages about Business Ethics in Stories Told by Chinese Managers' (2007) 74 *Journal of Business Ethics* 457; T. Dunfee, and D. Warren, 'Is Guanxi Ethical? A Normative Analysis of Doing Business in China' (2001) 32 *Journal of Business Ethics* 191; and M. M. Yang, *Gifts, Favors, and Banquets: The Art of Social Relationships in China* (Cornell University Press 1994)

¹⁰⁴ See R. Peerenboom, *China's Long March Toward Rule of Law* (Cambridge University Press 2002) 466

¹⁰⁵ E. Todeva, 'Business Network in China: Legacies and Practice', In S. Clegg, K. Wang and M. Berrell, (eds.), *Business Network and Strategic Alliances in China* (Edward Elgar 2007) 256

¹⁰⁶ R. Peerenboom (n 104) 466

parties.¹⁰⁷ This reduction of transaction cost contributes to economic development. On the other hand, this interlaced personal network strengthens "rent-protection" path-dependency. In respect of corporate governance, horizontal clientelism may range from appointing an executive's friend or relatives to be the company's senior officer to passing a corporate opportunity to an executive's family member. Vertical clientelism in general is more harmful than the horizontal clientelism, as it usually involves government official or judicial corruption.¹⁰⁸ Vertical clientelism may range from local government administrative intervention in a law suit against a local firm to leaking official confidential information to a market participant. Both horizontal and vertical clientelism involve a system of exchanging interests. Imagine a purchasing manager deciding to buy overpriced supplies from a personal acquaintance who in turn helps the manager's son into a prestigious school.¹⁰⁹ Imagine also a government official giving a preferential policy to a company in exchange for a position of senior executive with handsome remuneration for his son. In the first scenario, the purchasing manager realises his personal interests at the expense of shareholders' interests. In the second scenario, the governmental official gains personal benefits from his governmental authority. In both cases, the persons in power, whether economically or politically, have strong rent-creating and rent-seeking ability in this cultural environment. The following part will explain these points using a group of cases.

Keloon's scandal exemplifies horizontal clientelism in corporate governance. Keloon is a State-owned company seated in Guangdong province. In 2001, it was involved in serious financial trouble. The local government decided to sell it to Gelin Keer, a domestic private company listed on Hong Kong's Growth Enterprise Market. After this acquisition, Gelin Keer's chairman of the board, Gu Chujun, took a seat on

¹⁰⁷ R. Gilson, 'Controlling Family Shareholder In Developing Countries: Anchoring Relational Exchange' (2007-2008) 60 Stanford Law Review 633

¹⁰⁸ Braendle and others, 'Corporate Governance in China - Is Economic Growth Potential Hindered by Guanxi?' (2005) SSRN, Working Paper Series 25/04/2005 <<http://ssrn.com/abstract=710203>> accessed 20th July 2011

¹⁰⁹ *ibid* 11

Keloon's board. In order to fully control Keloon's financial resources, Mr Gu filled Keloon's board with his own confederates. Two years after the acquisition, Mr Gu's confederates occupied 6 of the total 7 positions of the board. Another of Keloon's major institutional investors who held nearly 7 per cent of its shares had no voice on the board. Furthermore, Mr Gu's personal connections extended to all key sectors of the company, from production to accountant department. Three years after the acquisition, CSRC's investigation found that Mr Gu had appropriated nearly 3.4 billion RMB (approximately £22 million sterling) from Keloon by moving these funds to other business entities owned by him. The investigation also indicated that Mr Gu's personal connection and network played a key role in this financial crime. Three directors of Keloon, Liu Yizhong, Jiang Baojun and Zhang Xinhan assisted in money transfers between Keloon and Gelin Keer, although they clearly knew these activities were illegal. The money which was handled by them totalled 187 million RMB (approximately £12.5 million sterling). Liu Yizhong, Mr Gu's other friend who was a director of an accountancy firm, provided assistance by making false statements in Keloon's financial report. Clearly, the barriers to "insider control" are largely eliminated by deeply embedded "clientelism" in China's commercial world. The interest-exchange system facilitated Mr Gu's misappropriation.¹¹⁰

Additionally, the appointment of an independent director in China's listed companies provides numerous examples of horizontal interest-exchanging. According to a news report, a listed entertainment corporation based in Xi An selected a famous TV producer as its independent director. The TV producer frankly declared: "The manager is my friend!" Similarly, Sinor, a Chinese clothing manufacturer which is listed on Shenzhen Stock exchange, appointed a famous TV star as its independent director. The TV star Mr. Zhang publically admitted that the major investor of the company is, in fact, one of his best friends. Both the TV producer and the TV star

¹¹⁰ See *Ke Long An Shimo* [The Outline of Keloon Case] <<http://tech.sina.com.cn/e/2008-01-03/11141951481.shtml>> on 21st Shiji Jingji Baodao [21st Century Economy Daily] 3rd, January 2008 accessed 20th July 2011; and *Gu Chujun de Ke Long Tikuanji* [Keloon, An ATM for Gu Chujun] <<http://homea.people.com.cn/GB/41392/4596318.html>> accessed 20th July 2011

were obviously without legal or accountancy training. Therefore, they were only directors for the purposes of "window-dressing". Moreover, the TV producer and star's reputations were promoted by being appointed independent directors in listed companies. In return, their appointment secures some loose external supervision for the controlling insiders of these companies.¹¹¹

If the former cases are indicative of horizontal clientelism, vertical clientelism is well portrayed by a more recent case. Huang Guanyu is a top Chinese entrepreneur. According to *Forbes Magazine*, Mr Huang had the distinction of being the richest man in China from 2006 to 2008, and is the founder and chairman of Gome Group, the largest electronics retailer in China. Mr Huang is also an owner of a super-size real estate company which is listed on the domestic stock market and Hong Kong Stock Exchange. In November 2008, Mr Huang was suspected of being involved in share-price manipulation. Further CSRC investigations discovered that the businesses belonging to Mr Huang and his brothers relied largely on insider-trading, operating illegal business and engaging in commercial misrepresentation to general public. What was most shocking was the fact that at least nine senior officials were alleged to have provided protection for Mr Huang's illegal business activities. In order to achieve such "high-level protection", Mr Huang formulated a complicated social network, important members of which included the Mayor of Shen Zhen, the Director of the Ministry of Public Security's Department of Anti-Financial Crime and the Vice-Principal of Guangdong Province's People's Political Consultative Conference. All these high-rank government officials were arrested as a consequence of their involvement in Mr Huang's case.¹¹²

¹¹¹ Li. L.M, 'Duli Dongshi Bianyuan Hua Wenti Yanjiu' [Independent Director, Only A Decoration?] In B.S. Wang (eds.), *Zhuan Xing Shiqi Gongsi Fa de Xiandai Hua* [Modernizing Company Law in Transition Context] (She Hui Ke Xue Wenxian Chuban She 2003) [Social Science Press 2003] 133, 133-135. Also see S.B. Shen & J. Jing, "Will the Independent Director Institution Work in China?" (2005) 27 *Loyola Los Angeles International & Comparative Law Review* 223, 237-238

¹¹² See 'Sheji Huang Guanyu de Zhongguo Gaoguan' [The Senior Officials who are Connected with Huang guanyu] <<http://www.cnfol.com/>> accessed 20th July 2011 and Huang Guanyu An Shimo [A Outline of Huang Guanyu Case] summarised by Caijing Magazine <<http://www.caijing.com.cn/2009/hgy/>> accessed 20th July 2011

Another case that exemplifies horizontal clientelism is the Zijin Mining scandal. Zijin Mining is China's largest gold producer. In 2010, it was responsible for an acid spill that polluted a river and poisoned 1,890 metric tons of fish in Fujian Province. As a listed company, Zijin Mining should have disclosed complete and accurate information about this disaster to the general public in a timely fashion. However, Zijin Mining delayed disclosure of the incident for nine days and local government deliberately played a role in assisting the company to conceal the environmental disaster. According to the subsequent investigation, there was an interest-exchanging relationship between Zijin Mining and local government officials. Many retired senior officials took seats on Zijin's board, and some even possessed a significant number of shares in Zijin Mining. For example, Mr Zheng, a retired local government senior official, held a shareholding valued at 9 million RMB (approximately 900,000 pound sterling). In return, local government not only lost administrative supervision of the public company, but also provided assistance in concealing its unlawful activities.¹¹³

Whilst these cases are illustrative, they nevertheless present an extreme. Most interests-exchange activities in China are not so severe, being often at the edge of legality without necessarily breaching law. Nonetheless, it cannot be doubted that clientelism is supported by a "rule of man" regime, as opposed to a "rule of law" regime which would keep it in check. A person in power can create and seek rents only in an environment where their powers are under-regulated. If legal regimes and enforcement mechanisms are strengthened, there would be less opportunity for "rent-creating" and a higher cost for "rent-seeking". However, this also means that special interest groups currently benefiting from the existing framework of clientelism are incentivised to block any significant reform from "rule of man" towards "rule of law".

"Corporatism" is regarded to be a middle ground between liberalism and

¹¹³ For a detailed case report, see <<http://news.163.com/special/00014IT2/zjkyfsxlg.html>> accessed 20th July 2011, English version available at <http://www.china.org.cn/business/2011-05/05/content_22499213.htm> accessed 20th July 2011

Marxism. It refers to a strong central government authority with the existence of some private interest groups who enjoy a certain degree of autonomy.¹¹⁴ With a strong tradition of totalitarianism, China survives by maintaining an accomplished hierarchical system, which can be traced back to the influence of Confucianism.¹¹⁵ As early as the late 19th century, when the concept of a "company" was first introduced into China, the Qing government attempted to control corporate practice by establishing a number of government controlled companies. In these companies, the government had the power to dispose of the company's assets and appoint its directors and managers.¹¹⁶ After China became a republic, whether under the control of socialism or nationalism, there was no significant change in the strong controls exercised by the government over Chinese companies. Even after the formal implementation of the "socialist market economy" in 1990s, despite the transfer of underlying ideology from Marxism to Corporatism, governmental control on companies was still stringent. "Corporatism" in the context of corporate governance is mainly manifested by two institutional arrangements. One is administrative regulation and the other is the exercise of direct control of companies by the establishment of Party organization in listed companies.¹¹⁷

The CSRC issued a large number of market regulations. Unlike the flexible approach adopted in some Western Jurisdictions, the CSRC's regulations are usually legally binding. For example, the CSRC's *Principles of Corporate Governance for Listed Companies* says that "the Code is applicable to all listed companies within the boundary of the People's Republic of China. Listed companies shall act in the spirit of

¹¹⁴ H. J. Wiarda, *Corporatism and Comparative Politics: The Other Great "Isms"*, (Armonk 1996)

¹¹⁵ Y.W. Wei, 'An Overview of Corporate Governance in China' (2003) 30 *Syracuse International & Comparative Law Journal* 26

¹¹⁶ J.M. Dou, *Research on the History of Corporate Ideology in China* (1999) 21-22; see also Chi-Kong Lai, 'China's First Modern Corporation and the State: Officials, Merchants, and Resource Allocation in the China Merchants' Steam Navigation Company, 1872-1902' (1994) 54 *The Journal of Economic History* 432, where the author finds that 'The [Qing] government had long been recruiting private entrepreneurial and material resources to launch various kinds of joint ventures, often adopting different approaches to what was called "official supervised merchant enterprise" (kuan-tu shang-pan).'

¹¹⁷ As MacNeil argues, the Chinese socialist market does not rely upon rule of law but upon a large number of administrative regulations and the direct control of shares in listed companies: I. MacNeil 'Adaptation and Convergence in Corporate Governance: the Case of Chinese Listed Companies' (2002) 2 *Journal of Corporate Law Studies* 289, 339

the Code in their efforts to improve corporate governance"; and article 91(5) of the code states "A listed company shall disclose information regarding ... the actual state of corporate governance of the company, the gap between the company's corporate governance and the Code, and the reasons for the gap." Additionally, the CSRC's regulating power extends to the inner affairs of public companies. It requires "local governments to ensure that companies under their jurisdiction amended their Articles of Association to reflect the *Guidelines on Articles of Association*."¹¹⁸ In practice, the CSRC's intervention reaches every corner of a public company's corporate governance. For example, in 2002, the CSRC urged the Tianjin Capital Environmental Protection Company to improve its corporate governance by the end of the year.¹¹⁹ The CSRC's report highlights that one of the issues which this listed company needed to be improve was the fact that memos on directors' meetings were too simple to record clearly individual directors' opinions.¹²⁰ This level of scrutiny is obviously out with the usual regulatory supervision provided by a typical market regulator in a market economy system.

In addition to the mandatory market regulations and administrative interventions in a company's inner management, the CSRC's enforcement mechanisms are sometimes without a consistent inner logic. As Clarke argues,

Sometimes, it [the CSRC] threatens to use these powers; other times, intriguingly, it does not. Still other times it simply declares that certain acts will not be valid under certain conditions, but it does not automatically follow that other government agencies in China, particularly courts, will give effect to that declaration if it seems to go beyond the CSRC's authority.¹²¹

¹¹⁸ D. Clarke, 'The Ecology of Corporate Governance in China' GWU Law School Public Law Research Paper No. 433 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1245803> 41

¹¹⁹ See Notice issued by CSRC at 22nd, July 2002 (2002 number 8). Available from <<http://www.csrc.gov.cn/>>

¹²⁰ *ibid*

¹²¹ D. Clarke (n 118) 36

Consequently, although we cannot deny that mandatory administrative regulations, intervention in a company's inner affairs, and even the CSRC's erratic enforcement of the regulations contribute to improving the corporate governance regime of public companies, all these regulatory approaches also contribute to a rent-creating and rent-seeking process. Enacting mandatory regulation is creates rents. Intervening in a company's affairs can sometimes be to seek rents. Whether or not to enforce a rule in certain conditions, sometimes largely depends on political considerations.

Despite having indirect control, the State places direct control on super-scale public companies through State-ownership. As highlighted above, most of China's listed companies are controlled by the State. Through State-ownership, the government can control the company not only through shareholder power, but through the organization of the Communist Party in the company. Article 19 of the 2005 Company Law says,

The Organization of the Chinese Communist Party shall be established in the company based on the Provisions of the Constitution of the Chinese Communist Party to carry out activities of the party. The company should provide all necessary conditions to assist the activities of the party organization.

The organization of the communist party plays an important role in State-controlled companies in practice. This is because the board of directors usually gives unconditional approval to business proposals made by the Party organization.¹²² Furthermore, other research shows that 92 per cent of directors are party members, suggesting that a correlation between the appointment of directors and the power of

¹²² C.E. Bai, *'Zhongguo Gongsi Zhili Biange'* [The Reform of Public Company's Corporate Governance] (Tsinghua University) <http://finance.sina.com.cn/hy/20090411/15146092369_2.shtml> accessed 20th July 2011

the Party still exists.¹²³ This result is confirmed by research on China's political control of listed companies, which suggests that local party committees in listed firms remain involved in all major corporate decisions, especially those relating to personnel.¹²⁴

To conclude, under corporatism, the government can ensure that large-scale private businesses do not engage in business activities which threaten the Communist Party's interests. They do so through mandatory administrative regulation, whilst ultimately controlling important sectors or resources, such as the military industry, the power and energy industry, and public communications through State-ownership. The major aim behind adopting Corporatism is therefore to solidify the controlling party's political totalitarianism.

Corporatism and clientelism are mutually reinforced in China's "rule of man" regime. Clientelism provides cultural soil for the growth of corporatism. Corporatism grants strong administrative powers to governmental authorities and officials, which enables them to seek rents. Although adopted to protect the Party's totalitarianism, the culture of clientelism, in tandem with the relatively weak legal system, gives rise to rent-seeking activities which realise personal benefits for State officials rather than securing Party interests. A report issued by the State-owned Asset Supervision and Administration Commission highlights that there is a positive link between concentrated ownership and official corruption.¹²⁵ To elaborate, the greater the proportion of State-ownership in a public company, the more serious an official's corruption becomes. Therefore, in a cultural environment based on clientelism, officials have incentives to encourage policy-makers to enhance "corporatism" on an

¹²³ L.H. Tang & J.Y. Wang 'Modelling an Effective Corporate Governance System for China's Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy' (2007) 7 *Journal of Corporate Law Studies* 143, 155

¹²⁴ V. Nee, S. Opper and S. Wong 'Developmental State and Corporate Governance in China' (2007) 3:1 *Management and Organization Review* 27; see also E.C. Chang & S.M.L. Wong, 'Political Control and Performance in China's listed Firms', <http://www.hiebs.hku.hk/working_paper_updates/pdf/wp1067b.pdf> accessed 20th July 2011

¹²⁵ A SASAC's research report available at <<http://www.sasac.gov.cn/n1180/index.html>>

ideological level. Unfortunately, in China, many authorities have two identities. They are both "policy-maker" and "policy-enforcer". A typical example of this type of authority is the CSRC.¹²⁶ Corporatism in turn reinforces the role played by clientelism within the institutional framework. In order to guarantee that all key positions are assigned to members who are willing to act in the Party's or government's interest, positions in State-influenced companies are assigned on the basis of personal connection rather than achievement.¹²⁷ Gilson and Milhaupt's recent research supports this observation. They find that

[in China] "Princelings" (taizi dang)-children of influential party members, whose nickname derives from their quasi-hereditary privileges. The term is also used more broadly to refer to those closely connected to the Party establishment through marriage or collegial relationships. The Princelings operate outside of established hierarchies, wielding influence beyond and across the separate spheres of politics, business and the military. The links between party officials and business managers are extensive and lucrative. In 2002, Newsweek reported on an internal Party survey indicating that ninety-eight per cent of senior officials had relatives in significant business or government positions.¹²⁸

This observation is supported by empirical evidence as well. Indeed, one survey targeting 215 mid-rank officials in Nanjing province indicates that 56.9 per cent of interviewees acknowledged that personal relationships and social networks are the most important factors in securing their political promotion in the future.¹²⁹

Consequently, the tie of corporatism and clientelism constitutes "rent-protection

¹²⁶ See Chapter II, section 2.4.1

¹²⁷ Braendle and others (n 108) 10

¹²⁸ R. Gilson & C. Milhaupt, 'Economically Benevolent Dictators: Lessons for Developing Democracies' (2011) 59 *American Journal of Comparative Law* 227, 266 and X.L. Ding, 'In formal Privatization through Internationalization: The Rise of Nomenklatura Capitalism in China's Offshore Businesses,' (2000) 30 *British Journal of Political Science* 121

¹²⁹ M. Tian 'Chuzhang de Zhengzhi Jingjixue' [Political-Economy of China's Mid-rank Officials], *Financial Times* (Chinese version) <<http://www.ftchinese.com/story/001030741?page=2>> accessed 20th July 2011

path dependence". Social networks are likely to undermine the "rule of law" by obstructing its development and implementation.¹³⁰ Bestowing preferential treatment upon an individual who has a close relationship with persons in power violates the fundamental values of the rule of law, namely "fairness", "accountability" and "transparency". In addition, corporatism leads to Party domination of the legal system, and the subordination of law to administrative policy. In the last resort, the Party is above law.¹³¹ Indeed, there is little point in relying on the courts and legal professions, when local governments are the only agencies able to compel performance or enforce an agreement.¹³²

Both corporatism and clientelism are deeply embedded in Chinese cultural and institutional settings. Privileged interest groups under the current institutional regime and cultural environment will make efforts to block any significant change towards a "rule of law" system. Rent-protection path-dependence is therefore unlikely to be completely overcome in a short period. The existence of clientelism and corporatism creates difficulties in promoting corporate governance in public companies through the "rule of law". It also means that China cannot adopt a whole set of Western institutions and legal rules. Furthermore, company law needs to be equipped with mechanisms tailored to the specific characteristics of the Chinese context, in order to respond to the influences of corporatism and clientelism. More importantly, the question is raised as to whether these conclusions mean that the findings of the above case studies which declare the formal convergence model has a variety of advantages are wrong. Indeed, it raises the question of whether these conclusions mean that the functional convergence is, in fact, a better model for dealing with China's problems after all.

4.2.2.2. Level Two: Efficiency-driven Path-Dependence

¹³⁰ R. Peerenboom, 'Social Network, Rule of Law and Economic Growth in China: The Elusive Pursuit of the Combination of Private and Public Ordering' (2002) 31 *Global Economic Review* 1

¹³¹ W. Menski, *Comparative Law in a Global Context: The Legal System of Asia and Africa* (2nd edn, Cambridge University Press 2006) 592

¹³² R. Peerenboom (n 130)

As Roe states, "rules might be path dependent because the identity of the locally efficient legal rule-the rule efficient for a given country-might depend on the rules and structures that the country had at earlier times."¹³³ Following this argument, the essence of "efficiency-driven path-dependence" is about an initial condition of a system, and how does this initial condition change or influence the development of the whole system. This part will therefore begin by determining the starting point of the evolution of the Chinese company law system. It will then go on to analyse how "efficiency-driven path-dependence" influences the evolution of company law reform in China.

4.2.2.2.1. The Starting Point of China's Legal Reform of Corporate Governance

When the first company code in Chinese history was adopted in the early 20th Century, Chinese intellectuals believed that the corporate system was a dynamic power for the rise of the Western economy. For example, the following comments were made:

Industry and commerce [in China] cannot progress if a corporate system is not developed. Then China will never become rich and strong. The corporation is one of the decisive factors that enable British merchants to dominate the world. As a result, although other countries including France, Spain, and German have spared no effort in competition, they are no match.¹³⁴

However, both ruler and scholar encountered an inevitable problem when they began to draft the company code; namely, how to develop a company law system in a modern commercial cultural desert. Weber concludes that "the legal forms and

¹³³ L. Bebchuk & M. Roe (n 98) 155

¹³⁴ J.M Dou (n 116) 13-14

societal foundation for capitalist 'enterprise' were absent" in traditional China.¹³⁵ Fairbank makes a similar point by arguing that "non-development of Chinese law along lines familiar to the West was plainly related to the non-development of capitalism and an independent business class in China."¹³⁶ In respect of the company law, Kirby puts it as:

Prior to the Company Law of 1904, very little in written Chinese law addressed the regulation of private economic activity. Qing China had no commercial code, nor, really, a civil code. What it did have, in the form of the Great Qing Code, been primarily a penal code, pre-eminently concerned with the regulation and punishment of officials.¹³⁷

In respect of commercial law related elements, the Great Qing code only included the civil activities, such as marriage and the succession of property, which were important for the Confucian Family system. Furthermore, there wasn't even a formal institution for settling commercial disputes.¹³⁸ This shortage of local knowledge of commercial litigation can be partly attributed to Confucian moral standards. Confucius once said: "The Superior Man cares about virtue; the inferior man cares about material things. The Superior Man seeks discipline; the inferior man seeks favours."¹³⁹ Again, on another occasion, Confucius told a student that "the Superior Man is aware of Rightness, the inferior man is aware of benefit."¹⁴⁰ It is understandable that ancient Chinese officials, who were trained in Confucian philosophy, were reluctant to be involved in commercial disputes, as pursuing profit was morally suspect under Confucianism, not to mention the dispute triggered by

¹³⁵ M. Weber, *The Religion of China: Confucianism and Taoism* (H H. Gerth Trans., Free Press 1951) 85

¹³⁶ J. Fairbank & M. Goldman, *China: A New History* (Cambridge, MA: Belknap Press of Harvard University Press 1992) 185-186

¹³⁷ W. Kirby, 'China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China' (1995) 54 *Journal of Asian Study* 43, 44

¹³⁸ D. Faure, 'Zhongguo Ziben Zhuyi De Mengya' [The Emerging Capitalism in Ancient China] (2002) 1 *Zhongguo Jingjishi Yanjiu* [The Journal of China's Economic History] 62

¹³⁹ 'Analects of Confucius' (English Version) available <<http://www.kzxy.com.cn/Article/ArticleShow.asp?ArticleID=3138>> accessed 20th July 2011

¹⁴⁰ *ibid*

seeking personal benefit.¹⁴¹ The legal gap, at that time, was filled by private force. According to Kirby's observations, commercial dispute resolution was usually dealt with by local notables, based on the detailed regulations of guilds and families as well as on longstanding custom. However, decisions would normally be based on a considerable degree of personal comprehension of local practices on the part of the decision maker.¹⁴² The lack of a uniform commercial code and a heavy reliance on personal understanding and comprehension severely undermined the justice of each decision. Therefore, a mechanism of commercial dispute settlement based on formal legislation was not established in China until 1904.

In addition to a shortage of legal institutions, Chinese businessmen had little knowledge of "capital balance". They rarely had any awareness of "bad debt" and "depreciation of industry materials". Lack of advanced financial techniques compounded the difficulty of expanding the scale of private industry.¹⁴³ All these observations indicate that, China, as an agricultural country, did not have sufficient local resources or knowledge through which a modern company law system could evolve spontaneously. The anxiety of suffering a shortage of local resource was also reflected by an Imperial Edict issued in 1903, which said:

Commence and the encouragement of industries have ever been from ancient times to the present a matter of real importance to governments, but according to old tradition, We have looked upon industries and commerce as a matter of the last importance...now We appoint Prince Tsai-chen, Yuan Shih-k'ai and Wu Ting-feng to arrange, first of all, a Code of Commercial Law, which may serve as a standard.¹⁴⁴

¹⁴¹ D. Faure (n 138) 62

¹⁴² W. Kirby (n 137) 45; and also S. Mann, *Local Merchant and the Chinese Bureaucracy 1750-1950* (Stanford University Press 1987)

¹⁴³ D. Faure (n 138) 62

¹⁴⁴ 'Recent Chinese Legislation Relating to Commercial, Railway, and Mining Enterprises with Regulations for Registration of Trademarks and For the Registration of Companies' 10 (2nd edn, translated by E.T. William Trans. Mercury Limited 1905)

Beyond the pre-modern commercial culture, external pressures played an important role in forcing China to adopt Western law. China's sovereignty since the 1840s was restricted by the system of extraterritoriality. In the Sino-British Treaty of Commerce of 1902, Great Britain proclaimed her willingness to relinquish her extraterritorial privileges, "when she is satisfied that the state of Chinese laws, the arrangement for their administration, warrant her doing so."¹⁴⁵ Therefore, in order to abolish the extraterritoriality system, the implementation of a large number of perceptibly Western rules and standards into the Chinese legal system through legal transplant became not only inevitable but necessary.

It seems that both internal and external factors required the Qing government to use the transplant approach in developing its own company law system. In fact, the earliest Company Code in China, *Company Law 1904*, copied many articles from Japan's Commercial code.¹⁴⁶ In 1914, *Company Law 1904* was replaced by more detailed legislation, namely the Ordinance Concerning Commercial Law Association 1914. This law mainly copied German law and included some elements from common law systems.¹⁴⁷

Some scholars argue that these two company codes did not have a deep influence on China's business practices, because the instability of society, weak economic infrastructure and foreign economic monopolies slowed down the growth of commercial law culture in China. Additionally, the development path was also hindered by the cultural gap between the traditional Chinese culture, which emphasises the family economy based on clan relationships, and Western company law culture, which emphasises the effective allocation of public capital and cooperation disregarding business partners' identity.¹⁴⁸ Indeed, famous political

¹⁴⁵ W. Kirby (n 137) 44

¹⁴⁶ J. Farrar, 'Developing Corporate Governance in Greater China' (2002) 25 University of New South Wales Law Journal 466

¹⁴⁷ *Xin Shang Fa* [New Commercial Law] (Min You She 1914) [Min You Press 1914]

¹⁴⁸ Y.W. Wei, 'A Chinese Perspective on Corporate Governance' (1998) 11 Bond Law Review 363, 366-367

reformer, Liang Qichao, says that, "the commercial code is merely a copy of the Western law. The legislators do not understand the spirit of law and the commercial practice. The law is inapplicable."¹⁴⁹

Even in such conditions, the adoption of company laws still brought some changes to commercial practice in China. By 1910, there were 197 limited liability companies and 68 joint venture companies in China. The 1914 Company Law introduced the concept of "legal person" into China's legal regime.¹⁵⁰ This concept was embraced by the local businessmen. As a commentator says in 1922, "recognizing a company's legal personality enhances its foundation...promotes its business credit and facilitates its expansion".¹⁵¹ Another comment made in the same period says, "legal personality makes distinction between the companies' properties and the shareholders' personal properties. It reduces disputes between shareholders and creditors."¹⁵² With the practice of the company laws, Chinese legislators began to appreciate that company law should meet the demand of the local context. A corporate law book published in 1934 states that "law should be based upon local business reality, it is not necessary to form an identical law with that of the European countries."¹⁵³ In this period, even Western commentators took a fairly positive view of China's legal reform. Kirby argued that this period was the "Golden Age" of company law in China.¹⁵⁴ Pound, a distinguished American legal scholar and educator, made the following comment on China's commercial legislation:

The Chinese Civil Code was chiefly influenced by the Swiss, which thus far is the high-water mark of Continental codification. But the Chinese Civil Code made

¹⁴⁹ Q.C. Liang 'Jinggao Guozhong Zhitan Shiyezhe' [Some Suggestions for the Domestic Entrepreneur], in *Yin Bin Shi Heji* [A Selection of Work of Yin Bin Study] (volume 21)

¹⁵⁰ Z.L. Lu, Ren Xianbing, Qingmo Gongsilv he Beiyang Zhengfu Shiqi Gongsi Tiaoli de Bijiao Yanjiu' [The Company Law in Qing Dynasty and Northern Warlords Government] *Yi Bin Xueyuan Yuanbao* [Journal of Yi Bin University] 27

¹⁵¹ Shi Bao [Daily News] 30th December 1913

¹⁵² H.T. Bi 'Guanyu Woguo Gongsi Shang Jige Wenti de Shangque' [Some Comments on China's Company Law] (1932) *Falv Pinglun* [Law Review] 455

¹⁵³ X.T. Fei, 'Gongsifa Yaoyi' [The Essence of Company Law] (Shanghai Faxue Jv 1934) [Shanghai Law Press 1934]

¹⁵⁴ W. Kirby (n137) 48

some notable improvements, especially in incorporating commercial law, doing away with an artificial historical separation in Continental law, and some borrowing from Anglo-American law... the Chinese codes will rank easily with best examples of modern legislation.¹⁵⁵

Nonetheless, the socialist government did not protect and further develop this emerging modern commercial law culture. Instead, it destroyed this valuable experience during the planned economy period (1949 to 1978). Throughout this period, there was nearly no room for the development of commercial law culture, as no market competition was allowed and nearly all business activities were controlled by State authorities. Additionally, the weak commercial culture developed from 1904 to 1949 was destroyed by political movements. There was a vacuum in the study of modern company law during these movements. The Cultural Revolution prohibited any study of the "West" or "Tradition". By 1957 the government began a political event called the "anti-right wing movement" (*fan you yun dong*), where people who studied any western subject were regarded as "right-wing supporters".¹⁵⁶ Learning from "tradition" was prohibited by the Socialist Party as well. In 1974, the Party released a document which required all Chinese to participate in a campaign of attacking Confucian philosophy (*Pi Lin Pi Kong*). In the Party's eyes, Confucius represented Feudalism and its traditions.¹⁵⁷ In addition to banning the study of the "West" and "Tradition", the Cultural Revolution vitally disrupted the education system. According to Meng & Gregory's research, within the Cultural Revolution, senior high school stopped student recruitment for 6 years, whilst universities stopped student recruitment for an even longer period. Many individuals missed their chance to obtain

¹⁵⁵ R. Pound, 'Law and Court in China: Progress in Administration of Justice' (1948) 34 American Bar Association Journal 273, 274; see also R. Pound 'Progress of the Law in China' (1948) 23 State Bar Journal 354

¹⁵⁶ Q.M. Sun, 'Zhengfeng Fanyou Yundong de Yuanyin Hezai?' [The Reasons for the Anti-right Wing Movement in China] (2003) 5 Tongji Daxue Xuebao [Journal of Tongji University] 6

¹⁵⁷ 'Xianqi Pilinpi Kong de Xin Gaochao' [The Movement of Attacking Confucius and Linbiao] (1974) 3 Guangxi Shifan Daxue Xuebao [Journal of Guangxi Shifan University] 7-9 and M. Goldman, 'China's Anti-Confucian Campaign, 1973-1974' (1975) November, China Quality 436

university degree.¹⁵⁸

The evolution of China's company law which started with the *Company Law 1904* and *Company Law 1914* was abruptly halted by the Cultural Revolution. After the Revolution, there were some experiments enacting laws to govern State-owned or foreign-invested enterprises, such as the *Industry and Enterprise Law 1988*, the *Wholly-Foreign Invested Enterprise Law 1986*, the *Chinese-Foreign Equity Joint Ventures Law 1979*, and the *Chinese-Foreign Contractual Joint Ventures Law 1988*. However, these laws which were still based on Socialism were merely for the purposes of transition. After 1992, the government required State-controlled enterprise to establish a "modern enterprise system" with "clarified property rights, designed authorities and responsibilities, separate government and enterprise functions, and established scientific management".¹⁵⁹ Against this background, the evolution of China's company law was recommenced in the 1990s. A respected Chinese company law scholar, Liu, describes the legislative process of *Company Law 1993* by borrowing Mr Deng Xiaoping's famous metaphor of China's economic reform. He says that drafting the *Company Law 1993* was like "crossing a river by feeling stones" (*mo zhe shitou guo he*).¹⁶⁰ The 1993 Company Law, which was drafted without the support of a scientific legislative methodology, was surrounded by uncertainties. For example, the corporate structure established by the 1993 Company Law adopted a German-style two tier model under which a company, no matter its scale, must have a board of directors and a supervisory board.¹⁶¹ However, the arrangements of this two tier structure are fundamentally different from that of German law. According to *Company Law 1993*, there is no hierarchical relationship

¹⁵⁸ X. Meng, and G. Robert, 'Exploring the Impact of Interrupted Education on Earnings: The Educational Cost of the Chinese Cultural Revolution' (January 2007), IZA Discussion Paper No. 2548. <<http://ssrn.com/abstract=958710>> accessed 20th July 2011

¹⁵⁹ See 'Zhonggong Zhongyang Guanyu Jianli Shehui Zhuyi Shichang Jingji Tizhi Ruogan Wenti de Jueding' [Decision on Socialist Market Economy] issued by 14th Central Government Commission section 2, (1993) <<http://www1.china.com.cn/chinese/archive/131747.htm>> accessed 20th July 2011. See also Chapter II above, at section 2.3.1.

¹⁶⁰ J.H. Liu, 'Gongsifa de Xiugai yu Jieshi: Yisifaquan de Shidu Ganyu wei Zhongxin' [Reforming Company Law: A Centralism of Judiciary Intervention] (2005) 3 Falv Shiyong [Journal of Legal Application] 5

¹⁶¹ *Company Law*, (1993) (n 75) Chapter 3,

between the board of directors and the board of supervisors. Both directors and supervisors are appointed by shareholders.¹⁶² In contrast, under German law, directors are overlooked by supervisors and may be appointed by them.¹⁶³ Some argue that China's corporate structure was transplanted from Japanese law.¹⁶⁴ Indeed, ostensibly, the corporate structure adopted in the 1993 law is very similar to that of the Japanese law. However, legislators have ignored that Japan's corporate structure was built around three major elements: life-time employment contracts, cross-holding networks, and a main-bank system with strong external monitoring powers.¹⁶⁵ In China, these key external elements closely connected with Japan's corporate structure, were absent. Instead, during the 1990s, nearly all enterprises had controlling State-shareholders. Empowering general meetings to appoint directors and supervisors exaggerated the "insider-control" problem.

This example highlights the dilemma faced by legislators. On the one hand, the shortage of learning from the "West" and "tradition" places Chinese legislators in an embarrassing position. Most of them are not equipped with the theories of modern company law, nor even systematic legal training. Despite a superficial understanding of Western company law, nearly no local commercial knowledge and academic resource can rely on. Thus theoretical foundation for drafting company law is weak. On the other hand, the commercial practices that used to be controlled by the State provided little guidance to legislators as to how the "socialist market economy" would develop in China. At the time, China's economic reform was also at its starting point. As the prospects of economic reform were unclear it was difficult to predict the post-reform economic infrastructural needs to be met by company law.

¹⁶² *ibid*, article 38

¹⁶³ *Aktiengesetz* [German Stock Corporation Act] (1965) article 84

¹⁶⁴ D. Feng, 'Zhongguo Gongsi Zhili Moshi De Yanjin' [The Evolution of China's Corporate Governance Regime] (2003) 43 *Beijing Daxue Xuebao* [Journal of Beijing University] 207; M. Siems, 'Legal Origins: Reconciling Law & Finance and Comparative Law' (2007) 52 *McGill Law Journal* 55, 66

¹⁶⁵ Miwa, Yoshiro and Ramseyer, J. Mark, 'The Myth of the Main Bank: Japan and Comparative Corporate Governance' (September 2001), Harvard Law and Economics Discussion Paper No. 333, <<http://ssrn.com/abstract=285254> or [doi:10.2139/ssrn.285254](https://doi.org/10.2139/ssrn.285254)> accessed 20th July 2011 See also R. Gilson & C. Milhaupt, 'Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance' (1999) 99 *Columbia Law Review* 508

All these difficulties forced legislators to face a same question as their predecessors in Qing Dynasty, in drafting the first company code. The adoption of the "socialist market economy" leads legislators to tackle the question of how to establish a company law system in an environment where commercial activities are stifled and local legislative resources are absent. Similarly to the 1904 Company Law, the *Company Law 1993* was, to a large extent, a copy of Tai Wan's company law.¹⁶⁶ As a result of the poor theoretical grounding of legislators, some Western rules were introduced into the Chinese legal system. For example, legislators established a basic modern corporate structure consisting of a shareholder meeting, a board of directors, and a board of supervisors, as well as an accountability mechanism for directors and supervisors.¹⁶⁷ Although the *Company Law 1993* was significantly revised, the reforming approach based on legal transplant was subsequently consistently reinforced in the *Company Law 2005*. A large number of Western rules including institution of independent director, directors' duties of loyalty, derivative actions, shareholder's appraisal rights, and cumulative voting, etc. were introduced into Chinese legal system.¹⁶⁸ There are two major reasons for continuing this approach of legal transplant.

Firstly, the purpose of the company law regime is to encourage economic development. Like the Qing government, the socialist government had a strong desire to boost the domestic economy using a good company law regime. As R. Peerenboom argues, "the legal system also performs an enabling function by creating the basic infrastructure for transactions, including markets, security exchanges, mortgage systems, accounting practices, and so on"¹⁶⁹ After China entered the WTO, as with

¹⁶⁶ M. Siems (n 164) 66

¹⁶⁷ *Company Law* (1993) (n 75), article 38, 103 & 214, 215

¹⁶⁸ B.S. Wang & H. Huang (n 87) 229-249; J.V. Feinerman, 'New Hope for Corporate Governance in China?' (2007) 191 *The China Quarterly*, 590, 600; and K.B. Pissler and J.H. Liu, 'Corporate Governance of Business Organizations in the People's Republic of China: The Legal Framework After the Revision of the Company Law in 2005' (October 22, 2010), SSRN Working Paper Series <<http://ssrn.com/abstract=1695888>> accessed 20th July 2011

¹⁶⁹ R. Peerenboom (n 104) 36

many other jurisdictions, China's policy-makers had to provide an efficient company law regime, which not only promoted the competitiveness of domestic companies in the global product market, but also attracted foreign investment. The Western rules, especially the Anglo-American corporate law rules, sent a strong signal to Chinese policy-makers that the adoption of these rules makes Chinese companies achieve a same degree of success as Western companies.¹⁷⁰ The pressure from competition in the international market led Chinese legislators to adopt a legal instrumentalism in reforming company law.

This assumption of good law resulting in rapid economic development leads to another phenomenon by which the adoption of some rules in legal reform are driven by the desire to perfect legal theories of positive law rather than create a legal regime that fits its socio-cultural context. For example, Tang in his article says that, "the new laws [*China's Security Law 2005* and *Company Law 2005*] have been widely applauded in China. The revision will raise China's score in the shareholder protection index developed by La Porta and colleague in their 'Law and Finance' article."¹⁷¹ This drive for legal perfection is explained by Watson's argument, which claims that "general law reform should primarily be approached not from the angle of what people in society want in particular situations, but from the angle of improving the quality of the Source of Law".¹⁷² It is undeniable that legislators engaged in Chinese legal reform sought to equip Chinese law with more sophisticated Western legal rules, which temporarily failed to fit the socio-cultural context, though they may have significant potential to promote economic development in the long run.

Secondly, the influence of interest groups also acts as "convergence force" which exerts a decisive influence on China's company law reform. Some Chinese lawyers argue that the recent development of China's company law regime can be attributed to

¹⁷⁰ C. Xi (n 31) 37

¹⁷¹ X. Tang (n 91)

¹⁷² A. Watson, 'Society's Choice and Legal Change' (1980-1981) 9 Hofstra Law Review 1473, 1481

the lobbying efforts of institutional and individual shareholders.¹⁷³ The Chinese media have significantly more autonomy in reporting on financial misconduct than they do on reporting on most other areas of Chinese law and society.¹⁷⁴ According Kang & Shi,

Finance, sports, entertainment, and technology have been key areas where the Chinese press has made significant but gradual progress in their freedom of reporting and commenting Chinese newspapers and magazines have also played an active role in exposing corporate fraud and pushing corporate governance legislation.¹⁷⁵

The voice of shareholding minorities, as articulated through the media, exerts significant influence on policy-makers. It is often argued that the Chinese government might have little incentive to protect the minority rights, as this might expose the State-ownership to extensive risks. However, following the ideology of a harmonious society, Hu Jintao & Wen Jiabao's government pay particular attention to the lobbying efforts by institutional and minority shareholders.¹⁷⁶ This ideological change could be explained by an official statistic which indicates that, by 2007 nearly 100 million individual stock accounts had been opened in China. In Beijing and Shanghai, the quantity of individual stock accounts exceeded four million, which was nearly equal to the total number of families in these two large cities.¹⁷⁷ In such circumstances, a weak company law system might enable powerful insiders to make themselves better off at the expense of a vast number of middle-class family interests. This unfair distribution of social welfare will intensify the contradictions between different social

¹⁷³ J.Y. Wang 'Rule of Law and Rule of Officials: Shareholder Litigation and Anti-dumping Investment in China' The Foundation for Law Justice and Society in collaboration with The Centre for Socio-Legal Studies, University of Oxford <<http://www.fljs.org/uploads/documents/Jiangyu%231%23.pdf>> accessed 20th July 2011

¹⁷⁴ *ibid* 38

¹⁷⁵ See also Y. Kang, L. Shi, E.D. Brown, 'Chinese Corporate Governance: History and Institutional Framework', Centre of Corporate Ethics and Governance Report (Rand Corporation 2008)1, 32

¹⁷⁶ C. Hawes 'Interpreting the PRC Company Law Through the Lens of Chinese Political and Corporate Culture' (2007) 30 University of New South Wales Law Journal 813

¹⁷⁷ D.K. Bao 'Yi Yi Gu Min' [One Hundred Million Individual Shareholders] *Caijing Shi Bao* [China Business Post] 19th March 2007

classes and may even threaten the government's legitimate position.¹⁷⁸ Making the company law system achieve some important international standards sends a strong signal to individual shareholders that the law offers them adequate protection.

Consequently, due to a shortage of local knowledge at the starting point of company law development as well as pressures from globalization and individual shareholder lobbies, the legal transplant approach is a reasonable and pragmatic choice for policy-makers wishing to develop Chinese company law. Some scholars show that the formal convergence model causes conflicts between transplanted rules and the socio-economic context. However, this analysis allows us to understand that there is no firm evidence to establish that an effective alternative, capable of replacing the transplant approach existed at the time when the evolution of the company law started during in Qing Dynasty. Some scholars believe that a functional convergence approach based on Confucian morality would be a capable alternative to the formal convergence model. Nevertheless, Confucian morality cannot be shown to enhance the competitiveness of Chinese enterprises in the global market. Equally, Confucian morality cannot be evidenced as being capable of translation into a set of workable rules, which offer substantial protections for minority shareholders. Additionally, even in the unlikely event that it was possible to prove that a functional convergence model based on Confucian morality is a better choice, this model would still not be an efficient means of abolishing the formal convergence model. The following parts will explain the reasons for this argument.

4.2.2.2.2. The Key Components of Efficiency-driven Path Dependence

4.2.2.2.2.1 Sunk Adaptive Cost

"Sunk adaptive cost" indicates the phenomenon whereby once costs are sunk into an existing system without the existence of any better alternatives, maintaining this

¹⁷⁸ On a similar point see C. Xi (n 31) 31

system is efficient.¹⁷⁹ As mentioned above, a large number of rules from civil law and Anglo-American systems have been introduced into China's company law regime. In order to illustrate the considerable quantity of the transplanted rules and institutions, this part uses anti-director and anti-block-holder indexes to test China's legal reform of corporate governance. Anti-director and anti-block-holder indexes are sets of standards, which have been developed by a group of law and finance scholars. These indexes are usually used to evaluate the quality of a shareholder protection regime within a given jurisdiction.

Shareholder Protection Regime (China)		
I. Shareholder protection against executives	Legal Resources	
A. Anti-director index ¹⁸⁰	Company Law 2005 Securities Law 2005	Market Regulator's Regulations
(a) Shareholder can email their vote to the company		Yes ¹⁸¹
(b) Shareholders are not required to deposit prior to the AGM		
(c) Cumulative voting or proportional representation of minorities in the board of directors is allowed	Yes ¹⁸²	Yes ¹⁸³
(d) An oppressed minorities mechanism is in place	Yes ¹⁸⁴	
(e) The minimum percentage of capital that is necessary for a shareholder to call an extraordinary general meeting is equal to or less than 10%	Yes ¹⁸⁵	
(f) Shareholders have pre-emptive rights that can		

¹⁷⁹ C.W. Huang (n 102) 370

¹⁸⁰ R La Porta and others, 'Law and Finance' (1998) 106 Journal of Political Economy 10

¹⁸¹ *Corporate Governance Guideline 2002* art. 8

¹⁸² *Company Law* art.106 (2005)

¹⁸³ *Corporate Governance Guideline 2002*, art. 31

¹⁸⁴ *Company Law* art.152 (2005)

¹⁸⁵ *Company Law* art.102 (2005)

only be waived by shareholder votes		
B. Additional protection		
(a) Securities litigation against executive misrepresentation	Yes ¹⁸⁶	
(b) Executive duties of loyalty	Yes ¹⁸⁷	
(c) Derivative Action by Shareholders	Yes ¹⁸⁸	
II. Minority protection against blockholders ¹⁸⁹		
A. Anti-block index		
(a) Shareholder may take judicial recourse against decision taken at a shareholder meeting (SHM)	Yes ¹⁹⁰	
(b) At least 50% of total voting shares must be represented at a SHM for it to take a binding decision	Yes ¹⁹¹	
(c) Mandatory takeover bid	Yes ¹⁹²	
(d) Acquisition of larger blocks of shares triggers mandatory disclosure		Yes ¹⁹³
B. Additional protections		
(a) Compulsory independent board members	Yes ¹⁹⁴	Yes ¹⁹⁵
(b) Class shareholder voting scheme by which minorities are enable to have a voice in corporate decision-making		Yes ¹⁹⁶

¹⁸⁶ *Guanyu Shouli Zhengquan Shichang Yin Xujia Chenshu Yinfa de Minshi Qinquan Jiufen Anjian Youguan Wenti De Tongzhi* [The Notice on Relevant Issues Concerning Accepting Civil Tort Dispute Cases Caused by False Statement on Securities] and *Guanyu Shenli Zhengquan Shichang Yin Shujia Chengshu Yinfa De Minshi Peichang Anjian De Rougan Guiding* [Several Provisions on Hearing Civil Compensation Caused by False Statement on the Securities Market Provisions] issued by Chinese Supreme Court on 1st September 2003

¹⁸⁷ *Company Law* (2005) art.148

¹⁸⁸ *Company Law* (2005) art.152

¹⁸⁹ K. Pistor, M. Raiser & S. Gelfer, 'Law and Finance in Transition Economy' (2000) 8 (2) *Economics of Transition* 325, 360. This table does not contain the variables of the anti-block index which overlap with the LLSV' index.

¹⁹⁰ *Company Law* (2005) art.22

¹⁹¹ *Company Law* (2005) art.104

¹⁹² *Securities Law of the Peoples Republic of China*, art.88 (2005)

¹⁹³ *Shangshi Gongsi Shougou Guanli Banfa* [CSRC's Takeover Provisions], art.13

¹⁹⁴ *Company Law* (2005) art.123

¹⁹⁵ *Corporate Governance Guidelines* (2002), Chapter 5:Independent Directors

¹⁹⁶ *Minority Shareholder Protection Provisions 2004*

(c) Limitations on block-holder's controlling powers (e.g. majority shareholder's fiduciary duties)		Yes ¹⁹⁷
(d) Proxy Voting Scheme		Yes ¹⁹⁸

As the above table shows, the current legal regime includes nearly all the international standards for shareholder protection. It can be argued that some of these transplanted rules may not work well in China and may even cause some problems. However, it would be inefficient to abolish these rules at a time when they are developing into an integrated system, given the significant investments made in creating this system. All companies aligned their business forms and management structures with this legal framework. Both market participants and legal end-users have invested time and effort into learning, and adapting to, this system. Consequently, the cost of change could outweigh any advantages accruing from such change. The rational solution, therefore appears to be, as Roe's phrases it, to "resurface" rather than "revolutionize" the existing system.¹⁹⁹

4.2.2. 2.2.2 Learning Effect

"Learning effect" refers to the phenomenon whereby the more one model is used, the more its efficiency can be improved vis-à-vis other alternatives.²⁰⁰ As noted, the legal end-users have already made great efforts in learning the Western legal theories (not only the company law theories) so as to solve the Chinese problems.²⁰¹ The "learning effect" is not limited to the legal end-users, who use the law in their daily work, but extendable to the people who work under the regulation of the laws. If the laws change fundamentally, the market participants are not only forced to re-invest their efforts to learn the new law, but also compelled to change the existing business

¹⁹⁷ *Corporate Governance Guidelines* (2002), art. 19

¹⁹⁸ *Articles of Association Guidelines 2006*, art. 61; and *Corporate Governance Guidelines 2002*, art. 1

¹⁹⁹ M. Roe, 'Chaos and Evolution in Law and Economics' (1996) 109 *Harvard Law Review* 650

²⁰⁰ T. Boas (n 93) 37

²⁰¹ B. Liebman & T. Wu (n 81) 291 and above at section 4.1.4.1, 102-104

customs. All these activities increase the costs of judicial and business practice.

4.2.2.2.3 Network Effect

The "network effect" in economics indicates that the demand for a technology and its value to each current user increases with each additional unit sold.²⁰² The network externality effect also exists in the East Asian jurisdictions of company law reform. All the major East Asian jurisdictions, except North Korea, have westernised their company law regime. Japan's commercial code has transplanted many important elements of U.S company law.²⁰³ South Korea has also introduced some crucial institutions from Anglo-American legal systems into its company law regime.²⁰⁴ Hong Kong's company law, needless to say, inherits many key doctrines and traditions from UK company law.²⁰⁵ The movement toward Western law in East Asian jurisdictions encourages Chinese legislators to adopt a similar approach in reforming China's company law. For example, the 1994 company law is nearly a copy of the Taiwan Company Law. Furthermore, as mentioned, the Chinese corporate governance structure can be regarded as a transplant from Japan. Firstly, adopting a similar rule of law can reduce the transaction cost of international business between Chinese companies and companies from neighbouring States. Secondly, the experiences of the legal practice of company law in other East Asian jurisdictions, especially Hong Kong, are valuable resources for China in improving its own company law regime.²⁰⁶

4.2.2. 2.2.4 Complementary Effect

²⁰² T. Boas (n 93) 37

²⁰³ Miwa, Yoshiro and Ramseyer (n 164) see R. Gilson & C. Milhaupt, 'Choice as Regulatory Reform: The Case of Japanese Corporate Governance' (2005) 53 *American Journal of Comparative Law* 343

²⁰⁴ Jay Choi, Sae WoonPark, and Sean Sehyun Hoo, 'The Value of Outside Directors: Evidence from Corporate Governance Reform in Korea' (2007) 42 *Journal of Financial and Quantitative Analysis* 941; and see B. Black and others, 'Corporate Governance in Korea at the Millennium: Enhancing International Competition' (2001) 26 *Journal of Corporation Law* 537

²⁰⁵ J. Farrar, (n 146) 474

²⁰⁶ For the influence of East Asian Jurisdictions on China's legal reform of corporate governance, see above section 4.2.2.2.1 at page 129, the example of Japan, and also see page 130, the example of Taiwan.

"Complementarities" refer to the fact that costs that are sunk into professional institutions, which are developed to facilitate the operation of the current system and to maintain and continue them are often efficient.²⁰⁷ The above case study provides an example of an emerging complementary system.²⁰⁸ Under the current company law regime, a complementary system is becoming increasingly obvious. For example, with the introduction of director's duties of loyalty, derivative actions are necessarily introduced into China's legal system, as a complementary mechanism for enforcing the doctrine of the duty of loyalty. Similarly, sub-committees under the board of directors are necessarily implemented in order to facilitate the institution of an independent director. This makes directors have a better understanding of their responsibilities. The function of a single transplanted rule therefore is enhanced by this complementary system.

Overall, the evolution of company law seems to be locked into efficiency-driven path-dependence. Even if the functional convergence model can be shown to be more beneficial than the formal convergence model, it is still inefficient to replace the formal convergence model where it is not possible to prove that the benefits of the functional convergence model outweigh the costs of replacing the formal convergence model.

4.2.3. Beyond Path-dependence: Convergence through Congruence

This part goes beyond the singularity of path-dependence. Indeed, law does not merely react, but shapes economic and cultural contexts. One of the leading examples of the "law matters" thesis is La Porta *et al's* empirical research on the relationship between shareholder protection and the development of financial markets across jurisdictions. La Porta *et al* argue that strong investor protection fosters valuable and broad financial markets, dispersed ownership of shares and efficient allocation of

²⁰⁷ C.W. Huang (n 103) 370

²⁰⁸ See above at section 4.1.4.2.

capital across firms, since good protection motivates people to invest their money into stock markets.²⁰⁹ In addition, Gilson's research also supports the "law matters" thesis. Gilson points out that in 1999 the German government eliminated capital gain tax on the sale of stock in German corporations by other German corporations, with the explicit goal of eliminating barriers to dissipate concentrated cross-holding.²¹⁰ Under the "law matters" thesis, a well-functioned legal regime can accelerate the transformation of the economy.

In China, the law does influence the cultural and economic context. Firstly, contractual convergence plays an important role to make some parts of the Chinese economic and cultural context congruent to that of the Western Jurisdictions. Coffee, in his article, once declares that "large firms can choose the stock exchange or exchanges on which they are listed, and in so doing can opt into governance systems, disclosure standards, and accounting rules that may be more rigorous than those required or prevailing in their jurisdiction of incorporation."²¹¹ Much evidence shows that Chinese public companies are increasingly convergent with their counterparts in developed jurisdictions through international listing. For example, foreign companies listed in the UK are responsible for complying with the Combined Code and those listed in the US have to reach the standards set out by the Sarbanes-Oxley Act. Since the early 1990s, there have been an increasing number of the Chinese companies to raise capital on overseas stock markets. A survey indicates that 82 Chinese companies were listed on overseas stock exchanges in 2004. By the end of 2006, this figure increased to 99. By the first half of 2009, 156 Chinese companies were successfully listed on world leading stock exchanges, including the New York Stock Exchange, NASDAQ, the London Stock Exchange, the Hong Kong

²⁰⁹ R La Porta and others, 'Investor Protection and Corporate Governance' (2000) 58 Journal of Financial Economics 1

²¹⁰ R. Gilson (n 87) 342

²¹¹ J. Coffee, 'The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications' (1999) 93 Northwest University Law Review 651-652

Stock exchanges and the Singapore Stock Exchange.²¹² The Chinese public companies, in seeking to list on the foreign stock exchanges, had achieved a substantial level of similarity with their overseas competitors, at least on a structural level. Being foreign listed expands the participation of Chinese public companies in the global economy and substantially enhances their information disclosure and accounting practices.

The impact of contractual convergence is not limited to the foreign listing companies, but it is extendable to the domestic companies. Accession to the WTO presents the toughest test that China's weak legal system has yet had to face. As part of the conditions for WTO membership, China has promised to live up to international standards of transparency, accountability and fairness. In response to this challenge, enhancing the flexibility of company's Article of Association, as an important step toward contractual convergence, is increasingly recognised by China's Company Law. In 2005 Company Law, 31 articles explicit that certain legal requirements can be opted in or opted out by Article of Association or shareholder agreement. In contrast, the Company Law 1994 only has 15 articles, which enable the company to make their own arrangement by Article of Association. Under such legislative regime, individual market players can achieve contractual convergence with international standards by arranging its Article of Association. Furthermore, CSRC's listing rules and guidance also requires the public companies to adopt some core international standards of corporate governance. Guideline of Article of Association for Listing Company is an important device to achieve this purpose. This regulation includes 12 chapters and 198 articles. Its requirements arrange from companies' shareholder meeting to companies' financial and accounting system. The provision on independent director²¹³ and cumulative voting²¹⁴ can be regarded as important evidence of contractual convergence.

²¹² Zhongguo Haiwai Shangshi Gongsi Minglu [List of China's Over-sea Listed Companies] <<http://www.globalipo.cn/shangshigongsiml.asp>> accessed 20th July 2011

²¹³ See article 104 of the Guideline

²¹⁴ See article 82 of the Guideline

In addition to the revision of company law and CSRC's guideline, the process of contractual convergence is also accelerated by foreign investors those are invited to invest in Chinese public companies. In 2006, CSRC, People's Bank of China and State Administration of Foreign Exchange jointly issued a document, namely *Measures for the Administration of Securities Investment within the Borders of China by Qualified Foreign Institutional Investors*.²¹⁵ According to the regulation, foreign fund-management company, insurance company, securities company and commercial bank, which achieve certain policy requirements (mainly on company's investment ability, its fund-management and investment experience)²¹⁶ can invest in Chinese public companies. By September 2009, 87 foreign institutional investors, including UBS, Goldman Sachs and Deutsche Bank, were licensed to invest on the Chinese stock markets. There is little doubt that these top quality international investors can promote the compliance of key international standards in China's domestic listing companies. Some studies also indicate that accounting standards and information disclosure on China's stock markets have been enhanced by the widespread participation of Qualified Foreign Institutional Investors (QFII). Finally, as Howson concludes that "China's firm organization and governance has seen a formal convergence with the Western shareholder-oriented model."

In addition to the changes closely related to corporate governance issues, the broader legal and economic infrastructure has also experienced a significant movement toward the Western style market economy. The recent adoption of the Property Law in China lays down a foundation for the market economy by taking a substantial step towards the protection of private property rights. As some commentators indicate, this law for the first time in Chinese history grants equal protection to both public and private property, breaking up the orthodox ideology in

²¹⁵ Hege Jingwai Jigou Touzizhe Jingnei Zhengquan Touzi Guanli Banfa [Measures for the Administration of Securities Investment within the Borders of China by Qualified Foreign Institutional Investors] issued by People's Bank of China and State Administration of Foreign Exchange on 26th August 2006

²¹⁶ *ibid* article 6

favour of public ownership against private ownership and individual liberty. Additionally, the banking sector has also experienced a fundamental reform. Through selectively implementing a series of international standards and best practice, the major State-controlled commercial banks are now equipped with internal regulatory systems appropriate to independent commercial entities.

Mapping out all these changes, it is not intended to prove that the Chinese legal and economic infrastructure is well suited to the adoption of Western legal rules and institutions. It is true that most overseas listed companies retain their Chinese characteristics. Similarly, the contractual convergence which is mediated by the 2005 Company Law and CSRC's regulations may not control the Chinese corporate governance problem well. It is equal true that a number of difficulties limit the QFIIs' role in the corporate governance of China's public companies. Additionally, legal-economic infrastructural reform is also suffering from various problems in China. However, all these legal-economic movements toward a Western style of corporate governance or market economy at the very least motivate or force Chinese public companies to establish a modern corporate governance system. A clear example lies in the fact that the roles of shareholders, stakeholders, directors and employees in Chinese public companies, are all instantly recognizable to anyone who is familiar with a Western model of corporate governance. Evidence of changes the cultural context is also more difficult to gather. However, it at least shows that transplanted rules and institutions are capable to conveying a sound commercial culture to China's context. Consequently, there is a possibility to graduate change the cultural context by implementing appropriate legal rules and institutions. With the multi-level reforms in economic and legal sectors, the economic-cultural context surrounding the legal reform of corporate governance will share more and more commonalities with that of Western jurisdictions. As a result, legal rules and institutions which harmonise local features with Western experience are fit for application in the Chinese context.

In addition to promoting economic reform, the transplanted legal rule or institution gradually changes China's commercial culture. Taking the independent director requirement as an example, many argue that traditional Chinese culture is dominated by collectivism. Therefore, independent directors are reluctant to act independently. However, some recent cases have shown that independent directors in China have begun to challenge block holder misconduct. The most recent reported cases are those of Jiarui New Materials Co. (Jiarui) case and Yahua Holding Co. (Yanhua). Jiarui was a listed company domiciled in Hunan Province, the central area of mainland China. In 2005 Jiarui granted a guarantee against its block holder's bank loan, which was nearly six times larger than Jiarui's total net assets. This activity explicitly violated CSRC regulations as well as Company Law 2005. The company's three independent directors suggested that the board cancel the guarantee and enhance the risk management regime of the company. Additionally, in order to reduce the ultimate control of the block-holder, they vetoed the appointment of a director nominated by the block-holder. Yahua is also a listed company located in Hunan province. In 2007, Yahua was involved in a take-over transaction. The buyer who prepared to purchase Yahua's shares required the block-holder to appoint two consultants of its related companies as Yanhua's directors before the takeover was closed. This violated the CSRC's takeover provisions. One of the company's independent directors cast his vote against this appointment and disclosed the information by public notice. Prior to both these two cases, in 2004 there was a series of cases in which independent directors had made their voices heard to challenge block-holders and the insiders using their controlling position. As we can see, the implementation of the independent director institution reduces the influence of collectivism, whilst fostering a culture of "independence".

4.2.4. Concluding Remarks

Firstly, the two levels of path-dependence determine which approach, formal convergence or functional convergence, is more suitable for China's company law

reform. In response to "rent-protection path-dependence", a company law regime in the Chinese context should be equipped with some characteristics, which make it effective and efficient in protecting shareholder interests in a clan and friend-relationship based commercial environment and corporatism based economic and financial policy environment. In this regard, Western law may not provide much guidance. This observation leads us back to the "context theory" by which law should be suitable to the local socio-cultural context and existing legal-economic infrastructure.

Nonetheless, the research on "efficiency-driven path-dependence" illustrates that China's case is more than complicated. In order to maximise the "learning effect", "network effect" and "complementary effect" of the existing system, it would be inefficient to abolish the current reform approach which is based on legal transplant. The evolution of Chinese company law is extremely sensitive to its starting point, an serendipitous decision on legal transplant that underwent little scientific analyse before being adopted in the original position makes for very heavy influence over the development of today's company law regime in China. As a result, a considerable gap between the existing legal regime and the local socio-cultural context exists. Furthermore, for several reasons, the legal regime is locked into a model, which conflicts with some intrinsic characteristics of China's political-cultural context. In other words, a transplanted legal rule which fits the existing legal regime may not fit in with the local socio-cultural context.

Secondly, the previous investigation explains the second and third questions posed in Chapter I.²¹⁷ "Lock-in effect" and lack of modern commercial culture gives Chinese legislators few technical options when drafting company law. Legal

²¹⁷ See above at section 1.2.3: (2) If Western transplanted rules do not work well in the Chinese context, why do Chinese legislators persistently introduce legal rules or institutions from Western jurisdictions into China's legal system? Is the decision irrational? (3) In Western jurisdictions, lawyers and judges generally treasure their domestic legal traditions. Why then do Chinese commercial lawyers and judges, tend to take significant amounts of experience from Western jurisdictions, whilst deliberately keeping a distance from China's own cultural and legal traditions?

transplant seems to be the only pragmatic approach. In addition, perfecting the company law regime is not, to a large extent, aimed at meeting the demands of the socio-cultural context, but to making theoretically perfect law that acts as a dynamic force to drive economic development. Indeed, regarding law to be a dynamic force that leads economic development is a long-standing view held in Chinese governance culture. It is reflected by Deng Xiaoping's famous "two hand theory", in which, on the one hand, the economy must be developed, and on the other hand, the legal system must be strengthened to maintain an environment for such development.²¹⁸

The reason that legal elites intentionally divorce the current legal regime from traditional legal culture is partly because of the lack of a domestic commercial law culture and partly because of anxiety over the fierce competition of the global market. Firstly, historical study of the development of company law in China shows that a commercial culture was stifled in ancient China. Both government officers and the market participants have little knowledge of modern commercial practices. Given China's pre-modern commercial law culture, it is difficult to foster a strong and effective company law system, which can well support the development of a market economy. As a result, local customary law and practice are usually dismissed in China's legal reform as being "backwards" or "old and bad habits", impeding economic and legal development than enhancing them.²¹⁹

Secondly, when China was forced to open her doors to the Western world in Qing dynasty, Chinese scholars were faced with the issue of how to enable Chinese enterprises to have strong competitiveness amongst global competition. As Li demonstrates,

It would be a tool for promoting China's industrial development. Modern

²¹⁸ X.P. Deng, *Deng Xiaoping Wenxuan* [Selection of Works by Deng Xiaoping] volume 3 (People's Publisher 1989) 107

²¹⁹ J. Cheng, 'The Transformation of Chinese Law: From Formal to Substantial' (2007) 37 Hong Kong Law Journal 689, 737

industrial capitalism, it was believed, demanded Western, corporate structures to do business. Only by changing the legal and economic foundations of business relationships could Chinese entrepreneurs hope to compete with their Western and Japanese counterparts. A central goal, therefore, was to promote the creation of Chinese companies to compete with the foreigners who were producing and marketing their goods on Chinese soil.²²⁰

For the next 100 years after the Qing dynasty launched China's first company law code, although a series of legal revisions reflected different ideologies imposed by different governments, two beliefs rarely changed throughout China's modern history. Firstly, the belief that there is a cause-and-effect relationship between Western-style company law and a strong national economy. This is a belief on which laws have been drafted. The second belief is that modern company law is a major device in promoting the competitiveness of Chinese enterprises in the global market. These two beliefs, derived from anxiety about modernization, drive Chinese legislators to adopt a utilitarian approach towards company law reform.

This economic oriented view adopted by Chinese legislators towards company law is not without theoretical support. There is a dichotomy between "instrument law" and "culture-based law".²²¹ Under this dichotomy, the law in the instrumental extreme is relatively culture-neutral, compared with the culture-based law. Cotterrell further develops this classification. According to his theory, there are four pure types of "community"; namely, instrumental community, traditional community, community of believe, and affective community. Company law, as a major component of commercial law, belongs to the category of instrumental community and is relatively culturally neutral in nature, especially when it is compared with family law or constitution. This is because the law in this category is tied to "economic interests

²²⁰ C. Li, 'Gongsi Lv 1904 Yu Zhongguo Gongsifa De Xiandaihua' [The Company Law 1904 and Modernization of China's Company Law] 1974 (10) *Zhongda Faxue Pinglun* [Zhongshan University Law Review] 174; and W. Kirby (n 136) 43

²²¹ R. Cotterrell, 'Is There a Logic of Legal Transplants?' In D. Nelken and J. Feest (eds.), *Adapting Legal Cultures* (Hart Publishing 2001) 80

rather than national customs or sentiments."²²²

Thirdly, the striking tension between transplanted law and local context is not still. The correlation and interaction between China's reform of its company law regime and the development of economic infrastructure from a historical perspective illustrate that the law can modify the economic context in certain conditions. As a result of the influence of foreign laws and transplanted laws on the domestic jurisdiction, some important economic components in China have gradually become congruent to those of developed jurisdictions.

To conclude, some may argue that the "rent-protection path-dependence" resists the "rule of law" system. The inherent characteristics of China's political and cultural context determine that company law reform should rely on Chinese local knowledge. However, we should note these unique Chinese characteristics now rest on a wide-range of commonalities between China's legal-economic infrastructure and that of the West. Consequently, China's approach to company law reform should be capable of achieving a balance between local resources and Western experience. This finding also suggests that the conclusion of the case studies is not a coincidence. Although a formal convergence model causes many problems from the perspective of rent-seeking path dependence, compared with the functional convergence model, it is still a more pragmatic and feasible approach in a transitional jurisdiction, which does not possess a vigorous domestic commercial law culture and has been locked into the model of legal transplant.

4.3. Conclusion

This chapter sketches out the methodological issues involved in China's legal reform of corporate governance by answering questions about whether the formal convergence model has competing advantages when it is compared with the

²²² *ibid* 82

functional convergence model, and what those advantages are (if any). Following these enquiries, this chapter has undertaken a comparative study of the formal convergence model and functional convergence model using case studies. The results of these case studies indicate that the formal convergence model, at least, has three competing advantages: (1) it is supported by Western experience; (2) it has a complementary effect; and (3) it is time-saving. In the final part this chapter formulated the rationales behind the findings of the case studies by analysing what determines the formal convergence model's role in China's legal reform of corporate governance. It puts the evolution of Chinese company law into a theoretical framework of path-dependence. The two levels of path-dependence and Westernised economic components are the key determinants in favour of the formal convergence model. Finally, by reviewing the findings of this chapter, it solves the two interesting puzzles presented in Chapter I and provides some theoretical insights regarding the scholarship on China's corporate governance. In the following chapter, this paper will focus on how to re-formulate the existing agency-cost controlling devices following the formal convergence model in practice.

Chapter V. Modelling an Efficient Company Law Regime for Controlling Agency Cost: A Comparative Study between China and the UK

5.1. Introduction

Former chapters have located the major problems of China's corporate governance regime and their legal implications. Furthermore, they have engaged in some theoretical analysis on several important topics. These included (1) the importance of the company law regime in China's legal reform of corporate governance; (2) the advantages of utilizing the formal convergence model in reforming China's company law; and (3) the determinants of the advantages or priorities of the formal convergence model. This chapter attempts to make a more practical contribution to this paper. On the basis of the theoretical conclusions achieved in former chapters, it deals with the most troublesome problem of China's company law system; namely, the fact that it is "rich in principles but lacks details."¹ It focuses on several key legal provisions, which are assigned to regulate agency problems. By comparing these provisions with similar legal principles in the UK, it identifies what needs to be improved for the sake of improving the effectiveness of these provisions. Furthermore, on the basis of comparative study, it provides some detailed suggestions on how to transform these important legal provisions into a more efficient model.

5.2. Director's Fiduciary Duties

¹ Y.W. Wei, 'Director's Duties under Chinese Law: A Comparative Review' [2006:3] University of New England Law Journal 31, 55

5.2.1. General Background²

In accordance with the Companies Act 2006 (hereinafter 2006 Act), "directors" include any person occupying the position of director, regardless of title.³ Article 3 of the Companies (Model Articles) Regulations 2008 says that directors are the managers of the business of a company. In addition, the 2006 Act has little to say on the appointment of directors, leaving this matter to a company's Articles of Association.⁴ This legislation requires a public company to appoint at least two directors.⁵ Additionally, there is a minimum age requirement for directors⁶. The Act allows legal persons to be directors of the companies, though at least one natural person must also act as a director of a company.⁷ It is widely accepted that the intentions of the company can be derived from the intention of its officers and agents.⁸ In *Bolton Engineering v Graham*⁹, Lord Denning LJ held that:

Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.¹⁰

As it represents the state of mind of the company, a wide range of managing powers are bestowed upon the board through a company's Articles of Association. Notably,

² For general empirical comparative research on the board of directors between China and the UK, see J.Z. Yang, 'The Anatomy of Boards of Directors: An Empirical Comparison of UK and Chinese Corporate Governance Practices' (2007) 28 *Company Lawyer* 24

³ Companies Act 2006 (CA 2006), s.250

⁴ L. Sealy & S. Worthington, *Case and Materials in Companies Law* (9th edn, Oxford University Press 2010) 264 On a similar point, see P. Davies, *Gower and Davies's Principles of Modern Company Law* (8 edn, Sweet & Maxwell 2008) 307 article 17 of the Companies (Model Articles) Regulations 2008 (SI 2008/3229) directs that a director may be appointed by an ordinary resolution of the members or by co-option by directors.

⁵ CA 2006 s.154

⁶ *ibid* s.157

⁷ *ibid* s.155

⁸ B. Pettet, *Company Law* (2nd edn, Person Education Limited 2005) 147

⁹ [1957] 1 Q.B. 159

¹⁰ *ibid* 173

authority to exercise the company's powers is delegated, not to individual directors, but only to the directors as a board. The board may sub-delegate that power to individual directors and other officers.¹¹

Generally, the board has the following powers:

- to change the company's capital structure, management, and internal control structure;
- to approve annual reports and accounts;
- to approve contracts entered into by the company which are not in the ordinary course of business;
- to appoint or remove the company secretary and external auditors; and
- to approve nominees to the board following recommendation by the nomination committee.¹²

By contrast, the Chinese *Company Law 2005* does not provide a definition of director. Instead, it gives a definition of senior executive. According to the law, "senior executives" refers to managers, vice managers, persons in charge of the finance of a company, and the secretary of the board of directors in a listed company, as well as any other person indicated in the Articles of Association. Additionally, senior executives bear director's fiduciary duties.¹³ As in UK law, there are rules relating to the number of members on a board, which in Chinese public companies is

¹¹ P. Davies (n 4) 307 and see article 5 of the Companies (Model Article) Regulations 2008 (SI 2008/3229)

¹² C. Law and P. Wong, 'Corporate Governance: A Comparative Analysis between the UK and China' (2006) 16(9) *International Company and Commercial Law Review* 350, 355

¹³ *Company Law* art.148 (2005)

restricted to 5 to 19 members.¹⁴ Additionally, a person shall not be a director where he is without the capacity of civil conduct or only with limited capacity of civil conduct.¹⁵ Under the current legislation, the chairman of the board, executive director or manager can be the representative of the company by the authorization of the Article of Association.¹⁶ However, the Chinese law contains no provisions clarifying that the state of mind of the company is equal to the state of mind of the board as a whole or that of the general meeting¹⁷.

Under *Company Law 2005*, a director's managing powers include:

- determining the company's operating and investment plan;
- establishing the company's internal management structure; and
- hiring and replacing general managers and deciding issues concerning their compensation.¹⁸

In China's *Company Law 1993*, some provisions regarding director's duties have

¹⁴ *ibid* art.109 (2005)

¹⁵ According to articles 11, 12 and 13 of the *Zhonghua Renming Gongheguo Minfa Tongze* [*General Principles of the Civil Law of People's Republic of China*], adopted by 4th Session of the Standing Committee of the 6th National People's Congress, April. 12, 1986, (effective January 1, 1987), a person under 18 years of age has limited capacity of civil conduct and a mentally ill person who is unable to account for their conduct shall be a person having no capacity for civil conduct. Additionally, a person who has reached the age of 16 but not the age of 18 and who earns his/her own living shall be regarded as a person with full capacity for civil conduct. Therefore, someone who has reached 16 years of age and has no mental illness can be appointed a director of a company.

¹⁶ See *Company Law* art.11 (2005); and C.B. Xie, 'Gongsi Daibiaoquan Zhidu Jiqi Dui Zhongguo Lifa De Jiantao Yu Gaige Wenti Yanjiu' [Examining and Reforming the Legislative System on Corporate Representation] In B.S. Wang (eds.), *Zhuanxing Zhong De Gongsifa De Xiandaihua* [Modernizing Company Law in Transition Context] (Shehui Kexue Wenxian Chubanshe 2003) [Social Science Academic Press 2003] 100

¹⁷ In Chinese legislation, the general meeting usually refers to the "supreme organ" or "authorized organ". Furthermore, *Company Law* (2005) also grants a power of business management to the general meeting. On this point see M. Siems, *Convergence in Shareholder Law* (Cambridge University Press 2008) 154

¹⁸ It is summarized by Takeshi Jingsu in 'Corporate Governance for Listed Company in China-Recent Moves and Improve the Quality of Listed Company' (2007) 10 *Nomura Capital Market Review* 36, 38-39

been set out.¹⁹ However, that Law did not intentionally include a "duty of loyalty" by explicitly stating that directors owe duties of loyalty to the company. Rather, these duties were first introduced into the Chinese legal system by *Company Law 2005*. Article 148 of the 2005 Law says directors owe duties of loyalty to the company and that directors or senior managers must avoid the following:

- misappropriating the company's property;
- depositing the company's funds into his or any other individual's personal account;
- violating the Articles of Association, without the approval of the general meeting or the board of directors, including loaning the company's funds to others or providing securities to any individual;
- entering into an agreement or transaction with the company by violating the Articles of Association or without the approval of the general meeting;
- exploiting corporate opportunities by taking advantages of his position, or operating business competes with the company he works for, without the approval of the general meeting;
- misappropriating commissions from transactions between the company and other parties;
- disclosing the company's confidential information without permission;
- other acts which are inconsistent with the duties of loyalty to the company.

¹⁹ For director's duties in *Company Law* (1993), see generally Z.Y. Jin, 'The Role of Shareholders in Enforcing Directors' Duties: A Comparative Study of the United Kingdom and China' (2006) 17(11) *International Company and Commercial Law Review* 318

The Law states that the income of any director or senior executive from any act in violation of the preceding paragraph shall belong to the company.

By comparing these duties of loyalty with the "no conflict rule" which is an important part of fiduciary duties in the UK, similarities become apparent. According to UK law, directors are not allowed to make a profit out of the following scenarios without the approval of the board or general meeting:

- a transaction with the company;
- the director's personal exploitation of the company's property, information or opportunities; or
- the receipt benefits by a third party because of a director exercising their directorial functions in a particular way.²⁰

Clearly, the content of duties of loyalty in Chinese company law closely resembles that of fiduciary duties in the UK. This is not only because the fundamental duty of a fiduciary is to be loyal to the trustee in the UK²¹, but also because the Chinese duties of loyalty are mainly concerned with the "no-conflict rule".

Despite these similarities, an important characteristic makes Chinese duties of loyalty different from UK fiduciary duties. The above sub-provisions all focus on how to prevent a director from being put in a position where their interests conflict with those of the company. This characteristic shows that the ambit of duties of loyalty is considerably narrower than that of UK fiduciary duties. According to the 2006 Act, in addition to the former three sub-groups, there are another three groups of duties, which

²⁰ P. Davies (n 4) 497, and CA 2006, s.175

²¹ P. Koh, 'The Director's Fiduciary Obligations-A Fresh Look?' (2003) 62(1) Cambridge Law Journal 42 Also see L. Sealy, 'Directors' Duties in the New Millennium' (2000) 64 Company Lawyer 64

directors have; namely:²²

- they must remain within the scope of the powers which have been conferred upon them;
- they must act in good faith to promote the success of company; and
- they must exercise independent judgment.

5.2.2 Why are Fiduciary Duties Transplantable?

Before discussing how to improve China's company law by transplanting legal rules from UK law, it is necessary to consider one thing that could seriously thwart the transplant of fiduciary duties. It could be argued that a similar set of duties exist in civil law system and they also can be applied in the context of director's duties.²³ However, it seems that China's newly-revised company law transplants these duties from Anglo-American Jurisdictions rather than Civil Law Jurisdictions.²⁴

This is the fact that this group of duties is deeply embedded in the UK's legal tradition.²⁵ Fiduciary duties under Equity refer to the idea that beneficiaries are entitled to the single-minded loyalty of their trustees, or, more generally, that principals are entitled to the single-minded loyalty of their fiduciaries. It demands a

²² P. Davies (n 4) 497 and CA 2006 sections 171, 172 and 173.

²³ See Black. B, Cheffins. B, Gelter. M, Hwa-Jin. K, Nolan. R, Siems. M, & Prava. L, "Report to Russian Center for Capital Market Development: Comparative Analysis on Legal Regulation of the Liability of Members of the Board of Directors and Executive Organs of Companies (English Language Version)" (February 2008). ECGI - Law Working Paper Series 103/2008 Available at SSRN: <http://ssrn.com/abstract=1001990>, 29. Director's fiduciary duties also exist in Germany.

²⁴ For this point see Xi. C, 'Foreign Solution for Local Problem? The Use of US style of Fiduciary Duty to Regulate Agreed Takeover in China' (2008) 11 Journal of Chinese Economy and Business Studies 408 and N. Howson also indicates that in his article, new Article 148 [of company law 2005] which for the first time in China's corporate law, directly address directors' and officer's fiduciary duties, and in a distinctly Anglo-American Way. See N. Howson, 'The Doctrine that Dared Not Speak Its Name: Anglo-American Fiduciary Duties in China's 2005 Company Law and Case Law Intimations of Prior Convergence' in H. Kanda, Kon-Sik Kim, C. Milhaupt (eds.), Transforming Corporate Governance In East Asia, (Routledge 2008) 193

²⁵ L. Sealy, 'Director as Trustee' (1967) 83 Cambridge Law Journal 83

general denial of self-interest.²⁶ A director's fiduciary duties come from his or her trustee-like position. By contrast, Chinese lawyers have not developed such a solid theoretical framework to explain the nature of duties of loyalty.²⁷ Although the Trust Law 2001²⁸ introduced relationships of trust into the Chinese legal system, this does not play a major role in business life nor do judges or market participants have an in-depth understanding of this concept.²⁹ Therefore, the comparison between the fiduciary duties in the UK and the duty of loyalty in China may be characterised as being "a dry juxtaposition of the rules of one legal culture with those of another",³⁰ which is criticised by some comparative lawyers. Indeed, it is reasonable to ask how Chinese legal end-users can understand standards or rules developed from Equity, which is a concept with which they are unfamiliar.³¹

²⁶ S. Worthington, *Equity* (Oxford University Press 2006) 131

²⁷ In Chinese academia, there is a debate on the nature of duties of loyalty. Some argue that as Chinese judges and lawyers are not familiar with the concept of "trust", the legislator should borrow an equivalent concept (mandate relationship) from civil law jurisdictions to interpret the nature of the relationship between the director and the company. On this point see, D.W. Li, D.H. Liu & X.Y. Qian 'Dongshi Falv Yanjiu' [Legal Analysis of Corporate Director] (2002) 02 Jiushi [Knowledge Seeker] 53 and Z.L. Cheng & L.W. Pu, 'Zhongguo Shangshi Gongsigongsi Dongshi Quanli Jianguan' [Supervising The Managing Powers of the Directors in Chinese Listed Companies] Colloquium Paper of Chinese Bar Association Annual Symposium (2001) <<http://ckrd.cnki.net/grid20/detail.aspx?filename=ZHQL200111003045&dbname=CPFD2001>> accessed 20th July 2011

²⁸ Zhonghua Remin Gongheguo Xintuo Fa 2001, [Law of Trust of the People's Public of China (2001)], adopted by 21st Session of the Standing Committee of the 9th National People's Congress, April 28, 2001

²⁹ For example, see M.N. Zhang, 'Dongshi Diwei Yanjiu' [Examining Director's Legal Position] (1998) 2 Dangdai Faxue [Modern Law Science] 46. Clarke argues that the fiduciary duties which come from the law of trust are unlikely to work in China, as there is no equivalence of a trust relationship in the Chinese legal system, D. Clarke, 'Lost in Translation? Corporate Legal Transplants in China' (July 3, 2006), GWU Law School Public Law Research Paper No. 213 <<http://ssrn.com/abstract=913784>> accessed 20th July 2011. However, recently both legislators and legal researchers have begun to focus on the implementation of "fiduciary duties" in Chinese legal system. For example, the *Shareholder Protection Provisions 2004*, Article 5(1) say that blockholders owe fiduciary duties (cheng xin yi wu) to the company and its shareholders. For academic studies see X. Tang, 'Konggu Gudong De Shouxin Yiwu: Cong Meiguo Fa Shang Yizhi' [Controlling Shareholder's Fiduciary Duties: Transplanting from the US], In B.S Wang (eds.), *Zhuanxing Zhong de Gongsifa de Xiandaihua* [Modernizing Company Law in Transition Context] (Social Science Academic Press 2003) 534; T.S. Zhou, 'Dongshi Chengxin Yiwu De Goujian: Yingguo Gongsigongsi Fa De Qishi' [Formulating Director's Fiduciary Duties in Chinese Context: Some Lessons Provided by the UK Law] (2009) 04 *Beijing Gongshan Daxue Xuebao*, [Journal of Beijing Technology and Business University] 105; and J.B. Lou, H. Yan & Y. Zhao, 'Gongsigongsi Fa Zhong Dongshi Jianshi Gaoguanrenyuan Xinyi Yiwu De Falv Shiyong Yanjiu' [The Studies on the Application of the Duties of Loyalty to Company's Director and Executives] in P.Z Gan, L.F Liu (eds.) *Xin Leixing Gongsigongsi Susong Yinan Wenti Yanjiu* [Practical Issues of the New Company Law] (Perking University Press 2009) 306

³⁰ P. Legrand, 'How to Compare Now' (1996) 16 Legal Studies 232

³¹ For a similar point, see J.Q. Liu, 'Corporate Governance in China: From the Protection of Minority Shareholder' (2006) 2 The Corporate Governance Law Journal 311, 331

However, the nature of director's fiduciary duties may be not as influential as it appears in this particular context. Firstly, fiduciary duties in the context of company law are no longer mysterious Equity principles. They have been legislated by the UK's 2006 Act and developed into a series of legal provisions. By integrating the Equitable principles into statute, the culturally specified characteristics of fiduciary duties of trustees in Equity are fading. By contrast, its technical characteristics are further enhanced. To elaborate, through legislation, the inscrutable Equitable considerations behind fiduciary duties are translated into "technical language", which is comprehensible to a well-trained company lawyer with a civil law background. For example, Japan, also a civil law jurisdiction, has successfully adopted Anglo-American fiduciary duties in its Commercial Code, although this took several decades.³² This phenomenon partly proves that cultural barriers are not insurmountable in transplanting Anglo-American fiduciary duties to a civil law jurisdiction. Moreover, the essential elements of fiduciary duties have already been adopted by Chinese law. As mentioned, the concept of the duty of loyalty which is based on the no-conflict rule, is an important part of *Company Law 2005*. Furthermore, in practice, Chinese judges have used some core elements of fiduciary duties to solve practical problems. The Equity doctrine of "proper purpose" is an apt example. In the context of company law, the "proper purpose" doctrine primarily requires a director, who is in the trustee's position to maximise shareholder interests. Although this doctrine is not formally adopted in China's company law, judges in Beijing have cited it as the underlying principle for their judgments. In 2006, Beijing Zi Qiao, a real estate company, filed a claim against its director on the basis of a breach of the director's duties of loyalty. In this case, the defendant had a personal grudge against other executives in the company. A strong desire for revenge led him to enter into a complementary contract with the company's debtors on behalf of the company without undergoing the formal decision process required by the Articles of Association. This agreement waived the company's contractual rights valued at

³² H. Kanda & C. Milhaupt, 'Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law' (2003) 51 *American Journal of Comparative Law* 887, 897

4,000,000 RMB (approximately 400,000 pounds sterling). The court held that the defendant breached the director's duty of loyalty on the basis that the director's decision in entering into the contractual relationship was not for a proper purpose, namely maximizing the company's interests, but rather for retaliating against his colleagues and the company.³³

The former analysis does not attempt to deny that fiduciary duties, to some extent, are cultural phenomenon. Instead, it suggests that cultural barriers which stand in the way of legal transplant are surmountable, especially where Equitable principles have been translated into technical terms through legislation, while some of key elements have been adopted by the receiving jurisdiction. Thus, even though Chinese legal end-users have little knowledge of the Equitable considerations behind fiduciary duties, this shortage of knowledge may not influence their capacity to appropriately appreciate and use the concept of fiduciary duties to deal with practical problems in a technical sense.

In addition to cultural considerations, others argue that Anglo-American style fiduciary duties demand support from a sophisticated court system. Their application and enforcement requires that the court system be empowered with a wide-range of residual law-making powers. In a transition economy, the court system may not be in a position actively to develop rules for regulating executive behaviour.³⁴ Nevertheless, Howson's research on Chinese judicial enforcement of the director's duty of loyalty under the 1993 Law suggests otherwise. Howson finds that the duty of loyalty was not even formally introduced by the 1993 Company Law and that Chinese judges aggressively went beyond what was permitted in legislation. He writes that the "Chinese court has been proven perfectly willing and technically able to invoke and enforce, on their own and without authorization—and with respect of individual cases

³³ (2006) Yi Zhong Min Chu Zi Di 05884 [Beijing First Intermediate Court (commercial court) no. 05884]

³⁴ K. Pistor, and C.G. Xu, 'Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory', In C. Milhaupt (eds.), *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals* (Columbia University Press 2003) 77

having no precedent-like effect—basic corporate fiduciary norms."³⁵ This research has provided much evidence to suggest that the duty of loyalty can be properly utilised by Chinese judges, even without the support of detailed legislation. Pistor and Xu's argument alleging that Anglo-American fiduciary duties need the support of judicial direction is correct. Nonetheless, in the case of China this argument may only suggest that as a transitional jurisdiction, it needs to positively adopt a more elaborate version of fiduciary duties rather than abolishing these doctrines.

In sum, as a result of cultural and institutional differences, copying the UK's fiduciary duties into China's company law directly will not work. Therefore, the demands of Chinese company law are important. The following parts will locate the legal rules which are still ambiguous or absent in the regime of director's fiduciary duties. Following that, it will select some legal doctrines from the UK and adjust them to make them capable of dealing with China's problems.

5.2.3. What Needs to be Reformed?

As mentioned above, compared with the UK's fiduciary duties, the duty of good faith has not been adopted in Chinese company law. This raises the question of whether China's company law needs this doctrine to cope with director misconduct. One might argue that as duties of care and loyalty have been transplanted into the Chinese legal system, the duty of good faith is no longer needed. It is widely accepted that there are two types of director for whom the duty to act in the interests of the company may pose particular difficulties. These are directors of subsidiary companies and nominee directors. These two types of director are more likely to pursue a holding company or nominator's interests than the company's interest.³⁶ Similarly, research on Delaware corporate law indicates that traditional duties of care and loyalty are not

³⁵ N. Howson, 'The Doctrine that Dared Not Speak Its Name: Anglo-American Fiduciary Duties in China's 2005 Company Law and Case Law Intimations of Prior Convergence' in H. Kanda, Kon-Sik Kim, C. Milhaupt (eds.), *Transforming Corporate Governance In East Asia*, (Routledge 2008) 198

³⁶ B. Pettet (n 8) 173

adequate to cover all types of improper conduct by directors or managers, where a company is controlled by an imperator CEO or controlling shareholder with a passive board. The duty of good faith plays a fundamental role in extending the contours of director's duties in this context. It covers most of the important types of case in which a manager's conduct although improper does not violate the duty of loyalty.³⁷

It is common that listed companies are controlled by a single majority shareholder in China.³⁸ As a result, many directors are nominated by the majority shareholders of listed companies. According to He's research on 348 listed companies in 2004, the companies in which the chairmen of the board were nominated by controlling shareholders occupied 87 per cent of all samples.³⁹ Similarly, the empirical evidence provided by NANKAI University strikingly found that only 11.36 per cent of Chinese listed companies implemented the cumulative voting scheme⁴⁰ in appointing directors.⁴¹ This means that minority shareholders have little power in appointing directors in China. However, listed companies usually declare that they are fully independent from their holding companies and holding companies will not exert any level of influence on a subsidiary's management nor on their usage of corporate assets. Nevertheless, in practice, a large number of directors and executives still manage the business in favour of the majority's interests rather than the company's interests. According to Cheng and Pu's survey on nominee directors in Chinese listed companies, nearly all the nominee directors interviewed expressly acknowledged that

³⁷ M. Eisenberg, 'The Duty of Good Faith in Corporate Law' (2006) 31 Delaware Journal of Corporate Law 1, 27

³⁸ See above Chapter II at section 2.3.2.2

³⁹ W.D. He 'Shenjiaosuo Shangshi Gongsi Zhili Zhuangkuang Diaocha Baogao' [Empirical Studies on the Listed Companies' Corporate Governance Regime in Shen Zheng Stock Exchange] Zhengquan Shibao [Securities Times] 18th December 2003

⁴⁰ *Company Law* (2005) art.106

⁴¹ Nan Kai Daxue Gongsi Zhili Yanjiu Zhongxin [Corporate Governance Research Centre Nankai University] "Shang Shi Gong Si Zhi Li Ping Jia Yan Jiu Bao Gao" [Evaluation of the Listed Companies' Corporate Governance] *Zhengquan Ribao* [Securities Daily] 24th February 2004

they would pursue the nominators' interests rather than those of the company.⁴² Therefore, the absence of a duty of good faith may mean that a director's misconduct cannot be properly regulated in China.

Secondly, unlike the UK's fiduciary duty which is a mixture of various legal standards, tests and rules, other than the catch-all in sub-provision 8 of the *Company Law 2005*, nearly all the sub-provisions of that law are bright-line rules. Furthermore, none of these rules are drafted in a detailed manner, nor are they equipped with sufficient operative guidance. Arguably, bright-line rules are easier to understand and be enforced by the judges. However, they usually suffer from a problem of under-inclusiveness. Consequently, the form of this set of provisions needs to be updated by more sophisticated standards and tests.

The major tasks of a comparison between the UK's director's fiduciary duties and China's director's duties of loyalties are as follows:

- to enlarge the ambit of the duties of loyalty (Task I)
- to insert operative standards and tests for the doctrine of "no-conflict interest" in China (Task II)

Having addressed the above tasks, the following elements of fiduciary duties will then receive particular focus within each of those tasks:

Task I

- the duty to act bona fide in the best interests of the company and not for any

⁴² Z.L. Cheng & L.W. Pu, 'Wo Guo Shangsi Gongsi De Dongshi Quan Ji Jiankong' [Controlling Director's Powers in China's Public Company], Colloquium Paper of Chinese Bar Association Annual Symposium 2001
<<http://ckrd.cnki.net/grid20/detail.aspx?filename=ZHQL200111003045&dbname=CPFD2001>>
accessed 20th July 2011

collateral purpose;

- the nominee director's duty of good faith;

Task II

- the duty of a director not to put themselves in a position where their personal interests may conflict with those of the company; and
- the duty not to appropriate assets belonging to the company.

5.2.4 Task I: Enlarging the Ambit of Duties of Loyalty

As there are few relevant resources in China that can be compared to UK case law, this section will primarily focus on the extent to which duties of good faith in the UK can be transformed into a set of manageable provisions for dealing with Chinese problems.

5.2.4.1 The Duty to Act Bona Fide in the Best Interests of the Company and Not for Any Collateral Purpose

Following the recent company law reform in China, some elements of the duty of good faith have already been transplanted into the legislative framework in a piece-meal manner. The *Company Law 2005* says that directors shall comply with laws, administrative regulations and their Articles of Association. According to Delaware corporate law, this provision covers an important aspect of the duty of good faith.⁴³ In addition, the *Corporate Governance Guidance for listed Companies* (Corporate Governance Guidance) issued by CSRC lays down a duty under which

⁴³ Under Delaware corporate law, a director is not allowed to maximize corporate profits by violating law or regulations. See M. Eisenberg (n 36) 31

directors must faithfully, honestly and diligently perform their duties in the best interests of the company and the shareholders as a whole.⁴⁴ However, firstly, as quasi-legislation, the enforceability of the CSRC's Guidance is questionable. It is difficult to see the basis on which the CSRC would enforce this provision unless breaches were to cause a market failure. Secondly, this provision cannot escape being symbolic and therefore difficult to put into practice due to the number of undefined terms that it contains. For example, what does "faithful, honest and diligent performance" refer to in this particular context? These observations suggest that whilst Chinese legislators may be aware of the importance of the duty of good faith, legal rules regarding this concept are ill-formulated.

In order to implement the duty of good faith, the fundamental question to be addressed is in whose interests directors should work. In the UK, the interests of the company traditionally equate to the long-term interests of its shareholder, specifically, "the shareholders' interests collectively" or "the shareholders' interests, present and future".⁴⁵ Under the 2006 Act, a fundamental change in this doctrine was made. According to this Act, directors, whilst ultimately required to promote shareholder interests, must take account of factors affecting the company's relationships and performance, such as stakeholder's interests. The Act reminds directors that shareholder value relies on the successful management of the company's relationship with other stakeholders.⁴⁶ In practice, this "enlightened shareholder approach" may not give rise to increased legal liability on the part of directors.⁴⁷ This is because the only duty at stake is the duty to promote the success of the company, and as long as directors have made good faith business judgments with reasonable care, skill and diligence they are unlikely to be in breach that duty.⁴⁸ Overall, "enlightened shareholder value" is radically different from the "pluralist approach". The latter

⁴⁴ *Corporate Governance Guidelines*, art.33

⁴⁵ L. Sealy & S. Worthington (n 4) 301 and Davies (n 4) 507

⁴⁶ L. Miles & M. Lower 'Giving Effect to the Statutory Duty of Loyalty' (2006) 5 Sweet & Maxwell's Company Law Newsletter 1

⁴⁷ See Sealy & S. Worthington (n 4) 321

⁴⁸ *ibid*

requires the director give equal consideration to stakeholder interests in making a business decision. However, under the current regime, the members' interests are still paramount, but the interests of stakeholders are to be taken into account when determining the best way of promoting the members' interests.⁴⁹

In contrast, the Chinese *Company Law 2005* does not clarify whose interests the director should work for. The CSRC's *Corporate Governance Guideline* answers this by saying that a director should work for shareholders' interests as a whole.⁵⁰ However, another article says that listed companies are obliged to ensure that stakeholder interests are properly protected.⁵¹ The socialist tradition exerts deep influence on corporate legislation whereby employee interests are strongly protected. A series of provisions in the Company Law are highlighted for this purpose:

- Company shall hear and consider employees' opinions and suggestions, where the company proposes to re-structure its organization.
- The company which is invested by two or more State-owned enterprises, board of director should consist of employee representatives.
- The company shall appoint employees representatives as the members of supervisory board. The employee representatives must be no less than one third of the board members.

Creditor protection has also been enhanced by recent legal reforms. According to the Guidance issued by the Chinese Supreme Court on implementing the Company

⁴⁹ Davies (n 4) 508

⁵⁰ *Corporate Governance Guideline* art.33

⁵¹ *ibid* art.81

Law 2005⁵², if a director fraudulently appropriates a company's assets or accounting documents, creditors are entitled to sue the director on the grounds of a breach of the duty of diligence.⁵³

After this belief introduction, some distinctions can be drawn between the China's company law regime of directors and its UK law counterpart. Firstly, the board structure is different. In China, the supervisory board, which represents the stakeholders' interests, is parallel to the board of directors. It is bestowed with a wide range of powers by which it can restrict improper business decisions being made by directors.⁵⁴ In the UK, however, due to its one-tier board structure, it is necessary for the board of directors to weight up conflicts between shareholder and stakeholder interests. Secondly, Chinese company law encourages stakeholders to monitor or participate in the company's decision-making process. By contrast, in the UK, the simple fact is that the central management of the company's business is in the hands of the board.⁵⁵ Overall, in China because the supervisory board is able to review and adjust decisions which shareholder profits are maximised at the expense of stakeholder's interests, it is understandable that directors are required primarily to consider shareholders' long term interests in their management under the two-tier board structure.

The second question is how to test whether a director is acting in bona fide best interests of the company. The "duty of good faith" is a widely used doctrine in the Chinese civil law system, especially in contract law. It is an underlining principle,

⁵² Zuigao Renming Fayuan Guanyu Shiyong Zhonghuarenminggongheguo Gongsifa Rougan Wenti de Guiding (I&II) [Supreme Court's Judiciary Interpretations on China's Company Law 2005 I & II] Chinese text is available at <http://www.chinacourt.org/flwk/show1.php?file_id=109879> accessed 20th July 2011

⁵³ Chinese Supreme Court's Guidelines on Company Law 2005 (II), articles 18 and 19

⁵⁴ *Company Law* art. 54 (2005) and *CSRC Corporate Governance Guideline* Chapter 4

⁵⁵ Davies (n 4) 410

which both parties to a contract must obey.⁵⁶ However, no evidence indicates that the "duty of good faith" in contract law is able to solve company law issues, despite the fact that companies might be regarded as a nexus of contracts.⁵⁷ As already mentioned, the *Company Law 2005* provides an objective standard to test whether a director operates the company's business in good faith. According to the law, directors are held liable to a company for loss caused by their conduct when it breaches law, regulations or the company's Articles of Association.⁵⁸ This objective standard is a workable criterion. Nonetheless, it may still suffer from the problem of under-inclusiveness. A director may pursue his personal interests at the expense of the company's interests by means that circumvent the rigid bright-line rules under current legislation. For example, the chairman of a board may appoint their friend or family member to be a senior executive in the company. Such a chairman (usually the insider who can take *de facto* control of the board) may proceed with such an appointment despite knowing that their friend or relative is clearly incapable of being a senior manager because, for example, they are without any business experience or are ill-educated. In such a case, the shareholders or liquidators may be able to sufficiently prove the existence of the above facts as well as loss (e.g. payment of high remuneration made to this person) caused by this decision. However, the director will not be accountable for the company's loss, if the court applies an objective test to this case. The director's decision does not breach any law or regulation, even though the chairman may not be able to provide sufficient evidence to establish that the appointment is underpinned by valid commercial reasons.

⁵⁶ The concept of "good faith" plays a very important role in Chinese contract law and property law. Generally, "good faith" in a civil law context is recognised as a tool through which a judge can exercise their discretionary power to fill the gaps in different cases. On this point see G.D. Xu, *Minfa de Yiban Yuanze: Chaoyue Chengwenfa de Xianzhi* [General Principles of Civil Law: Overcoming the Limitations of Statutes] (Zhongguo Zhengfa Daxue Chubanshe Di er Ban 2001) [2nd edn, China University of Political Science and Law Publisher 2001] Chapter 3. However, in the context of Chinese company law, "good faith" is still an under-developed legal theory.

⁵⁷ There is a radical difference between a contractual relationship in the context of a company and a normal arms-length transaction. For example, fiduciary principles are uncommon in contract relations which are based on arms-length transactions: See F. Easterbrook & D. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 90

⁵⁸ *Company Law* art.113 (2005)

It could be argued that judges can rely on the catch-all in sub-provision 8 of the 2005 law to hold a director liable for this improper decision. However, not only is a judge's ability to exercise discretionary power on a case to case basis questionable, but without thorough interpretation or operative guidance, this provision itself does not make much sense. Besides this ambiguous catch-all provision, an additional bright-line rule is implemented by *Company Law 2005* prohibiting directors from promoting majority shareholder interests at the expense of the company. Under the law, any loan or guarantee provided to a majority shareholder or *de facto* controller should be approved by disinterested shareholders at the shareholders meeting.⁵⁹ In other words, directors must not provide loans or guarantees to the above persons without the consent of the members. Whilst easy to enforce, this rule only addresses one small facet of a huge pitfall. Again the preceding analysis highlights that such fragmented rules cannot provide an all-round control on a director's immoral conduct. Consequently, more specific standards and tests by which "good faith" can be more accurately assessed should be introduced into the Chinese legal system. UK case law provides some valuable experience in this regard.

The underlying principle of good faith can be found in *Re Smith and Fawcett Ltd*⁶⁰. Lord Green MR held that "[directors] must exercise their discretion bona fide in what they consider - not what a court may consider - is in the interests of the company".⁶¹ In other words, judges are well suited to enforcing standards and integrity, but not to undertaking a review of corporate decisions on an objective basis.⁶² This view is confirmed by the more recent case of *Regentcrest v. Cohen*.⁶³ Here, it seems that the judge was not applying an objective test of good faith e.g. would a reasonable director in the circumstances have thought this action was in the interests of the company? Rather, he simply tested the credibility of the directors'

⁵⁹ *ibid* art.16

⁶⁰ *Re Smith and Fawcett Ltd* [1942] Ch.304

⁶¹ *ibid* 306

⁶² L. Sealy 'Bona Fides and Proper Purposes in Corporate Decisions' (1989)15 *Monash University Law Review* 265

⁶³ [2001] BCC 494 (Chancery Division)

assertions regarding their subjective motivations.⁶⁴ Accordingly, under the regime of 2006 Act, "success" is to be determined on a company-by-company basis. It is for the directors to interpret the company's objective and to make practical decisions about how best to achieve them.⁶⁵ Both UK case law and statute suggest that directors are entitled to decide what the best interests of the company are and that their decisions are not generally subject to second guessing by the courts. Easterbrook and Fischel have made an insightful analysis of the rationale behind this legal arrangement by explaining why same judge who decides on whether an engineer has designed compressors on jet engines properly cannot review a company manager's decision:

Businesses rarely encounter "sure things". Often managers must act now and learn later; delay for more study may be the *worst* decision; the market will decide whether the decision was good...How can the court know whether a poor outcome of a business decision is attributable to poor management (inputs) or to many other things that affect firms?"⁶⁶

However, this does not mean a director's business decision is not subject to judicial review under any circumstance. According to Gower,

in most cases compliance with the rule that directors must act honestly and in good faith is tested on common-sense principles. The court will ask itself whether it is proved that the directors have not done what they honestly believed to be right, and normally accepting that they have unless satisfied that they have not behaved as honest men of business might be expected to act.⁶⁷

Similarly, in judiciary practice, some cases confirm that director's business decision can be reviewed by court objectively. Pennycuick J. in *Charterbridge Corp Ltd v*

⁶⁴ L. Sealy & S. Worthington (n 4) 325

⁶⁵ *ibid* 320

⁶⁶ F. Easterbrook & D. Fischel (n 57) 98-99

⁶⁷ P. Davies (n 4) 388

Lloyds Bank Ltd⁶⁸ said that:

the proper test, I think, of whether a director of a company has acted bona fide in the interest of the company ... must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company.⁶⁹

In practice, the court requires the plaintiff to prove the bad faith or dishonesty of the director.⁷⁰ As Sealy says, the best approach in applying the duty of good faith is to regard it as the ground upon which a corporate decision may be challenged as irregular and held to be void or voidable.⁷¹ Following this line of thought, several grounds for challenging business decisions under the duty of good faith can be identified; namely, "improper motives", "abused or exceeded or not genuinely exercised power" and "unreasonableness".⁷²

In *Howard Smith Ltd v Ampol Petroleum Ltd*⁷³, Lord Wilberforce held that "in a case that the court has found that directors have believed they were acting *bona fide* in the interests of the company. The court must find whether the purpose for which the director acted was objectively proper or improper".⁷⁴ This means that directors might act in complete subjective good faith, but find themselves in breach of the requirement to act for proper purpose.⁷⁵

⁶⁸ *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] C.h. 62;

⁶⁹ *ibid* 74

⁷⁰ B. Black, B. Cheffins, M. Gelter, Kim, Hwa-Jin, R. Nolan, M. Siems, and L. Prava, 'Report to Russian Center for Capital Market Development: Comparative Analysis on Legal Regulation of the Liability of Members of the Board of Directors and Executive Organs of Companies (English Language Version)' (February 2008), ECGI - Law Working Paper Series 103/2008 <<http://ssrn.com/abstract=1001990> 34> accessed 20th July 2011

⁷¹ L. Sealy (n 62) 268

⁷² *ibid* 268

⁷³ *Howard Smith v Ampol Petroleum Ltd* [1974] A.C. 821, PC 835

⁷⁴ *ibid* 835

⁷⁵ L. Sealy & S. Worthington (n 4) 311

In *Punt v Symons & Co Ltd.*,⁷⁶ in order to pass a special resolution, the directors issued new shares to five additional members. Byrne J held that,

It is argued on the evidence that but for the issue by the directors of the share under their power as directors, and, therefore, in their fiduciary character under the general power to issue shares, it would have been impossible to pass the resolution proposed; and that the shares were not issued bona fide, but with the sole object and intention of creating voting power to carry out the proposed alteration in the articles...if I find as I do that shares have been issued under the general fiduciary power of the directors for the express purpose of acquiring an unfair majority for the purpose of altering the rights of parties under the articles, I think I ought to interfere.⁷⁷

In *Hogg v. Cramphorn Ltd.*,⁷⁸ the directors of the defendant company, in order to forestall a takeover bid, had issued shares with special voting rights to the trustees of a scheme set up for the benefit of the company's employees. This was held to be an improper use of the directors' powers to issue shares. Buckley J. held:

It is not, in my judgment, open to the directors in such a case to say 'We genuinely believe that what we seek to prevent the majority from doing will harm the company and therefore our act in arming ourselves or our party with sufficient shares to outvote the majority is a conscientious exercise of our powers under the articles, which should not be interfered with'. Such a belief, even if well founded, would be irrelevant ... The power to issue shares was a fiduciary power and if, as I think, it was exercised for an improper motive, the issue of these shares is liable to be set aside.⁷⁹

⁷⁶ [1903] 2 C.h 506

⁷⁷ ibid 513

⁷⁸ [1967] Ch. 254 (Chancery Division)

⁷⁹ ibid 268

In *Extrasure Travel Insurance Ltd v Scattergood*,⁸⁰ the court created an objective standard for testing the improper purpose. In the event that a director's decision is challenged, the court will take the four-step test: (1) identify the power whose exercise is in question; (2) identify the proper purpose for which that power was delegated to the directors; (3) identify the substantial purpose for which the power was in fact exercised; and (4) decide whether that purpose was proper.⁸¹ The answers to the above questions can in general be found by reviewing the company's Articles of Association and other shareholder agreements. As Lord Hoffmann states "An abuse [improper and unlawful exercise] of these powers [fiduciary power] is an infringement of a member's contractual rights under the article"⁸² The test for improper purpose is an objective one, even if it is applied to a director's subjective motivations.

Additionally, "patent unreasonableness" is an important test for the duty of good faith, since a director's unreasonable decision may breach his duty to act in the genuine belief that he is acting in the best interests of the company. In *Brady v Brady*⁸³, Lord Oliver held,

The words "in good faith in the interests of the company" form, I think, a single composite expression and postulate a requirement that those responsible for procuring the company to provide the assistance act in the genuine belief that it is being done in the company's interest.⁸⁴

The test of genuineness was also applied in the *Halt Garage* case⁸⁵. In this case, a company paid remuneration to a sick director who took no part in the business. After the company was insolvent, the liquidator brought proceedings claiming the whole of

⁸⁰ [2002] All E.R. (D) 307.

⁸¹ *ibid.* See also Z.Y. Jin (n 19) 318

⁸² *Sherborne Park Residents Co Ltd, Re* (1986) 2B.C.C 582

⁸³ [1989] A.C. 755, HL

⁸⁴ *ibid* 778

⁸⁵ *Re Halt Garage* [1982] 3 All E.R. 1016

the sick director's remuneration. Lord Oliver held that "in the postulated circumstance of a wholly unreasonable payment, that might, no doubt, be *prima facie* evidence of fraud...the real test must, I think, be whether the transaction in question was a genuine exercise of power".⁸⁶ As Sealy states,

the court normally only reviews the integrity and regularity of the process of the decision made by corporate organ, and not the reasonableness of result; but, exceptionally, a result may be so unreasonable that the court is entitled to infer that it has not been reached by proper purpose.⁸⁷

Consequently, patent unreasonableness may lead a court to conclude that a director does not achieve a minimum threshold of genuineness for the duty to act in good faith.

Finally, as Gower says, "good faith must not only be done but must manifestly be seen to be done."⁸⁸ According to this Equitable principle, directors should not put themselves in a position where their interests will conflict the company's interests. Thus "conflict of interests" is another ground on which the court could reach a conclusion of bad faith.

Studying UK case law deepens our understanding of the vital role played by the duty of good faith in modern company law. Some Chinese legal commentators have already concentrated to these issues. Many of them suggest that an American style

⁸⁶ *ibid.* See also L. Sealy & S. Worthington (n 4) 273

⁸⁷ See L. Sealy (n 62) 277. However, in the UK, some cases indicate that the court may not inquire whether the director's honest belief was a reasonable one. (e.g. *Regentcrest plc (in liquidation) v. Cohen* [2001] 2 B.C.L.C. 80). The pre-condition is that the director provides evidence to prove that there were valid commercial reasons upon which the decision was made. See P. Davies (n 4) 388, and *Bishopsgate Investment Management Ltd v Maxwell* (No.2) [1994] 1 All ER 261, CA. In this case, the plaintiff proved that the company had suffered a loss caused by the director's unreasonable decision. The Court of Appeal held that the burden of proof will be upon the director to demonstrate the propriety of the transaction.

⁸⁸ P. Davies (n 4) 529

business judgment rule should be adopted in China.⁸⁹ Generally, the business judgment rule involves a presumption that a director has acted on an informed basis, in good faith, and in the interests of the corporation. A plaintiff must rebut one or more these presumptions, in order to challenge a director's decision.⁹⁰ The presumptions include:

- A judgment has been made. In other words, a director would not qualify for protection under the rule where they failed to make due inquiries or take action;
- a reasonable decision-making process was employed by the director in which he informed himself on the business judgment which he reasonably believed appropriate under the circumstances;
- the decision was made in subjective good faith; and
- the director and officer do not have any conflict of interests in the transaction which is approved by the decision.⁹¹

However, as in the UK, the subjective business judgment rule is not always strictly applied during the process of judicial review. The US courts in some cases also employ objective standards to review the quality of a decision. For example, in *Sam Wong & Son, Inc. v New York Mercantile Exchange*⁹², Judge Friendly held that

in determining whether a person made a decision in good faith it was relevant

⁸⁹ For example, see X. Xu & Z.R. Yang, 'Dongshi Yiwu yu Shangye Panduan Yuanze' [Director's Duties and Business Judgment Rule] (2001) 05 Falv yu Shehui Fazhan [Law and Social Development] 40; Y. Tao 'Shangye Panduan Yuanze yu Zhongguo Gongsi Zhili' [Business Judgment Rule and Chinese Corporate Governance] (2004) 04 Shangye Yanjiu [Commercial Research] 19; and H.G Li & H.Ge, 'Zai Zhonggou Shixing Shangye Panduan Yuanze' [Implementing Business Judgment Rule in Chinese Context] (2007) 18 Gongong Yanjiu [Public Science] 23

⁹⁰ B. Black and others (n 70) 47

⁹¹ M. Eisenberg 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' (1993-1994) 62 Fordham Law Review 437, 441

⁹² 735 F.2d 653 (2d Cir. 1984).

whether the decision had rationality ... We mean only a minimal requirement of some basis in reason ... Absent some basis in reason, action could be hardly in good faith even apart from ulterior motive. ⁹³

To sum up, although the tests for duty of good faith are subjective, both UK and US courts have developed some objective standards to prevent the serious problems arising in circumstances where an irrational business decision is protected solely because it is made in subjective good faith.⁹⁴

According to the above analysis, standards for the duty of good faith have been introduced to protect the director's business discretion rather than to impose excessive legal liability on directors. By contrast, the main aim of China's regime should be different as its main purpose is to make directors accountable for their misconduct.⁹⁵ Although protecting a director's business discretion is always important, in China a director's misconduct is under-regulated. A few vague provisions are therefore seemingly insufficient to restrict a director's improper motivation.

Regarding the implementation of the duty of good faith, dual levels of duties (duties of administrative regulation and duties of legislations) should work as complementary parts in China. This is because the divergence between standards of conduct and the standard of review can result from the effects of imperfect information⁹⁶. The first level of duties could be introduced by the CSRC in the form of administrative regulations. This level of duty might include a detailed outline of best practice in a director's decision-making process. The standards for best practice should mainly be based on objective elements and drafted in plain language, which makes them more accessible and easier to understand. This *ex ante* duty would lead a good results, as recent empirical research shows that in Chinese listed companies, a

⁹³ *ibid* 677-678. See also M. Eisenberg (n 91) 442

⁹⁴ M. Eisenberg (n 91) 442

⁹⁵ See, for example, Y.K. Zhu 'Lun Dongshi Wenze de Chengxin Lujing' [Duty of Good Faith: Approaching the Director's Accountability] (2008) 3 *Zhonggou Faxue* [China Law Science] 86

⁹⁶ M. Eisenberg (n 91) 438

director's knowledge of the best corporate governance practice has significantly improved. Some directors have already begun to consider the CSRC's practical guidance before making decisions.⁹⁷ The second level of duty which should be introduced in the form of legislation should be less demanding than the first. For example, under the first level of duty, it may be expected that directors act as intelligent and honest entrepreneurs in exercising their decision-making powers. However, under the second-tier of the duty, evidence which suggests that a director's business judgment has not been exercised intelligently is not sufficient to rebut the presumption that the director acted in the *bona fide* interest of the company, if the director can provide a valid commercial reason for this decision.

Essentially the following legal rules should be inserted into the regime of *ex post* duties under which a court can review a director's decision:

1. Establishing an overriding principle under which a director should act in the *bona fide* best interests of the company.

1.1 The interests of company can be interpreted as the long-term interests of the shareholders as a whole.

1.2 The director's decision is presumed to be made in good faith unless one of the following criteria has been met:

1.2.1 any undisclosed conflict of interest (direct or indirect) by the director;⁹⁸
and

1.2.2 any improper purposes of the director's decision, two basic tests for improper purposes should be established.

⁹⁷ N. Andrews & R. Tomasic, 'Directing China's Top 100 Listed: Corporate Governance in an Emerging Market Economy' (2006) 2 (3) The Corporate Governance Law Review 246

⁹⁸ For details of this doctrine, see section 5.2.5 below.

1.2.2.1 The director exercises his power unconstitutionally or for a purpose which is inconsistent with the initial purpose for which the power is delegated to the director by the Articles of Association.

For the above test, the four-step assessment⁹⁹ used in *Extrasure Travel Insurance Ltd v Scattergood* could be borrowed by Chinese judges to decide whether a director has used his powers unconstitutionally. For the Chinese listed companies, their Articles of Associations are relatively reliable resources for judges to decide whether the object of a director's decision is proper. This is because unlike quasi-partnership companies, listed companies are more likely to pursue a professional legal service in drafting their Articles of Association. In most cases, the quality of the Articles can be guaranteed by the involvement of law firms. Moreover, in China, the Articles of listed companies must be drafted in accordance with the standards laid down by the CSRC' *Corporate Governance Guideline* and the *Guideline for the Listed Company's Articles of Association*. Additionally, a company's Articles of Association must be reviewed by the CSRC before it is permitted to be listed on the stock market. Therefore, in general the purpose for which the power is delegated will be properly clarified by the Articles. Moreover, all listed companies' Articles of Associations are drafted in accordance with the same administrative regulations and reviewed by same market regulator. Consequently, the key articles of the Articles of Associations of different companies should be similar. The harmonization of key provisions of Articles of Association reduces the judicial cost in enforcing the duty of good faith because judges need only to review or interpret similar articles.

1.2.2.2 a patently unreasonable or irrational business decision which is not founded on the director's honest belief that he is acting in the best interests of the

⁹⁹ (1) identify the power whose exercise is in question; (2) identify the proper purpose for which that power was delegated to the directors; (3) identify the substantial purpose for which the power was in fact exercised; and (4) decide whether that purpose was proper.

company;

For this test, a substantial loss to the company does not necessarily lead to the conclusion that a director has acted in bad faith where he can prove that his decision was honestly made in the best interests of the company. In such a case, one criteria which can be employed is whether a director can prove the obvious positive connection between their decision and the interests of the company in the circumstances in which the decision was made.

We should recognise that "patently unreasonable", "honest belief" and even the "improper purpose rule" are standards which are difficult to interpret. The effectiveness of their application is largely based on judicial discretion.¹⁰⁰ The fact that Chinese judges generally lack commercial expertise poses a particular difficulty to the implementation of these standards. For instance, they may not be sophisticated enough to decide whether a business decision is made in the honest belief of the best interests of a company by reviewing detailed factual evidence. Nevertheless, even though this set of standards is not perfectly manageable for Chinese judges, it is still much more workable and pertinent, compared with the catch-all provision which says "other activities which breach the duties of loyalty".¹⁰¹ Introducing these standards into Chinese company law significantly upgrades the accessibility and transparency of a director's duty of loyalty. When legal certainty is promoted, the reasonable expectation is that companies or their shareholders will become more active in filing litigations against director decisions that are in breach of the duty of good faith. The courts will in turn have more opportunities to develop their professional skills as well as the standards for testing these duties in accordance with practical experience. As a result, directors will also find increasing risks involved in serving the majority shareholder or personal interests at the expense of the company's interests.

¹⁰⁰ Even in the UK and US, the duty of "good faith" is regarded as a notoriously ambivalent concept. On this point see Sealy (n 60) 268 and M. Eisenberg (n 91) 441

¹⁰¹ *Company Law* art.149(8) (2005)

2. any intentional breach of law, regulations and articles of association.

This final objective test which has already been adopted in Chinese law should be retained. This is because it is an important element of the duty of good faith and is highly congruent with existing bright-line rules in legislation.

5.2.4.2 Duty of Good Faith: Nominee Director

The starting point for good faith in the context of nominee directors can be found in *Scottish Co-operative Wholesale Society Ltd v Meyer*.¹⁰² Here, a majority shareholder maximised his own interests at the expense of the company's interests by setting up a competing business and cutting off the company's suppliers. The majority shareholder's nominee directors were aware of the majority's intention to destroy the company, but kept silent and failed to take necessary steps to protect the company against the majority's misconduct. In this case, Lord Denning concluded that,

They [the nominee directors] probably thought that "as nominees" of the co-operative society their first duty was to the co-operative society. In this they were wrong. By subordinating the interests of the textile company to those of the co-operative society, they conducted the affairs of the textile company in a manner oppressive to the other shareholders.¹⁰³

This decision clearly stated that the nominees' duties were owed solely to the company, and they are bound to exercise their powers and discretions in the interests of the company in preference to the interests of their principal.¹⁰⁴ Adhering to this principle, the decision of *Kregor v Hollins*¹⁰⁵ affirms that an agreement is unlawful, where it contains a provision under which a nominee director must subordinate the

¹⁰² [1959] AC 324.

¹⁰³ *ibid* 368

¹⁰⁴ E. Boros, 'The Duties of Nominee and Multiple Director' (1989) 10 *Company Lawyer* 211, 213

¹⁰⁵ (1913) 109 LT 225

company's interests to their nominee or a particular group of shareholders.¹⁰⁶

In the *Boulting v ACTAT*¹⁰⁷ Street J narrowly interpreted this principle. He held that once a director has taken his position on the board he must exercise his power only in the interests of the company as a whole considering the interests of the members as a collective group in preference to the interests of his appointer.¹⁰⁸ However this strict approach is widely criticised by lawyers as "impossibly high" or to "ignore the commercial reality"¹⁰⁹. Parsons stated:

The director who is a nominee of a substantial shareholder is between the devil and the deep blue sea. Happily perhaps for his peace of mind he is most often unaware of the company law principles. No doubt he will only remain a director while he furthers the wishes of the shareholder by whom he was appointed.¹¹⁰

The strict test under which a nominee director must not take their nominators' interests into consideration may put the nominee in an impossible position. Under these circumstances, a more lenient approach to the nominee director's duty should be adopted. In *Re Broadcasting Station 2GB*¹¹¹, the strict approach was tempered in Jacobs J's judgment. His lordship reached the view that nominee directors can have regard to their nominator's interests provided that the director has a reasonable belief that he is acting consistently with the company's interests as a whole.¹¹² This objective standard arguably is more consistent with the general commercial reality.¹¹³

¹⁰⁶ (1913) 109 LT 225

¹⁰⁷ [1963] 2 QB 606

¹⁰⁸ P. Crutchfield, 'Nominee Director: the Law and Commercial Reality' (1991) 12 *Company Lawyer* 109, 138

¹⁰⁹ E. Boros (n 104) 218; and P. Crutchfield *ibid* 138

¹¹⁰ R. Parsons 'The Directors Duty of Good Faith' (1956-1957) 5 *Melbourne University Law Review* 418

¹¹¹ (1913) 109 L.T. 225, 228, C.A.

¹¹² See P. Crutchfield (n 108) 139

¹¹³ *ibid*. However, others have argued that from a practical point of view, the difference between Jacobs J's approach and Lord Denning's decision is ambiguous and immeasurable. Different approaches may achieve the same conclusion in practice. See E. Boros (n 102) 218

Nominee director's duties are subject to a legal vacuum under Chinese law, as the *Company Law 2005* is silent on these duties. By contrast, the CSRC has made some effort to regulate the relationship between nominee directors and their nominators by imposing duties on majority shareholders rather than nominee directors. For example, Art.26 of the *Corporate Governance Guideline* says that the board of directors and supervisory board of listed companies are independent organs which are not subject to the majority shareholder's control. The majority shareholder and its subsidiaries must not directly or indirectly influence the business and investment of listed companies and their subsidiaries through any informal procedure (e.g. mandate or instruction). In addition, Art.27 prevents the majority shareholder and its subsidiaries from entering into competing business with a listed company. Aside from the issue of the extent to which the CSRC enforces these legal principles, the real concern here is that majority shareholder's duties should not be isolated from a nominee director's duties. Generally majority shareholders' who prejudice minority interests need their nominee directors' assistance to do so, especially in the listed companies where ownership and control is separate. As Lord Denning held in *Boulding v. Assn. of Cinematograph Television and Allied Technicians*¹¹⁴,

take a nominee director, that is, a director of a company who is nominated by a large shareholder to represent his interests. There is nothing wrong in it. It is done every day. Nothing wrong, that is, so long as the director is left free to exercise his best judgment in the interests of the company which he serves. But if he is put on terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful.¹¹⁵

The law should send a clear signal that nominee directors would be in breach of their duty if they prefer their nominator's interests to those of the company, where they honestly believe that a nominator is acting in his own interests to the detriment of the

¹¹⁴ [1963], 2 A.C. 606

¹¹⁵ *ibid* 626-627

company. Therefore, an approach which only imposes duties on majorities is not sufficient to protect the Company's interests.

The absence of a nominee director's duty can be attributed to ideological considerations. As we have already mentioned, employee representation on the board of director is a mandatory requirement for companies which are mainly invested in by the State. Therefore, such a law may conflict with China's socialist tradition, where it includes a strict rule under which nominee directors must exercise their powers in the interests of the company while disregarding the nominator's interests. However, the difficult position taken by the employee nominated director is not an issue unique to China.

In response to this issue in the UK, the suggestion made by Bullock Committee was that

[it] would be unrealistic not to expect ... employee representatives ... to argue strongly at board level for the interests of their constituents... [but their ultimate duty should be]... to weigh up the differing and conflicting interests in the company in order to reach decisions which they genuinely believe to be in the company's overall best interests.¹¹⁶

This suggestion, which is similar to the approach adopted by Jacobs J in the *Re Broadcasting Station 2GB* case, may be workable in the Chinese context. However, an unanswered question is whether an employee director should be entitled to subordinate the company's interests to the employee's interests in accordance with the socialist tradition. A recently issued administrative regulation provides guidance in this regard. The *Regulation on Employee Directors in Wholly State-Owned*

¹¹⁶ Bullock Committee Report (1977) para 52. See also E. Boros (n 104) 216

*Enterprises*¹¹⁷ suggests that there is no difference between the duties of employee directors and other non-employee directors and that an employee director should carefully weight up the conflict between company and employee interests. These provisions and the Bullock Committee's suggestions are essentially similar. Both suggest that it goes too far to allow an employee director to pursue their nominator's interests at the expense of the company's interests.

Overall it is not unrealistic to implement a nominee director's duty of good faith in the Chinese context. A statutory enactment similar to Ghana's Companies Code which enables nominees to give "special but not exclusive consideration" to the interests of the class they represent should be introduced in China.¹¹⁸ The reform proposal is as follows:

A nominee director is presumed not to be in breach their fiduciary duties by taking their nominator's interests into consideration or acting in accordance with their nominator's instruction, unless one of the following circumstances is present:

- (1) in so doing the director does not have a bona fide belief that he is also promoting the interests of the company as a whole; or
- (2) no honest and reasonable director could have formed the view that in so doing the director was also promoting the interests of the company as a whole.¹¹⁹

These dual standards adopted in *Re Broadcasting Station 2GB* are combined using both subjective and objective tests. The first circumstance above is a subjective test which is only satisfied where the plaintiff can prove that the director's decision is not based on his subjective belief that the company' interests is identical with the

¹¹⁷ 'Dongshi Hui Shidian Zhongyang Qiye Zhigong Dongshi Lixing Zhize de Guanli Banfa' [Regulation on Employee Directors in Wholly State-Owned Enterprises] issued by State-owned Assets Supervision & Administration Commission on 7th April 2009

¹¹⁸ Davies (n 4) 528

¹¹⁹ P. Crutchfield (n 108) 139 and 141

nominator's interests. This test is relatively difficult to satisfy. In addition to this orthodox test, the second one inserts an objective standard of reasonableness into the regime, which enables judges to play a more active role in judicial review by deciding whether the decision is "reasonable" based on their understanding of societal standards.

5.2.4.3 Conclusion

To conclude, this part first explained the importance of the duty of good faith in controlling agency cost in a context where insiders are powerful. It then discussed how to integrate the duty of good faith into China's legal regime. With appropriate modifications, the standards relating to duties of good faith in UK case law can be workable criteria, which fill a gap of China's company law. However, well-drafted legal provisions, although important, are still not determinative. Duties of good faith are not only about a set of perfectly designed legal rules, but are also achieved through positive legal actions in the real world. As Jacobs J states,

The fiduciary duties of directors spring from the general principles, developed in courts of equity, governing the duties of all fiduciaries -- agents, trustees, directors, liquidators and others -- and it must be always borne in mind that in such situations the extent and degree of the fiduciary duty depends not only on the particular relationships, but also on the particular circumstances.¹²⁰

Numerous UK legal sources addressed in this paper stem from judicial practice from the last hundred years. This includes a bundle of general legal principles that have fit into the model market economy. However, it is unwise to expect legal transplant to achieve a one model fits all effect. Reforming the law on paper is only the beginning for the development of duties of good faith in China's legal system. Its evolution in the local context relies on profound judicial understandings of local commercial

¹²⁰ *Levin v. Clark*, (1962) NSW 686

reality, skilful judicial analysis of factual evidence in each case and insightful legal reasoning on a case by case basis.

5.2.5 Task II: Reforming the "No-Conflict Rule"

In China, the "no-conflict rule" is particularly important. As a result of the multiple levels of agency relationship,¹²¹ insider-dealing and misappropriation of corporate opportunities by directors and executives will cause loss to State-owned assets. When these issues extend to State ownership, they are not merely legal issues, but become closely related to political stability and the national economy. This part will particularly focus on two doctrines of the "no-conflict rule": One is concerning "self-dealing transactions" and the other is the "corporate opportunities doctrine".

5.2.5.1 Self-dealing Transactions

The law concerning self-dealing governs transfer of property by a company to its director and *vice versa*.¹²² A self-dealing transaction is fundamentally different from an arm's-length transaction. In the latter type of transaction, both parties generally lack the information to assess their best interests and the overall transaction cost.¹²³ However, in a self-dealing transaction, there is usually asymmetric information between the two parties. The director as a party of the transaction is better informed. In short, the significance of self-dealing is that a director's involvement or interest on the other side of the contract represents a potential threat to the company.¹²⁴

In order to ensure that both parties hold an equal amount of information, the law requires the self-dealing director to disclose all material information to the company. Generally, self-dealing is permitted in both of Chinese and UK law, but the duty of

¹²¹ On this point, see Chapter II, section 2.3.2.

¹²² A. Walters, 'Companies Act 1985, s.320' (1998) 19(8) *Company Lawyer* 229

¹²³ A. Griffith, 'Section 317 and Efficient Self-dealing: What Should an Interested Director Be Required to Disclose?' (1999) 20(6) *Company Lawyer* 184

¹²⁴ A. Griffith, *Contracting with Companies* (Hart Publishing 2005) 265

disclosure is imposed on the interested director as a penalty default rule in both jurisdictions.¹²⁵ Under the *Company Law 2005*, a set of provisions have been issued to regulate self-dealing transactions. However, some considerable weaknesses of the legal regime need to be fixed.

5.2.5.1.1 The Ambit of Self-dealing Transactions

The concept of a self-dealing transaction should essentially cover a wide range of possibilities from a director's direct involvement as a third party to the situation where a director has a remote or indirect interest in a third party as a shareholder or creditor.¹²⁶ According to UK legislation, conflicts of interest can be divided into direct interests and indirect interests. Indirect interest means that the director needs not necessarily be a party to the transaction or arrangement.¹²⁷ Both direct and indirect interests can take a variety of forms.¹²⁸

Direct interests can take the following forms:

- Transactions between a director and the company that the director serves (Type I)
- Transactions between director and the subsidiaries of a company the director serves (Type II)

Indirect interests can take the following forms:

- Transactions between a person to whom a director is connected and the company that the director serves (Type I)

¹²⁵ CA 2006, s.175; *Company Law* art. 142 (2005)

¹²⁶ A. Griffith (n 124) 265

¹²⁷ CA 2006 s.175

¹²⁸ Here self-dealing is defined in a broad sense. It takes both the self-dealing transaction and the substantial property transaction into consideration.

- Transactions between a person to whom a director is connected and the subsidiaries of the company that the director serves (Type II)

UK legislation in accordance with the above categorization provides a set of systematic rules to regulate both direct and indirect interest conflicts between directors and companies. According to the 2006 Act, in a normal proposed transaction where a director has interests, he should disclose these to the board. In this sort of transaction, the general principle is that a contract involves self-dealing where a director has the beneficial interests of the third party. Thus even if the interest is only a small shareholding, a director should disclose this to the company.¹²⁹ Secondly, in substantial property transactions,¹³⁰ disclosure requirements are stricter. A director's personal relationship will be deemed to be a cause of conflict of interest. It triggers mandatory disclosure, no matter whether the director will actually obtain any interest by taking advantage of this relationship. Additionally, the director is required to disclose any conflict interest between himself or a person connected to him and the subsidiaries of the company he serves. Under the substantial property transaction doctrine, persons deemed connected to a director include:

(a) members of a director's family;

(b) a body corporate with which the director is connected;

(c) a person acting in his capacity as trustee of a trust (i) the beneficiary of which is the director, or a person who is connected with the director by virtue of (a) and (b), (ii) the terms of which confer a power on the trustee that may be exercised for the benefit of the director or any such person;

¹²⁹ A. Griffith (n 124) 275

¹³⁰ Similar to the UK, in Chinese legal system, there is a concept of a substantial self-dealing transaction. See *Independent Director Guidelines (2001)* Chapter 5, subsection 1. For the concept of substantial property transaction in the UK legislation, see CA 2006, s.191

(d) a person acting in his capacity as partner of the director or a person connected with the director by virtue of (a), (b), (c).

(e) a legal person under the law by which it is governed and in which- (i) the director is a partner (ii) his connected person by virtue of (a) (b) (c) is a partner (iii) the partner is a firm in which the director or his connected person by virtue of (a) (b) (c) is a partner.

A director's connected persons do not include a person who is himself a director of the company.¹³¹

Similarly, *Company Law 2005* includes a concept of a "connected relationship". Art. 217 says that a "connected relationship" indicates the relationship between a company's controlling shareholders, *de facto* controllers, directors, supervisors, senior executives and the incorporated entity directly or indirectly controlled by the above persons, and any other sort of relationship which may threaten the company's interests. Additionally, Art.20 further states that the controlling shareholders, *de facto* controllers, directors, supervisors, and senior executives of the company shall not exploit the company's interests by taking advantage of their connected relationship. However, in the section on director's duties, the law only requires disclosure by a director under circumstances involving type I direct interests. It says that a director must not enter into an agreement or transaction with the company by violating its Articles of Association or without the approval of the general meeting. Again, one might argue that the "catch-all" provision provided in Chinese Law can achieve a functional equivalence to the UK legislation. The terminology of "any other sort relationship" used in Chinese company law may well cover all types of connected relationship specified by the UK's 2006 Act. Additionally, the recently issued

¹³¹ CA2006, s.252

Accounting Standards for Enterprises No.36¹³² (Accounting Standards) lays down some provisions regarding this issue. In accordance with the Accounting Standards, listed companies must disclose related-party transactions through their financial statements to the general public. It further confirms that a "related party transaction" includes (i) transactions between executives or an executive's close family members and the company, and (ii) transactions between executives of a holding company or their close family members and the company.¹³³

Even if the Chinese court could rightly define connected relationships based on the catch-all provision on a case by case basis, the 2005 Law merely states that a director must not use their connected relationship to undermine a company's interests. It is logically inconsistent to conclude that this open-textual rule includes a requirement under which a director is bound to disclose indirect interests in substantial property transactions to members. Without a mandatory disclosure requirement, directors could argue that unnecessary disclosure triggering the need for shareholder approval will increase transaction costs for the company, especially where they claim that they honestly believe that the transaction is in the best interests of the company. Consequently, courts will struggle to decide whether a director has an indirect conflict of interests in such a transaction. This will take up more judicial resources and increase the difficulty of coming to a fair judgment. Under current legislation, even for a substantial property transaction, a director need not disclose direct or indirect interests, which conflict with the subsidiaries of the company he serves. Moreover, the rules in the Accounting Standards are not reliable, since they only require listed companies to disclose related party transactions. In other words, they do not impose a duty of disclosure on individual directors in the event that a director has an indirect conflict. Ironically, one might question how listed companies can disclose related-party transactions if directors are under no obligation to inform them those transactions are taking place. Clearly, the disclosure requirements for

¹³² Qiye Kuaiji Zhunze di 36 Hao [Accounting Standards for Enterprises No.36] issued by the Ministry of Finance on 15th February 2006 (number 3)

¹³³ *ibid* art.4 (9) and (10)

self-dealing transactions require reform.

Many Chinese lawyers claim that the law should not keep silent on the issue of whether a director needs to disclose a conflict interests between his family members and the company he serves.¹³⁴ This is particularly serious where the company is controlled by a few insiders. In the case of New China Life Insurance, the chairman of the board sold the company's projects at a considerably undervalued price to some companies managed by his brothers. The chairman did not disclose the transaction to the board or members. The result was that the boundary between the chairman's personal assets and the corporate assets were completely blurred.¹³⁵ However, a director is free to argue that under the current legal regime he is under no obligation to make such a disclosure. Chinese company law should clearly define the ambits of conflict of interest by broadening the concept of connected relationship. Firstly, the meaning of "family members" should be specified. In order to be consistent with the Accounting Standards, all close family members should be deemed as "connected persons". This concept refers to:

- a director's spouse
- a director's children and step children
- a director's parents and grandparents
- a director's brother and sister
- a director's aunt and uncle

¹³⁴ Y. Li, 'Meigou Gongsifa Zhong Zhongshi Yiwu Yuanze de Qishi' [Duty of Loyalty in American Corporate Law: What shall We Learn?] (2008) 30 (1) Dangdai Faxue [Modern Law Science] 121

¹³⁵ N. Yu, D.D. Su & M.H. Ji, 'Neibu Ren Guan Guo Guang' [Guang Guoliang, an insider] (2005) 186 *Caijing* [Caijing Magazine], <<http://www.caijing.com.cn/coverstory/2007-05-26/20527.shtml>> accessed 20th July 2011

- a director's cousin

Secondly, the concept of "connected relationship" should cover both a director's close relatives and companies in which a director has considerable direct or indirect financial interest.¹³⁶ Thus, the "connected relationship" should further extend to the following entities:

- (a) a director's family members;
- (b) a firm or unincorporated business vehicle in which a director or his family member is a partner or have substantial interests (e.g. shares or debt);
- (c) a person acting in his capacity as agent in an agent-principal relationship where the principal is a director or a person who is connected with a director by virtue of (a) and (b);
- (d) a business partner of a director and a business partner of a person connected with a director by virtue of (a) (b) and (c);
- (e) a legal person or other unincorporated vehicle in which the partner is a firm in which a director or his connected person by virtue of (a) (b) and (c), is a partner.

Finally, transactions between a director or his connected person and the subsidiaries of the company he serves should also be subject to mandatory disclosure. The concept of "family members" should be defined more broadly in China's legislation than it is in the UK law. In the UK, excessive burdens would be exerted on directors and their companies if the concept of family members were broadly defined. This results in a wide array of transactions needing approval from the members,

¹³⁶ B. Black and others (n 70), 68

which would adversely affect the efficiency of business activities.¹³⁷ Additionally, over-strict liability may discourage high quality individuals from becoming corporate directors.¹³⁸ Therefore, this mandatory member approval is only applied to particularly risky transactions.¹³⁹ By contrast, it is worth pursuing the safety of transactions at the expense of efficiency in China, as minority shareholders bear more serious risks from powerful insiders within the business environment. Furthermore, defining the ambit of family members and connected persons in a broad sense can alleviate the pressure faced by judges. Judges can make fair judgments based simply on whether a director has made a proper disclosure to the members rather than using a bundle of objective tests to review complicated factual evidence. Thus, defining "family members" in a broad sense as well as widening the ambit of director's duty of disclosure can reduce the risks borne by companies and their minority shareholders.

In addition to the technical considerations, the Chinese cultural context should be taken into consideration.¹⁴⁰ One of the fundamental Confucian teachings is *Li*, which is usually translated as being a "moral rule of correct conduct and good manners".¹⁴¹ *Li* consists of five fundamental relationships which a Chinese person should properly engage in. These five relationships include: "ruler and subject, father and son, husband and wife, elder and younger brother, and friend and friend."¹⁴² From these

¹³⁷ E.g. Chapter 2 of the *Company Law Reform Bill - White Paper 2005* published on 17th March 2005 says: "A genuinely modern and effective framework can promote enterprise, enhance competitiveness and stimulate investment." at page 8, Chapter 3 also says: "It is important however that the duties [of non-conflict of interest] do not impose impractical and onerous requirements which stifle entrepreneurial activities." at page 21 Following this ideology the UK government is unlikely to launch corporate rules which offer excessive protection to shareholders and stakeholders at the expense of business efficiency. However, this kind of all-round protection may meet the needs of the Chinese context.

¹³⁸ See *ibid* at Chapter 3, which says "The law on directors' liability needs to strike a care balance:... on the other, Britain needs a diverse pool of high-quality individuals willing to assume the role of company directors, and a willingness by directors to take informed and rational risks." at page 24

¹³⁹ B. Black and others (n 70) 62

¹⁴⁰ On how culture can affect the related party transaction in general, see M. Roe, 'Can Culture Constrain the Economic Model of Corporate Law' (2002) 69 *University of Chicago Law Review* 1262 and A. Licht, 'The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance System', (2001) 26 *Delaware Journal of Corporate Law* 147, 192-194

¹⁴¹ L.T. Lee & W.W. Lai, 'The Chinese Conception of Law: Confucian, Legalist and Buddhist' (1978) 29 *Hastings Law Journal* 1307, 1308

¹⁴² *ibid* 1308 and C. Rarick, 'Confucius on Management: Understanding Chinese Cultural Values and Managerial Practices' (2007) 2 *Journal of International Management Studies* 22

five relations, it is apparent that Confucianism is founded on a clan-based, blood related society. Indeed, in Confucian society, a large family usually provides educational, moral and material support to its members. In turn, family members are obliged by a moral obligation to pursue the interests of their immediate family or other family members, when they have power to do so.¹⁴³ As Wang concludes, "different from their counterparts in Western world, the rule of fair play is not the tradition for Chinese businessmen. In the Chinese business world, plain fact is that kinship determines property relationships."¹⁴⁴ Compared to Western people, the Chinese rely heavily on kinship in doing business. In such circumstances, they are more likely to facilitate a family member's interests at the expense of their employer's interests. The result of this cultural difference is that the risk of directors disclosing insider information to family members is considerably more acute in China. Furthermore, as a result of the one-child policy, many studies indicate that younger Chinese generations have closer relationships between cousins than ever before.¹⁴⁵ Accordingly, their relationships with uncles and aunts also need to be subjected to the mandatory disclosure rule.

Furthermore, section 252(c) of the UK's 2006 Act regarding related persons, would be inactive in the Chinese context because the concept of "trust" is unfamiliar to most Chinese businessmen, lawyers and judges. By contrast, principal-agent relationships are far more familiar for Chinese lawyers and judges.¹⁴⁶ Therefore, the "trust relationship" specified in UK legislation should be replaced by the "principal-agent relationship" in the Chinese legal system.¹⁴⁷

¹⁴³ See above, Chapter IV, section 4.2.2. 1,112-114

¹⁴⁴ D.D. Wang, *Shichang Jijin de Daode Jichu* [Market Economy and Its Morality] (Shanghai Renmin Chubanshe 2007) [People' Publisher Shanghai 2007] 62-63

¹⁴⁵ P. Wang, 'Dusheng Zinv Zhengze Shifou Gaibian le Zhongguo de Jiating Jiegou? Yige Shizheng Yanjiu' [Did One-child Policy Change the Traditional Family-relationship in China? A Empirical Research] (2004) 20 Nanjin She Hui Kexue [Studies of Social Science Nanjing University] 322

¹⁴⁶ E.g. in CNKI (the largest Chinese on-line library covering most disciplines of social science), searched search for "principal agent relationship" uncovers 783 results including journal articles, conference papers and articles in newspapers. By contrast, only 76 results are retrieved under the term "trust relationship".

¹⁴⁷ For a more detailed introduction of the content of "principal-agent relationship" in the context of company in China, see section 5.2.5.2.2.3.1 below.

Finally, the form taken by the regulatory regime is also important. In term of controlling self-dealing transaction, the CA 2006 enables companies to tailor their regulatory strategy through article of association. For example, section 175 sub-section 5 says that, authorisation (to director's conflict interests in proposed transaction) may be given by the directors—

(a) where the company is a private company and nothing in the company's constitution invalidates such authorisation, by the matter being proposed to and authorised by the directors; or

(b) where the company is a public company and its constitution includes provision enabling the directors to authorise the matter, by the matter being proposed to and authorised by them in accordance with the constitution.

As mentioned, the Chinese Company Law 2005 also provides considerable number of enabling and default rules which make companies have flexibility in designing their regulatory regime.¹⁴⁸ However, it is still not clear whether or not this flexible approach can be directly used in the context of controlling self-dealing transaction in China. This dissertation will discuss this issue in later part.¹⁴⁹

5.2.5.1.2. What Should a Director Disclose?

It is unclear what directors are bound to disclose to the board or general meeting in order to satisfy the disclosure requirement. In *Imperial Mercantile Credit Association v Coleman*,¹⁵⁰ Lord Chelmsford held that the disclosure of interest includes "not merely the declaration of the existence of the interest but the nature of that interest" because this "may be a most important element" in the considerations of

¹⁴⁸ See above at section 4.2.3 141

¹⁴⁹ See below at section 5.2.5.2.2.3.2 at 218

¹⁵⁰ (1873) LR 6 HL 189

those who have to decide whether a company should enter into a contract or not.¹⁵¹ In addition to that, Lord Radcliffe advised the Privy Council that:

There is no precise formula that will determine the extent of detail that is called for when a director declares his interest or nature of his interest. The amount of detail required must depend in each case upon the nature of the contract or arrangement proposed and the context in which it arises. His declaration must make his colleagues fully informed of the real state of the thing.¹⁵²

According to these decisions, section 177 of the 2006 Act requires a director with an interest in a self-dealing transaction to disclose the "nature and extent" of that interest. Nonetheless, the nature and extent of an interest is still an opaque concept.

The Law Commission's Consultation Paper¹⁵³ made some suggestions in respect of this problem. Paragraph 4.96 states that a director should be required to disclose the "material interests" of the proposed self-dealing transaction. The term "material" was interpreted as follows:

- material in the sense that the board would normally consider a transaction of this type to be material;
- material to the director; or
- material to the company.

Material interests could be defined as being "those whose disclosure might reasonably

¹⁵¹ *ibid* 201

¹⁵² *Grey v Augarita Porcupine Mines Ltd* [1952] 3 DLR 1.

¹⁵³ The Law Commission, 'Company Directors: Regulating Conflicts of Interests and Formulating A Statement of Duties', 1999 (Law Com no 261/ Scot Law Com no 173 A joint report with the Scottish Law Commission, Reference number: LC261/SLC173)

be expected to affect the decisions of the board".¹⁵⁴ Finally, this approach is not adopted by the 2006 Act, as courts are reluctant to upset Lord Radcliffe's "no precise formula" approach and run the risk of being under-inclusive in using a narrowly defined approach.¹⁵⁵

The Chinese *2005 Company Law* together with the CSRC's administrative regulations do not include any provisions related to what directors should disclose to the board or general meeting in self-dealing transactions. The only guidance given is the requirement set out in the Accounting Standards (No.36), which state that a company is obliged to disclose the following information on related-party transactions to the general public:

1. the nature of the relationship between the related party and the company; and
2. the type of related party-transaction (e.g. purchase or sales of goods, leasing etc.)

If these accounting requirements are taken as a starting point, a director at least needs to disclose the existence of interests and the amount of his interest in the proposed self-dealing transaction. Consequently, standards and mandatory rules should be designed as follows:

1. A director must disclose the "existence and the nature" of a conflict of interests:
2. If the amount of the director's interest is able to be quantified, the director must disclose the existence and the amount of the interest; or

¹⁵⁴ *ibid* 93-94

¹⁵⁵ The Consultation Paper clearly outlined concerns that "this approach is also likely to result in situation arising in which a director should be taken to be interested but which fall outside the statutory list", (n 153) 94.

3. If the amount of the director's interest is not quantifiable, a director must disclose the information that the board would normally consider in a transaction of this type;

4. A director is only entitled to retain the interests from the self-dealing transaction which is appropriately disclosed.

5.2.5.2 Corporate Opportunity Doctrine

5.2.5.2.1 General Introduction

During the planned economic period, business opportunity was not important to Chinese enterprises which were required to carry out productivity in accordance with government instructions. However, now that a quasi-market economy has been implemented in China over 30 years (1978-2011), business opportunity has become one of the main sources of profit for both individuals and companies. Under such conditions, there is an emerging phenomenon that executives tend to exploit a company's opportunities for their own benefit.¹⁵⁶ The newly enacted company law is an immediate response to this challenge. Article 149 of *Company Law 2005* makes directors and executives who make profits by exploiting corporate opportunities without member' approval liable to disgorge profits to the company. This provision attempts to establish a formal procedural rule, which imposes a duty of disclosure on directors, while enabling members to authorise directors to exploit certain opportunities. In addition, it confirms that directors who use their employers' business opportunities without proper authorization are not only liable for the company's losses but are bound to disgorge the profits they make. However, the current legislation still leaves some important notions unclear. Firstly, the ambits of "corporate opportunity" remain vague. Under the current legal regime, it is still unclear whether judges should

¹⁵⁶ J.H. Liu, *Xin Gongsi fa de Zhidu Chuangxin: Lifa Zhengdian yu Jieshi Nandian* [Institutional Innovation of New Corporate Law: Legislative and Judicial Controversies] Falv Chuban She 2006 [Law Press China 2006] 400

rely on a series of tests to identify corporate opportunity or whether they should employ a much stricter approach by regarding all conduct which uses business opportunity on an unauthorised basis as breach of the duty of loyalty. Secondly, under the current legislative framework, no provision clarifies whether a resigned director is entitled to use a mature opportunity outside his former directorship. Later parts of this section will provide some solutions to both these issues using a comparative analysis.

5.2.5.2.2 Drawing the Ambits of Corporate Opportunity

This part will not only discuss the UK's approach to corporate opportunity, but also the Delaware approach. The reason for incorporating the Delaware approach into this research is two-fold. Firstly, as stated earlier, the corporate opportunity doctrine is merely at the nascent stage in Chinese company law. As a result, there is little reliable judicial practice to investigate. This means that Western experiences are particularly important. The comparison of Delaware's approach and the UK's approach to corporate opportunity can provide a theoretical framework for formulating the corporate opportunity doctrine in the Chinese context. Secondly there are strong calls for the flexible approach adopted in Delaware case law to be introduced into the Chinese legislative framework, due to its considerable advantages in promoting economic efficiency.¹⁵⁷ For the same reason, some English lawyers have argued that the UK approach should be replaced by Delaware's corporate opportunity doctrine.¹⁵⁸ These arguments complicate this research. Before dealing with detailed technical issues, it is essential to answer the important question of whether the UK's approach to corporate opportunity is still a proper model for the Chinese company law to adopt if Delaware's approach has some overwhelming advantages. At the beginning, this part will therefore introduce the two leading common law approaches to corporate opportunity, before explaining the implications behind these approaches. Finally, on

¹⁵⁷ Y. Li, (n 134), 121-128; and L.Q. Li, 'Gongsi Jihui Lilun Ji Xin Gongsi Fa 149 Tiao Shiyong Yiyi' (Corporate Opportunity Doctrine and the Interpretation of art.149 of the Company Law 2005) (2008) 24 (1) Zhongguo Shiyou Daxue Xuebao [Journal of China University of Petroleum] 50

¹⁵⁸ J. Lowry and R. Edmunds, 'The Corporate Opportunity Doctrine: The Shifting Boundaries of the Duty and its Remedies' (1998) 61 The Modern Law Review 515

the basis of that analysis, it will make some further suggestions regarding the development of the corporate opportunity doctrine in China.

5.2.5.2.2.1 Formulating an Analytical Framework for Developing Corporate Opportunity Doctrine

5.2.5.2.2.1.1 UK's Approach v. Delaware's Approach: A Legal Analysis

The resemblance between the exploration of corporate opportunity and self-dealing transactions should be noted from the outset. A director is the arms, eyes and brain of a company. This means that, compared to members, executives are in a better position to access accurate information. Meanwhile the members rely heavily on their expertise. As a result of this information asymmetry, it is necessary to enact a strict rule by which the executives can be prevented from appropriating a company's opportunity. However, it would be unfair to ignore the fact that from another perspective directors are merely the normal employees of a company.¹⁵⁹ From this perspective, they should be entitled to exploit business opportunities, which are not related to a company's interests. Given these subtleties, it is difficult to formulate a series of concrete standards to distinguish between a company's interests and a director's personal interests. In the UK, corporate opportunity cases are generally reviewed under the overriding principle of the "no-conflict rule".¹⁶⁰ Therefore, in most cases courts will disregard questions about whether the opportunity belongs to the company or whether the company has a beneficial interest in the opportunity.¹⁶¹ Arguably, *Regal (Hastings) Ltd v Gulliver*¹⁶² is the most influential corporate opportunity case in the UK. *Regal Ltd*, which operated a cinema, obtained an opportunity to lease two additional cinemas. It prepared to sell all three cinemas to an

¹⁵⁹ See *Canadian Aero Service v O' Malley* [1973] 40 D. L. R. (3rd) at 382 per Lord Laskin J's reasoning.

¹⁶⁰ See, for example, P. Koh, 'Principle 6 of the Proposed Statement of Director's Duty' (2003) 66 *The Modern Law Review* 898

¹⁶¹ D. Kershaw, 'Does It Matter How the Law Think about Corporate Opportunities' (2005) 25(4) *Legal Studies* 543

¹⁶² [1942] 1 All E.R.

outsider. For this purpose, a subsidiary was formed. However, *Regal* was financially incapable of satisfying the landlord's conditions, which required it to pay the share capital of £5,000. Additionally *Regal's* directors were reluctant to grant a personal guarantee for the rent. Finally, two directors and *Regal's* solicitor decided to purchase the shares which *Regal* was unable to pay using its own funds. Three weeks later, following *Regal's* sale, both the directors and the solicitor made considerable profits. The new controllers of *Regal* filed litigation against the former directors. The House of Lords upheld the plaintiff's claim. Lord Russell held that,

The rule of equity which insists on those, who by use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fide... The liability arises from the mere fact of a profit having... The profiteer, however honest and well-intentioned, cannot escape the risk of being called upon to account.¹⁶³

This decision introduced a strict "no-profit rule", first established in the landmark trust law case of *Keech v Stanford*¹⁶⁴, into the law of corporate opportunity.¹⁶⁵ This means that a company's opportunity does not cease to be so merely because the company is financially unable to exploit it.¹⁶⁶ Furthermore, a more recent case denies the application of the "line of business test"¹⁶⁷ in corporate opportunity cases. In *O'Donnell v Shanahan*,¹⁶⁸ the Court of Appeal reconfirms the strictness and inflexibility of the "no conflict rule". It held that the "scope or line of business"¹⁶⁹ is not relevant in considering the extent and application of the no conflict and no profit rules in so far as they applied to fiduciaries such as trustees and directors.¹⁷⁰ In other words, directors are not allowed to exploit opportunities without the members'

¹⁶³ *ibid* 144-145

¹⁶⁴ [1726] Sel Cas Ch61

¹⁶⁵ J. Lowry and R. Edmunds (n 158) 517

¹⁶⁶ P. Davies (n 4) 562

¹⁶⁷ For the concept of "line of business test", see below at 202-203.

¹⁶⁸ [2009] BBC 822 (CA)

¹⁶⁹ *ibid*

¹⁷⁰ L. Sealy & S. Worthington (n 4) 354

authorization, even if there is only "a real, sensible, possibility of conflict".¹⁷¹

This strict ethic seems to have been adopted in the 2006 Act. Indeed, whilst corporate opportunity is subject to the no-conflict rule under s.175, the no-conflict rule would heavily overlap with the no-profit rule, where it is defined in a broad sense.¹⁷² Section 175(2) plays a considerable role in maintaining the strict approach by emphasizing that "it is immaterial whether the company could take advantage of the property, information or opportunity". However, some commentators argue that this orthodox approach is out of fashion. *Bhullar v Bhullar*¹⁷³ may be a good starting point to understanding this argument. In this case, a family company was in deadlock. Two of the company's directors had invested in real estate which was beside the company's property. Before this investment was made, these two directors had learned that the board had a clear intention to limit the company's business by restricting its scope. Therefore, arguably the interested directors had reasonable grounds to assume that the board did not want the company to purchase more properties. Accordingly, in this particular situation, this business strategy would lead the company to deny the business opportunity of purchasing an additional real property which was located in the company's next door. On the basis of this assumption, although the interested directors were aware of that the company's value would be promoted by acquiring its next door property, they did not disclose this business opportunity to the company. After purchasing this property, the company filed a petition against the directors based on the unfair prejudice doctrine and a breach of fiduciary duty. The Court of Appeal held that the interested directors were liable for a breach of fiduciary duty occasioned by misappropriating the company's business opportunity. However, this decision is widely criticised by lawyers on the basis that the facts of *Bhullar* indicated that, unlike in *Regal* where the directors intend to act opportunistically, the company took the initiative to restrict its future activities. Furthermore, there was no firm evidence to indicate that the directors took advantage of their positions in order to bring the

¹⁷¹ D. Kershaw (n 161) 537

¹⁷² *ibid*

¹⁷³ [2003] 2 B. C. L. C. 241, CA

opportunity to maturity and then usurped it from the company. Therefore it could be argued the court paid little attention to the differences between the facts of *Bhullar* and *Regal*. Davies argues the court's decision in *Bhullar* results in a questionable extension of the criteria for identifying a corporate opportunity.¹⁷⁴ Following this line of thought, some suggest that a more flexible approach to corporate opportunity should be transplanted into the UK. US corporate law, especially the case law of Delaware, is regarded to be the best model for this legislative reform.¹⁷⁵

The flexible attitude adopted by the Delaware courts can be unpacked by looking at the leading case of *Guth v Loft*.¹⁷⁶ Mr Guth was a dominant director who substantially controlled the management of Loft Inc (Loft). Loft's line of business covered several different sectors. One of them was the manufacture of syrup for soft drinks. Guth bought a secret syrup recipe from Pepsi and proposed to develop Pepsi into a nationwide brand by taking advantage of Loft's financing, manufacturing and retailing assistance. The court found Guth liable for a breach of the duty of loyalty. Judge D. J. Layton held that,

if there is presented to a corporate officer or director a business opportunity which the corporation if financially able to undertake, which is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.¹⁷⁷

Following the tests laid out in *Guth*, courts would generally examine whether the opportunity was (1) within the "avowed business propose" of the business; (2)

¹⁷⁴ P. Davies (n 4) 566

¹⁷⁵ J. Lowry and R. Edmunds (n 158) 515

¹⁷⁶ 5 A.2d 503 (Del. 1939)

¹⁷⁷ *Guth*, 5 A.2d 503, 511

reasonably incident to its present or prospective operation; or (3) so closely associated with the existing and prospective activities of the corporation that the defendants should fairly have acquired that business for or made it available to the corporation.¹⁷⁸ These inquiries underlie the traditional tests for corporate opportunity in Delaware, namely the "line of business test", "interest/expectancy test" and "fairness test".

So far, the technical differences between the Delaware approach and the UK approach can be roughly drawn. According to Lowery and Edmonds, the strict approach laid down in *Keech v Sandford* is fully applied to directors who enter into trust relationships with the company. Therefore, the UK courts do not pay much attention to investigating the circumstances surrounding a breach. Liability is triggered simply on the basis of the capacity of a profiteer. By contrast, the Delaware approach unties the determinate relationship between directorial fiduciary capacity and the strict liability of using corporate opportunity. It places more emphasis on a close analysis of the facts in each case, while reducing the strictness of pre-existing principles in judicial practice.¹⁷⁹ For example, in *Broz v Cellular Information System Inc*¹⁸⁰, the court held that,

It is important to note, however, that the test enunciated in *Guth* and subsequent cases provide guidelines to be considered by a reviewing court in balancing the equities of an individual case. No one factor is dispositive and all facts must be taken into account insofar as they are applicable.¹⁸¹

Thus, compared with the orthodox approach underpinned by the strict "no-profit rule" or "no-conflict rule", the Delaware approach seemingly has a better level of pragmatic flexibility to hold the tension between capitalist principles which encourage profit-making and equity's strict rule governing liability. As Lowery and Edmonds

¹⁷⁸ M. Salzwedel, 'A Contractual Theory of Corporate Opportunity and A Proposed Statute' (2002-2003) 23:83 Pace Law Review 100

¹⁷⁹ J. Lowry and R. Edmonds (n 158) 524

¹⁸⁰ Del Supr, 637 A2d 148 (1996)

¹⁸¹ *ibid* 155

conclude, "[the Delaware approach] facilitates directorial entrepreneurialism within a matrix firmly rooted in the notion of prophylaxis."¹⁸²

Nevertheless, if we look at the flexible approach closer, it is not difficult to find that it complicates the process of identifying corporate opportunity. Firstly, in respect of the "line of business test", as Davies argues, "[a] Company's business models rapidly change from time to time. Therefore it is difficult for the director to properly identify whether the opportunity is within the scope of the company's opportunity."¹⁸³ Furthermore, some vivid examples which could manifest the limitations of this test can be easily found. For instance, an opportunity to purchase adjacent land may not be in the line of a company's business or have anything to do with operating a golf course, but it may still be "detrimental to the best interests of the club' if the course plans to expand in the future".¹⁸⁴ As this example illustrates, although the "line of business test" is arguably the broadest of the *Guth* tests,¹⁸⁵ it would still suffer from considerable under-inclusiveness. By contrast, the "interest/expectancy test" is considerably narrower than the "line of business test". It only prevents directors from misappropriating a project or opportunities to which the company has a present contractual right.¹⁸⁶ In addition, its different formulation from that of the "line of business test" causes much uncertainty in judicial practice. Just as Koh explains, "it is not clear what the boundaries of impermissible conduct are, the answer depending on first, which test is adopted and, second, how the requirements of the particular test are interpreted by the relevant court".¹⁸⁷ Finally, the fairness test is also under threat of problems of indeterminacy. In corporate opportunity cases, US courts, like their UK counterparts, do not generally take concepts of good or bad faith into account.¹⁸⁸ This

¹⁸² J. Lowry and R. Edmunds (n 158) 525

¹⁸³ P. Davies (n 4) 566. For a similar point, see S. Scott, 'The Corporate Opportunity Doctrine and Impossibility Arguments' (2003) 66 *Modern Law Review* 858

¹⁸⁴ M. Salzwedel (n 178) 101

¹⁸⁵ P. Koh, 'Once a Director, Always a Fiduciary?' (2003) 62 (2) *Cambridge Law Journal* 403, 411-412

¹⁸⁶ P. Koh (n 185) 411

¹⁸⁷ *ibid* 414

¹⁸⁸ According to M. Salzwedel, "Concepts of good or bad faith are usually not evaluated in making an initial determination whether an opportunity is corporate in nature" (see M. Salzwedel (n 174) at 101)

means that whether it is "fair" for a director to use an opportunity relies entirely on the courts' discretion. In sum, Delaware case law has established a group of standards for identifying corporate opportunity. However, just as Judge D. J. Layton said in *Guth*, "the standard of loyalty is measured by no fixed scale."¹⁸⁹ These open-ended standards trigger a high degree of uncertainty surrounding corporate opportunity cases.¹⁹⁰ Taking all these factors into consideration, concluding that "uncertainty and ambiguity [in the context of corporate opportunity], resulting in guessing game as to the corporate fiduciary's freedom of action"¹⁹¹ should not be a surprise.

To conclude, corporate opportunity cases are generally reviewed under a broadly defined no-conflict rule in the UK. Compared to the open-ended standards employed by Delaware's case law, the UK's approach seems to be "inflexible", "inveterate" and "rigid".¹⁹² By contrast, Delaware's approach which has no structured principle has the leeway of allowing a change in position on the basis of the facts of each case. However, this attractive flexibility in the Delaware approach is at the expense of legal certainty. Furthermore, in the UK, by implementing the strict approach, the integrity of the duty of loyalty is well protected, whilst legal certainty regarding corporate opportunity cases is promoted.¹⁹³ Bearing all these differences in mind, it is necessary to unpack the reasons behind these two different approaches, before examining which approach is more likely to fit in with Chinese commercial reality.

5.2.5.2.2.1.2 Generalizing the Reasons behind the Different Approaches

Having examined the differences between the UK and Delaware approaches to corporate opportunity, some light will be shed on the implications of these differences.

¹⁸⁹ *Guth*, 5 A.2d 503, 510

¹⁹⁰ D. Kershaw, 'Lost in Translation: Corporate Opportunities in Comparative Perspective' (2005) 25(4) *Oxford Journal of Legal Studies* 603, 614

¹⁹¹ P. Koh (n 185) 415. On a similar point, see S.M Bainbridge, 'Rethinking Delaware's Corporate Opportunity Doctrine' (November, 06 2008), UCLA School of Law, Law-Econ Research Paper No. 08-17 <<http://ssrn.com/abstract=1296962>> accessed 20th July 2011

¹⁹² D. Kershaw (n 190) 622-623

¹⁹³ D. Kershaw (n 190) 625-626

In this part, the major reasons for the different approaches adopted by Delaware and the UK will be highlighted.

Firstly, judicial differences can be explained from a philosophical perspective. The UK's corporate opportunity approach, under which a fiduciary is obliged to comply with the "no-conflict rule", has its own inner logic. In *Bray v Ford*¹⁹⁴ Lord Herschell noted that:

It does not appear to me that this rule is, as has been said, founded upon principles of morality. I regard it rather as based on the consideration that, human nature being what it is, there is danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect. It has, therefore, been deemed expedient to lay down this positive rule. .¹⁹⁵

Moreover, Kershaw in his article further elaborated on the philosophical considerations behind of the strict approach. He wrote:

facts and evidence [of corporate opportunity cases] are deeply malleable and that honest and trustworthy witnesses' perceptions and recollections of events and of their own and other's actions may have been formed by the interrelationship of, amongst others, non-aligned interests, friendship, professional trust and personal pride... in many corporate opportunity situations "fairness" is not available for determination as its factual foundation is inaccessible.¹⁹⁶

Consequently, it is a matter of principle in the UK that a director should not be allowed to make profit out of his office. This approach is underpinned by an overriding philosophical dictum that decent commercial morality which is vitally

¹⁹⁴ [1896] A.C. 44.

¹⁹⁵ *Bray v Ford*, ibid 52-53

¹⁹⁶ D. Kershaw (n 190) 621

important to a sound economic environment would be effectively protected by consistent and integrated duties of loyalty.¹⁹⁷ Furthermore, the strict approach which gets around investigations and observations about the detailed facts of each case, is based upon a belief that the facts and evidence of the corporate opportunity cases are extremely difficult, if not impossible, to fully ascertain.

By contrast, Delaware's approach to corporate opportunity is deeply influenced by the "law and economics movement". In the context of company law, law and economics theory is generally manifested in a hypothetical contractual model. According to Cheffins, the hypothetical contract model is based on the idea that "welfare-maximizing legal rules may be developed by ascertaining what transactors would agree to under ideal contracting condition."¹⁹⁸ Chew has applied this thought to corporate opportunity cases. He argues that, "in the optimal situation the parties will have an express agreement on how they expect to resolve the corporate opportunity disputes. In the absence of this agreement, the courts should determine what their reasonable expectation would have been."¹⁹⁹ Therefore, under the hypothetical contract mode, the reasoning behind Delaware's approach, which places more weight on the idea of facilitation rather than prohibition, becomes understandable.

To sum up, the prophylactic approach employed by the UK is underpinned by an epistemology that dictates that consistency and stability of a legal regime should be cautiously protected in order to retain the essence of commercial morality. Consequently, moral philosophy plays an essential role in forming the approach to corporate opportunity in the UK.²⁰⁰ By contrast, Delaware's approach which relies on law and economics theories, would generally examine corporate opportunity in an

¹⁹⁷ P. Koh (n 185) 403

¹⁹⁸ B. Cheffins, *Company Law Theory Structure and Operation* (Clarendon Press Oxford 1997) 264

¹⁹⁹ P. Chew, 'Competing Interests in the Corporate Opportunity Doctrine' (1989) 67 North Carolina Law Review 435

²⁰⁰ In many cases, there would be conflicts between "moral values" and "wealth maximization", e.g. see R. Dworkin, 'Is Wealth a Value' (1980) 9 Journal of Legal Studies 191

"efficiency-minded, gap-filling, or bargain-substitute" framework.²⁰¹ This approach is underpinned by a philosophical assumption that the main function of fiduciary duties is to reduce transaction costs between parties.

Secondly, much evidence shows that different interests groups may present their interests to legislators through lobbying. The influence of this should not be underestimated.²⁰² This factor may also explain the different corporate opportunity approaches in these two jurisdictions. Kershaw has made an insightful analysis of the dynamic powers involved in the evolution of Delaware's corporate opportunity approach. He provided much evidence to show that Delaware's flexible approach could be attributed to directors' lobbying efforts.²⁰³ Indeed, under the institutional infrastructure in the US, persons and companies are free to incorporate or re-incorporate in different states applying different policies that may be of benefit to them. Therefore, all US states are under a competitive pressure to formulate attractive policies, which would encourage persons to incorporate business vehicles in their territories. It is widely recognised that Delaware wins this "charter competition" by applying policies which favour managers who control incorporation and re-incorporation decisions.²⁰⁴ Just as Kershaw concluded, "although the Delaware legislature is subject to the demand of multiple-interest groups, including management, shareholders and the bars, management interests are, on balance, likely to have more weight as managers make the incorporation decision."²⁰⁵ Consequently the flexible approach to corporate opportunity, to a large degree, could be regarded as a result of the effects of "charter competition". By contrast, there is no equivalent institutional pressure in the UK. Thus, it is understandable that UK legislation would employ a stricter approach to retain its traditional shareholder-value dominated

²⁰¹ M. Salzwedel (n 178) 90-91

²⁰² M. Siems, *Convergence in Shareholder Law* (Cambridge University Press 2008) 307

²⁰³ D. Kershaw (n 190) 610-612

²⁰⁴ *ibid* 611. See also L. Bebchuk, 'Federalism and the Corporation: the Desirable Limits on State Competition in Corporate Law' (1992) 105 *Harvard Law Review* 1443, 1462

²⁰⁵ D. Kershaw (n 190) 611

ideology.²⁰⁶

Thirdly, issues regarding the general nature of the judiciary also have some explanative power in relation to the differences between the UK and Delaware's approaches. Cheffins argues that Delaware's judges might be more learned than their UK counterparts in the field of company law. He notes that,

Delaware's court of chancery judges usually have prior background in the area since most have practiced corporate law before coming to the bench and thus will have had hands-on experience with the implementation of business transactions. ...[By contrast] since the typical English judge is a former barrister, he will have had an almost entirely litigation-related practice and thus will not have had the same experience with the mechanics of corporate deal-making.²⁰⁷

Additionally, Cheffins points out that UK company law is generally more detailed than other jurisdictions, including the US, because it attempts to "provide guidance to judges who are not well-suited to the task of applying rules which are expressed in the form of broad, general principles" because "the judiciary, when confronted with a situation where legislation fails to address directly a significant issue, has customarily been reticent to fill in the gap."²⁰⁸ This argument sheds some light on the different corporate opportunity approaches adopted by the UK and Delaware. UK judges appear to rely on the strict rule set out in previous case law, as they might not be well qualified to "pursue bold initiatives designed to reorganise legal principle".²⁰⁹ By contrast, judges in Delaware may have the expertise to select the applicable test or tests from a group of open-ended standards in accordance with the facts of each case.

²⁰⁶ E.g. see B. Cheffins, 'Minority Shareholder and Corporate Governance' (2000) 21(2) *Company Lawyer* 41, 42 and P. Davies, 'Shareholder Value: Company Law and Securities Markets Law - A UK View' (October 2000) 3 <<http://ssrn.com/abstract=250324>> accessed 20th July 2011

²⁰⁷ B. Cheffins (n 198) 311

²⁰⁸ *ibid* 352

²⁰⁹ *ibid* 335

This comparison between the UK's approach and Delaware's approach generalises the major factors influencing the evolution of the corporate opportunity doctrine; namely legal philosophy, institutional choice and judicial expertise. This has provided an analytical framework with which to examine the development of the corporate opportunity doctrine in the Chinese context.

5.2.5.2.2 Putting the Chinese Context into the Analytical Framework: A General Picture

This part will address which of the two approaches to the corporate opportunity doctrine (UK or Delaware) is more likely to fit in with the extant Chinese legal setting. In fulfilling this task, this part will place the Chinese context within the analytical framework formulated above. It will examine the Chinese context in relation to three dimensions; namely legal philosophy, and institutional and legal technical perspectives.

Chinese stock markets suffer from a shortage of sound extra-legal features, especially decent commercial morality. As economist, Wang Dingding concludes

Lack of decent commercial morality is the major problem for the Chinese market participants, including investors, managers and even labour forces. Some of them are morally corrupted and lack of self-discipline. As a result, in the Chinese market, "moral hazard" deters cooperation between parties.²¹⁰

Another economist, Wu Xiaobo, concludes that

With the process of urbanization and the development of modern media, China is witnessing exploitation, unfairness, ugliness and moral atrophy which are the

²¹⁰ See D.D Wang, (n 144) 17

by-products of brutal economic development. Powerful commercial empires show their intelligence, endless energy and glorious to us, but also their greed and selfishness...The Chinese should rebuild their commercial ethic urgently. ²¹¹

These arguments coupled with the corporate governance scandals mentioned in former chapters,²¹² show that commercial morality has been undermined. However, the lack of decent commercial morality in the market is not a result of the fact that the ethical standards in society are ruined at large. As Lord Acton wrote, "absolute power corrupts absolutely. Great men are almost always bad men".²¹³ Therefore, weak law or institutional devices which cannot promote sound commercial morality empower people to be corrupt and greedy. In such an environment, regarding "efficiency" as an overwhelming criterion above "commercial morality" and placing more emphasis on the idea of "flexibility" in legislation, will keep the market under-regulated. A set of flexible rules are not sufficient to foster the commercial morality of the market participants. Consequently, this under-regulated market with a corrupt moral environment would suffer from the "adverse selection effect"²¹⁴ which vitally harms the quality of the market.²¹⁵ Therefore, from a philosophical perspective, protecting commercial morality, rather than promoting economic efficiency, is a more important goal for the current company law regime in China.

Indeed, Art.149 illustrates that some consideration of such matters has already been made. For example, it establishes a mandatory requirement under which authorization for a director's use of a corporate opportunity must be given by the members, in both public and private companies. This rule which makes members'

²¹¹ X.B. Wu, 'Zhi Mei Laoban de Yifeng Xin' [A Letter to the Chinese Entrepreneurs in Mining Industry] on Financial Time Chinese website; see also X. Liang, 'Shichang Jiji Yaoqiu Daode Chongsu' [Market Economy Calls Moral Reconstruction] (2002) 16 *Zhongguo Jiji Liutong* [China Business and Market] 173

²¹² See chapter IV, section 4.2.2. 1,107-109.

²¹³ 'Letter to Mandell Creighton (5th April 1887), by John Emerich Edward Dalberg-Acton', in J. Figgis and R. Laurence (eds.), *Historical Essays and Studies* (Macmillan and co., limited, 1907) 504

²¹⁴ For the concept of "adverse selection" see Akerlof, George A., 'The Market for Lemons: Quality Uncertainty and the Market Mechanism' (1970) 84 *Quarterly Journal of Economics* 488

²¹⁵ See B. Black, 'The Legal and Institutional Preconditions for Strong Security Markets' (2001) 48 *University of California Los Angeles Law Review* 781, 786-787

approval compulsory would reduce the efficiency of company operations by increasing costs associated with giving authorizations to directors.²¹⁶ The reason for this rule is that disinterested approval of a director's actions would pose a threat to the substantive justice of such authorization. More specifically, disinterested directors have no direct interest in a particular case. However, they may have an underlying interest in culture of easy conflict approvals.²¹⁷ Additionally, this risk would be exacerbated by the clientelism-based cultural environment, which would promote under-the-table transactions between disinterested directors and directors who attempt to use opportunities for their own benefit.²¹⁸ Moreover, Delaware's approach which is based on the hypothetical contract model is unlikely to function in Chinese judicial practice. Some observers have argued that, there is an obvious tension between the moral stance which has long been adopted by the Chinese courts and the spirit of law and economics.²¹⁹ By interviewing Chinese judges, Cheng & Rosett found that "[in China] the letter [in contract] must be softened by deference to the relationship of the party and the moral demand of accommodation".²²⁰ Therefore, this approach which does not entirely insist on precise terms of contract and parties' original intentions might heavily reduce the functions of the hypothetical contract model in dealing with corporate opportunity cases. To conclude, even disregarding the technical mismatch between the hypothetical contract model and the approach for interpreting contracts adopted by the Chinese courts, it is undeniable that philosophically the strict approach which prioritises fostering a decent commercial morality would be more likely to enable company law to solve problems in China.

²¹⁶ In public companies, a general rule that requires approval from the general meeting would be less costly than the requirement of members' approval. E.g. S. Deakin & A. Hughe's empirical research indicates that for public company with dispersed ownership structure, the transaction costs of obtaining members' approval are high. See S. Deakin & A. Hughe, Director's Duties Empirical Findings (Report to the Law Commission) reported in The Law Commission & The Scottish Law Commission, 'Company Directors: Regulating Conflicts of Interests and Formulating A Statement of Duties' (August 1999) (n 149)

²¹⁷ P. Davies (n 4) 568

²¹⁸ For a detailed analysis, see J.Y. Wang 'The Strange Role of Independent Directors in a Two-tiers Board Structure in Chinese Listed Companies' (2007) 3 Compliance & Regulatory Journal 47, 54

²¹⁹ N. Zhu, 'A Case Study of Legal Transplant: The Possibility of Efficient Breach in China' (2005) 36 Georgetown Journal of International Law 1145, 1163

²²⁰ L. Cheng & A. Rosett, 'Contract with a Chinese Face: Socially Embedded Factors in the Transformation from Hierarch to Market, 1978-1989' (1991) 255 Journal of Chinese Law 143

In addition to the philosophical considerations, institutional pressure would also push Chinese company law to adopt a strict approach. Unlike Delaware's company law, which places more weight on managers' interests in order to thrive in the charter competition, the latest evolution of the Chinese company law is driven by a different institutional force. As mentioned above, the most powerful force driving legal reform in China seems to be political pressure from a combination of interrelated factors, including growing individual shareholder activism and the government's concern for social stability.²²¹ Therefore, Delaware's approach, which is largely oriented around executives' interests, does not meet the demands of the dominant institutional pressures in China. By contrast, the UK approach which functionally limits a manager's opportunistic behaviour to a narrower scope would meet the claims of the increasingly motivated constituency by supplying them with better protections. In addition, the high level of legal certainty provided by the strict approach will increase investor confidence and foster cooperation between investors and directors. As a result, potential causes of the social instability would be further reduced.

Finally, as noted in the former part, the effectiveness of the flexible approach relies heavily on judicial expertise. Thus, a weak court system creates particular difficulties in using Delaware's approach. In China, judicial expertise is often questioned by observers.²²² In addition, judges are not generally encouraged to develop case-law based jurisprudence.²²³ Consequently, it would be difficult, if not impossible, for Chinese judges to adjudicate corporate opportunity cases by selecting one or two applicable tests from a group of open-ended standards in accordance with the factual evidence in each case. Furthermore, the reception of the US approach

²²¹ J.Y. Wang, 'Rule of Law and Rule of Officials: Shareholder Litigation and Anti-dumping Investment in China', The foundation for Law Justice and Society in collaboration with The Centre for Socio-Legal Studies, University of Oxford <<http://www.fljs.org/uploads/documents/Jiangyu%231%23.pdf>> accessed 20th July 2011. See Chapter IV above at section 4.2.2. 2.1, 132-134

²²² See Chapter II, section 2.4.2.2; and Chapter III, section 3.2.

²²³ D. Clarke, 'The Ecology of Corporate Governance in China' GWU Legal Studies Research Paper No. 433 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1245803> 44

would cause additional problems. The flexibility of judicial practice is a double-edged sword. On one hand, it would promote "efficiency" in certain cases by relaxing rigid rules. On the other, it would trigger judicial misuse of wide discretionary powers and may even lead judges to engage in rent-seeking activities. In China, the latter is more likely to be the case. Consequently, Delaware's flexible approach would be too sophisticated to be properly adopted in China. By comparison, the UK's approach which provides greater legal certainty would be easier for Chinese courts to manage.

Consequently, the analysis coherently indicates that a "commercial morality promoting", "shareholder friendly", and "bright-line rule based" approach would meet the needs of corporate opportunities regulation in China. As highlighted above, the strict approach adopted by the UK to some extent includes these characteristics. Thus, following the rules provided by the UK case law, an attempt will now be made to formulate an approach to drawing the ambits of corporate opportunity in Chinese context.

5.2.5.2.2.3 Drawing the Ambits of Corporate Opportunity: Proposed Statute for *Company Law 2005*

5.2.5.2.2.3.1 Capacity-based Test

It is widely recognised that the orthodox approach established in the *Regal (Hasting)* case affirmed a capacity-based test in identifying corporate opportunity. This test develops from the fiduciary relationship between a company and its directors. As Lord Upjohn indicated in *Boardman v Phipps*,²²⁴ "the relevant rule for the decision of this case is the fundamental rule of equity that a person in a fiduciary capacity must not make a profit out of his trust."²²⁵ As already highlighted, this approach technically establishes a fixed relationship between directorial fiduciary

²²⁴ [1966] 3 All ER 721

²²⁵ *ibid*

capacity and strict liability. It does so by disregarding issues about whether a company is financially capable of pursuing this opportunity or whether a company has an interest in or expectancy of the opportunity. Thus, it has a strong prophylactic function which would ensure a high degree of protection and deterrence.²²⁶ Consequently, this approach functionally meets the significant demands made of shareholder protection in the Chinese context. However, there are nevertheless some technical obstacles which would deter the reception of such a capacity-based approach.

Firstly, the nature of the relationship between a company and its directors is undefined in Chinese law. Furthermore, although the *Company Law 2005* has introduced the duty of loyalty, the legislative framework contains no overriding principle that requires directors not to put themselves in positions where their personal interests conflict with the companies' interests. Therefore, it is questionable whether there is any theoretical basis for the existence and development of capacity-based liability. Yu's argument is a good foundation for beginning an analysis of this issue. She notes that in general the relationship between a company and its directors in China can be categorised as a principal-agent relationship.²²⁷ She further finds that

Agents have duties to exercise their powers in good faith and with a degree of care. Here, the duty of good faith is based on the doctrine of good faith in contract law, but goes beyond the scope of contract law by requiring directors to actively discharge their duties of good faith and to place their company's interests in front of their personal interests. ²²⁸

This view is further expanded by the other leading Chinese corporate lawyer, J.H Liu. In Liu's recent book, he points out,

executives who work as agents of companies should be faithful to the companies'

²²⁶ P. Davies (n 4) 515

²²⁷ Y.W. Wei (n 1) 42

²²⁸ *ibid*

interests all along ... in accordance with their duties of loyalty, the executive must not put their personal interests in front of the company's interests, [and] must not appropriate company's tangible or intangible interests without proper authorization...²²⁹

These arguments illustrate a relatively clear picture of the underlying theory for the reception of the "capacity-based test" in China. According to Yu and Liu's arguments, a director who works as an agent of the company is subject to a duty of self-denial. As a result of his capacity, he is not allowed to make any secret profits without the company's authorization. This principle although not expressed in legislation, can be deduced using theoretical reasoning.

Whilst it has been possible to locate a theoretical basis for the application of this approach, detailed technical problems may nevertheless also pose difficulties in applying the approach in China. A threshold for accessing capacity-based liability must be established. It should be clarified whether liability can be triggered by proving the "existence or possibility of conflict between a director's interests and the company's interest", or merely by establishing the "existence of profits". The former is generally less strict than the latter. The application of the no-conflict criterion is subject to significant judicial discretion in terms of the fact that in different cases, it can be defined in different ways.²³⁰ By contrast, the no-profit rule is more concrete. Where it is applied, plaintiffs only need to prove the fact that an executive has made unauthorised profits out of their position. Its strictness can effectively prevent the directors and executives from engaging in moral hazard. As a result, it provides a sufficient level of protection to shareholders. Overall, the no-profit rule which meets the demands of the corporate opportunity doctrine in the Chinese context is the best choice for reform legislation.

²²⁹ J.H. Liu (n 156) 397

²³⁰ D. Kershaw (n 161) 537

Nevertheless, the no profit rule has to some extent been rejected in the 2006 Act. Some commentators argue that the main reason for nullifying the no-profits rule is the fact that its inflexibility could stifle the modern economy and dampen entrepreneurial activities.²³¹ However, this would not be the case in China. If such an approach generates unaffordable transaction cost by applying a strict liability rule that makes directors give up business opportunities, and if employers are financially incapable of exploiting such opportunities, the question is raised of whether this means that such opportunities would be rendered unexploited and therefore wasted. Admittedly, one must accept that in some cases the potential value of business opportunities might only be realised by a particular director's professional knowledge, business judgment and expertise. However, directors' personal efforts should not be over-stated. Firstly, a business opportunity is only a belonging of the company' within the relationship between a company and its executives.²³² In other words, this opportunity is open for use by any capable third party, to the exclusion of unauthorised directors only. Therefore, in a highly competitive market consisting of a large number of business players in a same sector, this opportunity will surely be exploited by another party sooner or later. Secondly, recent research indicates that many business opportunities rejected by directors by reason of high transaction costs, under the strict no-profit rule are investment opportunities brought to directors by third parties. If a company is not financially capable of taking up an opportunity and the director is also reluctant to do so (because of the high transaction costs), third parties would expect the funding to be made available elsewhere.²³³ Therefore, the strict approach towards corporate opportunity cases would increase the transactions cost for certain parties (most likely the executives), but it is highly unlikely to decrease the social welfare at large. In addition, in the Chinese context, the foreseeable costs generated by a flexible rule are even higher than that of a strict rule. Firstly, the agency cost between the shareholder

²³¹ D. Kershaw (n 190) 617

²³² On the question of 'to what extent can the corporate opportunity be regarded as an property belongs to the company', see D. Kershaw (n 161) 547-548

²³³ D. Kershaw (n 190) 618

(especially minorities) and executive is severe.²³⁴ A flexible approach which defines corporate opportunity narrowly will promote an executives' opportunistic behaviour. It would reduce the transnational cost for executives by enlarging vertical agency cost,²³⁵ while further damaging commercial morality. On balance, therefore, it makes conditions worse. Moreover, the flexible rule would also increase the judicial costs. In order to properly apply the rule, the courts would have to take a long time to investigate the factual evidence of a case. This time-consuming and uncertain process leads both parties to invest a huge amount of time and effort into the litigation. Both would lose the best timing of fully exploiting the business opportunity. Finally, both parties would be worse off. Thus, it is difficult to conclude that economic efficiency will be harmed by a strict liability rule in China. Consequently, in Chinese context, the no profit rule would be a proper criterion for activating the "capacity-based liability" in corporate opportunity cases.

In accordance with the forgoing analysis, there is a theoretical basis for the implementation of the capacity-based test. Additionally, by employing the "no-profit rule", this test is likely to be workable in practice and to properly regulate the agency cost between executives and minorities - the central problem of Chinese corporate governance.

5.2.5.2.2.3.2 Reformulating Procedural Rules

As mentioned above, a procedural rule is set out by *Company Law 2005*. However, this rule must be integrated with more detailed guidance. In terms of procedural issues, according to the 2006 Act, the non-interested director's approval of another director's use of corporate opportunity is established as an enabling rule for public company. In other words, if the Articles of Association does not authorise

²³⁴ See Chapter II, section 2.3.2 above.

²³⁵ According to S. Turnbull, 'this [a strict approach to corporate opportunity] would make economic sense if the transaction cost of either the monitoring director's behavior or the ex post determination of their action are prohibitively high.' S. Turnbull, 'The Doctrine of Corporate Opportunity: An Economic Analysis' (1988) 13 Canada-United States Law Journal 193

directors to approve conflict-interests activities, the authorization should be granted by the members. Statutes concerning procedural issues surrounding the 2006 Act leave more room for private corporate players to decide which approach they want to adopt. This flexible approach is based on a strong belief that private parties have competent professional abilities to make proper judgments in accordance with their own needs. However, as Chinese market participants are generally less sophisticated than their UK counterparts, a mandatory rule seems to be more effective than an enabling rule. Furthermore, highlighted earlier, the members' approval is necessary for a directors' use of corporate opportunity. Consequently, a procedural rule based on the flexible approach would provide limited guidance in Chinese company law.

By contrast, the mandatory disclosure rule as stipulated by the American Law Institute (ALI) would be a sound model. This rule states that

a director or senior executive may not take advantage of a corporate opportunity, unless (1) the ... senior executive first offers that corporate opportunity to the corporation and makes disclosure concerning the conflict of interest and the corporate opportunity; (2) the corporate opportunity is rejected by the corporation"²³⁶

When compared to Art.149 this two-step approach makes clearer instructions for executives to follow.

However, ALI's rule sets a pre-condition for this disclosure rule, which could be inconsistent with the proposed no-profit rule. Under the rule set out by the ALI, a director is bound to disclose an opportunity for the company where "the executive becomes aware and knows it is closely related to a business in which the corporation

²³⁶ *Principles of Corporate Governance: Analysis and Recommendations* (St Paul, Minn: American Law Institution Publisher 1994) 5.05 a

is engaged or expects to be engaged."²³⁷ Nonetheless, under the no-profit rule, it is immaterial whether the company could benefit the opportunity. This means that even if an executive subjectively believes that the opportunity is not related to the company's interests, before pursuing it, he should place himself into a "safe-harbour" by disclosing the opportunity to the company. The rationale for this strict disclosure rule can be explained by arguments relating to human behaviour: "the conflict-parties, even those who believe that they act honestly and in good faith, cannot trust themselves to give impartial advice."²³⁸ This means that the self-interested executive is considered unable to evaluate "whether this opportunity is related to the company's interests", since his personal interests will ruin his "independence" which is essential to be a competent decision-maker in this context.²³⁹ Consequently, a mandatory disclosure rule is vital to preventing executives from misappropriating corporate opportunity.

5.2.5.2.3 The Duties of a Resigned Director

Another important issue surrounding the corporate opportunity doctrine is the duty of resigned directors. A strict adherence to a capacity-based principle could allow directors to escape their duties simply by terminating their directorship. In such circumstances, a managing director could exploit their former employers' interests by taking advantage of commercial secrets from their former directorship. However, the *Company Law 2005* includes no provision under which ex-directors retain continuing obligations in respect of their employers. To date there appear to have been no reported cases concerning this duty passing through the courts. In one reported case, a director disappeared from the company and engaged in competitive business with his employer. However, in this case the court did not accept that the director's

²³⁷ *ibid*

²³⁸ See M. Bazerman, K. Morgan and G. Lowenstein 'The Impossibility of Auditor Independence' (Summer 1997) *Sloan Management Review* 89, 91

²³⁹ D. Kershaw (n 161) 554

disappearance from his work could be regarded as resignation of his directorship.²⁴⁰ As a result, although the court held that the director's conduct breached his duty of loyalty, this does not mean it accepted that ex-directors owe a continuing responsibility to their employers. Consequently, the legislation leaves some gaps in regulating ex-directors' duties towards their former employer. This part will formulate some standards for resigned directors in the context of corporate opportunity by studying the UK common law and relevant UK statutes.

In the UK, common law principles impose a continuing obligation on resigned directors in the context of corporate opportunity. In *Island Export Finance Ltd. v. Umunna*,²⁴¹ Hutchinson J. held that,

It seems to me that counsel's bold submission [that English Law does not recognise any fiduciary duty after termination] cannot be right, amounting as it does to the contention that a director, provided he does nothing contrary to his employers' interests while employed, may with impunity conceive the idea of resigning so that he may exploit some opportunity of the employers and, having resigned, proceed to exploit it for himself. Such a suggestion has only to be stated to be seen to be unsustainable.²⁴²

Under the 2006 Act, s.170(2) (a) now states that s.175 can be applied to directors who have already resigned their directorships. Nonetheless, imposing an over-strict obligation on ex-directors may generate counter-productive effects. As Davies concludes:

Indeed, in order to encourage the exploitation of directors' talents, the general policy of the court is not to put executive directors of a company in any worse position than employees in terms of restraints on their post-resignation activities.

²⁴⁰ See Beijing Hua'er case (Beijing Haidian District Court 2001) for details in N. Howson (n 33) 150

²⁴¹ [1986] B.C.L.C. 460

²⁴² *ibid* 480

This means that, in the absence of explicit contractual restraints on the director, he or she is free to exploit after resignation even confidential information carried away in his or her head, unless this information amounts to knowledge of trade secret ²⁴³

The common law strikes a balance between protecting employer's interests and facilitating the exploitation of directors' talents by defining the scope of an ex-directors' continuing liability. This can be illustrated in two leading cases; namely, *Canadian Aero Service Ltd v. O'Mally*²⁴⁴ and *Industrial Development Consultant Ltd v. Cooley*²⁴⁵. In both cases, the courts held that ex-directors had breached their continuing liabilities to their former companies. In the *Canadian Aero Service Ltd* case, the president and the vice president of the plaintiff company (Canaero) negotiated a large aerial surveying and mapping contract with the government of Guyana on behalf of Canaero. However, they failed to make sufficient efforts to secure the contract for Canaero. Instead, they resigned their directorships and formed their own company (Terra). They then signed a contract with the government of Guyana in the name of Terra. In this case, Laskin J. held that,

In my opinion, this ethic [strict ethic] disqualifies a director or senior officer from usurping for himself ... a maturing business opportunity which his company is actively pursuing; he is also precluded from so acting even after his resignation where the resignation may fairly be said to be promoted or influenced by a wish to acquire for himself the opportunity sought by the company...²⁴⁶

The *Cooley* case manifests a similar group of facts. Mr Cooley, who was a managing director of the plaintiff company, participated in negotiating a building contract with officers from the Eastern Gas Board (Gas Board). However, the

²⁴³ P. Davies (n 4) 565

²⁴⁴ (1971) 23 D.L.R. (3d) 371

²⁴⁵ [1972] 2 A.L.L. ER 443

²⁴⁶ *Canadian Aero Service Ltd v. O'Malley* (n 244) 371, 382

negotiation was not successfully concluded. Shortly afterwards, the Gas Board formally approached Mr Cooley in his personal capacity for the building project. Mr Cooley resigned his directorship by lying that he was in ill health. He later went on to sign a valuable contract with the Gas Board. Roskill J. held that, the defendant was accountable to the plaintiff, because

from the time he embarked up on his course of dealing with the Eastern Gas Board ..., he embarked upon a deliberate policy and course of conduct which put his personal interest as a potential contracting party with the Eastern Gap Board in direct conflict with his pre-existing and continuing duty as managing director of the plaintiffs.²⁴⁷

Nonetheless, in *Island Export Finance Ltd v Umunna*²⁴⁸, an ex-director was allowed to keep the profits arising out of a contract which was essentially the same as an earlier contract secured for the plaintiff when Umunna worked as the plaintiff's managing director. In this case, the judge accepted that the ex-director's resignation was unrelated to the exploitation of a maturing business opportunity. Moreover, there was also no firm evidence to indicate that the plaintiff was actively pursuing the same opportunity in endeavouring to secure the contract for his own benefit. At first glance, the approach adopted in this case is more lenient than that of the *Cooley case*. However, a closer inspection reveals some key differences in the facts between these two cases. In both the *Cooley* and *Canadian Aero Service Ltd* cases, there was a material corporate opportunity prior to the directors' resignation. In *Cooley*, the director tried to avoid their fiduciary duty in order to obtain a business opportunity in their personal capacity by terminating their directorship. More importantly, the companies in both cases were interested in an identifiable business opportunity, although it was uncertain whether the companies could properly secure it.²⁴⁹

²⁴⁷ *Industrial Development Consultant Ltd v. Cooley* (n 245) 451-453

²⁴⁸ [1986] B.C.L.C. 460

²⁴⁹ In the *Cooley* case (n 245), the court found that the plaintiff had 10 per cent of opportunity to secure the contract with the Gas Board.

However, in the *Umanna case*, many of these key facts were absent. In these circumstances, if the court upheld the plaintiff's claim of a breach of fiduciary duties, the result would have been unjust for Mr Umanna. As Pettet argues, "if a director [Umanna] has a lifetime of general entrepreneurial activity in various markets, it will not be possible for a company which hires him for a few years of that lifetime to argue that all future business in that area becomes the business of the company".²⁵⁰ Consequently, the comparison between the *Colley* and *Umanna* cases conveys some important information. The UK courts tend to protect a director's business innovation by limiting the scope of an ex-director's continuing liability within a certain ambit. Continuing liability would only be enforced where an opportunity is not only maturing, but also where it is pursued by the company.²⁵¹ More specifically, a director's intention to resign and the plaintiffs' potential business opportunities are key determinants of a judicial decision. Firstly, if there is evidence to indicate that a director's motivation for resigning is to exploit a maturing corporate opportunity, the director can be found subjectively guilty of deliberately avoiding his fiduciary duties through resignation. Secondly, if evidence also shows that a company is actively pursuing an opportunity, the director will be objectively guilty if he puts himself in a position which conflicts with the company's interests.

Finally as Sealy concludes the following key facts would give rise to a breach of continuing liability in corporate opportunity cases:

- (1) the defendants had diverted for their own benefit a "maturing business opportunity" which their company was actively pursuing;
- (2) they were participants in the negotiations on behalf of the company;
- (3) their resignation had been "promoted or influenced" by a wish to acquire the opportunity for themselves; and
- (4) it was their position with the company rather than a "fresh

²⁵⁰ B. Pettet (n 8) 169

²⁵¹ See P. Koh (n 185) 421

initiative" which led them to the opportunity which they later acquired.²⁵²

It seems that these fact-based standards are quite clear and would allow Chinese company law to fill in the gaps relating to a director's continuing liability. However, as Chinese company law is without the support of case law, these standards would still be too abstract to solve problems in practice. For example, a director's motivation for resigning would be difficult to prove. There may be several reasons prompting a resignation, of which the "guilty" motive is but one. How would one assess this motive to be primary?²⁵³ Therefore, in addition to this group of standards, further guidance should be provided.

To start with, an objective standard is important. A court must be able to confirm whether a conflict of interests exists in a particular case from the outset. This is achieved by investigating whether the plaintiff actively sought this opportunity either when the director resigned or later when he obtained the contract. The court can then investigate the ex-director's subjective motive for his resignation. It is important in this context to note that corporate opportunity cases generally result from asymmetric access to information between a director and their company. A director, as the gatekeeper of a company, can block information from flowing to his employer. Thus, it would be useful for a court to consider whether the director, compared to the company, had an informational upper-hand in obtaining the commercial secret in question. For example, it would be useful to examine whether the defendant was a controlling director in the company holding considerable power and he participated in the negotiating process of this business opportunity. If the court finds that the director has an informational upper-hand, an assumption of impropriety should arise where such a director exploits any business opportunity, after his resignation and without prior disclosure to the company.²⁵⁴ In such circumstances, the defendant should have to provide evidence to rebut this assumption. Secondly, timing is also an important

²⁵² L. Sealy & S. Worthington (n 4) 365

²⁵³ On this point see P. Koh (n 185) 424

²⁵⁴ On a similar point, *ibid* 425

factor. If a director's exploitation of a business opportunity occurs one or two years after his resignation, it would be difficult to conclude that the ex-director should bear continuing liability.²⁵⁵ This is not only because many facts in the case will become ambiguous after such a long time, but also because the commercial secrets held by ex-directors will also lose their value over such a time period. However, if the conflict of interests between a company and its director happens shortly after the director's resignation, the court may have grounds to suspect the motivation behind the director's resignation.

To conclude, the first part of this section builds a workable legislative framework for director's continuing liability in Chinese company law by introducing some legal principles from UK case law. However, it is important to note that as the duties of resigned directors are highly fact-based, such cases rely heavily on a court's judgment of the facts in a given case. It is therefore difficult to formulate a fixed judicial approach to this particular group of cases. Establishing more concrete objective standards demand the support of empirical research. For example, empirical research might be able to measure how long a commercial secret generally retains its value in Chinese commercial practice. The answer to this question would be valuable in achieving a sound judgment in judicial practice.

5.3 Controlling Shareholder's Duties

5.3.1 "Controlling Shareholder's Duties" under China's Legal Regime

Having discussed a controlling strategy for vertical agency cost, this part focuses on mitigating horizontal agency cost. From a theoretical point of view, it seems that *ex post* protection for minority shareholders against controlling shareholders in public companies is not vitally important. This is because shareholders in public companies can protect their interests by utilizing the "vote by foot" rule under which they can

²⁵⁵ *ibid* 427

exist by selling their shares. Unlike shareholders in closely-held companies, public company shareholders have a stock market on which to express dissent through share trading. Nonetheless, in China, several factors make *ex post* protection essential for protecting minority shareholder interests. Firstly, information asymmetry is a serious problem on China's stock markets.²⁵⁶ Many cases show that the market price of shares is distorted by insiders manipulating and misrepresenting information.²⁵⁷ Consequently, the market price sometimes does not accurately reflect the fair value of a public company's shares. The "vote by foot" mechanism cannot therefore realise sufficient impact to protect minority shareholders. Secondly, the Chinese company law system does not provide effective alternative mechanisms to protect minority shareholders against unfair treatment by controlling shareholders. The previous chapter highlighted that minority shareholders are entitled to strong voting powers through the class-voting system. However, it seems that this procedural protection does not work well in China.²⁵⁸ Thirdly, the independent director regime has proved to be inadequate in restraining controlling shareholder abuse.²⁵⁹ Recent shareholding structure reform enables institutional shareholders to have a stronger voice in a public company's corporate governance. However, it is undeniable that such shareholders still play a limited role in balancing and checking the powers of controlling shareholders.²⁶⁰ To conclude, non-legal constraints (efficient capital and product market) are usually very weak in transition economies. They cannot properly control controlling shareholders. These economies therefore should have stronger legal rules

²⁵⁶ See Chapter II, section 2.3.2, above.

²⁵⁷ See CSRC's Administrative Sanction against the "Hangxiao Ganggao" Company and its insiders: full text available at <http://news.xinhuanet.com/stock/2007-05/14/content_6097360.htm> accessed 20th July 2011. See also Q.Y. Jiang, 'Monitoring Problems versus Fiduciary Duties in Chinese Stock Companies: an Economic and Comparative Analysis on Corporate Governance' in T. Eger, M. Faure & N.G. Zhang (eds.), *Economic Analysis of Law in China* (Edward Elgar 2007), 200

²⁵⁸ See Chapter IV, section 4.1.2.3.2, above.

²⁵⁹ D. Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 *Delaware Journal of Corporate Law* 125, 127-224

²⁶⁰ See C. Xi, 'Institutional Shareholder Activism in China: Law and Practice' (2006) 9 *International Company and Commercial Law Review* 251

to protect minority interests.²⁶¹ These conclusions are supported by research conducted by lawyers into company law regimes in transition economies.²⁶²

In order to enhance the minority protection regime, China's company law system imposes some duties on controlling shareholders. Article 21 of *Company Law 2005* sets out a general principle that controlling shareholders and *de facto* controllers shall not take advantage of their affiliations with others in an attempt to harm a company's interests and, where any losses are incurred in violation hereof, shall be liable for compensation. Article 217 defines a "controlling shareholder" as being a shareholder with more than fifty per cent of the total amount of share capital of a joint stock limited company or, a shareholder who, by virtue of their voting power, represented by their capital contribution or shareholding, has a significant impact on the decisions of the general meeting regardless of whether their holding is under fifty per cent. The rules provided in the *Guidelines for Articles of Association* are more straightforward. The *Guidelines* say that a company's controlling shareholder and *de facto* controller owe a duty of *bona fide* (*cheng xin yi wu*) to the company and to individual shareholders. The controlling shareholder must not harm the company or an individual shareholder's legitimate rights by illegally distributing profits, re-organizing assets, taking out corporate loans, sub-investment, appropriating the company's assets, or using his controlling position to injure other shareholders' interests.²⁶³

It seems that legal provisions about controlling shareholder duties are relatively accurate and competent, especially, when compared to other vague provisions in China's company law. The duties can be divided into two main parts. Firstly, they prevent controlling shareholders from using their affiliations with the board, usually

²⁶¹ G. Avilov, and others, 'General Principle of Company Law for Transition Economy' (1999) 24 *Journal of Corporate Law* 190, 204. See also G.M. Cheng, M. Firth, D.N. Gao & O.M. Rui, 'Ownership Structure, Corporate Governance, and Fraud: Evidence from China' (2006) 12 *Journal of Corporate Finance* 424

²⁶² *ibid*

²⁶³ *Guidelines for Articles of Association* issued by the CSRC, article 39

through nominee directors, to harm a company's or minority shareholders' interests. Secondly, they attempt to keep controlling shareholders away from involvement in conflict-interest transactions by enumerating a variety of prohibited conflict of interest activities. Indeed, the legislative framework is an effective response to the problems faced in securing sound corporate governance of public companies in China. Indeed, controlling shareholder tunnelling activities have long been a serious issue.²⁶⁴ Consequently, the current legislative framework may play a positive role in mitigating horizontal agency cost in China's public companies.

Nonetheless, even if these provisions are workable, they are still surrounded by vagueness. Although the *Guidelines for Articles of Association* impose several limitations on the actions of controlling shareholders, they fail to formulate a general principle, which connects these limitations to controlling shareholder voting power. The following parts will illustrate how UK and US company law regimes deal with controlling controlling shareholder's voting power. It will then analyse how Chinese company law selectively transplants Western experiences in formulating a more complete legal framework for controlling shareholder duties.

5.3.2 Controlling Controlling Shareholder's Powers: The UK Approach and the US Approach

5.3.2.1 The UK Approach

The UK's company law regime does not impose fiduciary duties on controlling shareholders.²⁶⁵ In the *Northern Counties Securities Ltd*²⁶⁶ case, the judge held that, "a member's vote is a property right which, prima facie, may be exercised in the

²⁶⁴ See Chapter II, section 2.3.2. 2, 37-38, above.

²⁶⁵ However, some corporate law scholars claim that fiduciary duties should be applicable to institutional shareholders in the UK, in order to require institutional shareholders to integrate environmental, social and governance issues ("ESG") into investment policy: see P.Q. Watchman, J.A. Wedderburn & L. Shipway, 'Fiduciary Duties in the 21st Century: A UK Perspective' (2005) 19(3) *Trust Law International* 127

²⁶⁶ See *Northern Counties Sec. Ltd. v. Jackson & Steeple Ltd.*, [1974] 1 WLR 1133

member's own interest and as he or she thinks fit. A member voting as such is under no fiduciary duty to the company."²⁶⁷ However, UK company law does provide some suggestions on how to prevent controlling shareholders from abusing their voting powers. In order to achieve this, two important mechanisms have been established. The first is the "shadow director regime" and the second the "the proper purpose test".

Instead of fiduciary duties, the law uses the concept of a "shadow director" to achieve functional equivalence. In accordance with the 2006 Act, a shadow director is "a person in accordance with whose directions or instructions the directors of the company is accustomed to act."²⁶⁸ Additionally, the Act further explains that, a corporation is not regarded as a shadow director of any its subsidiary companies for the purposes of (1) the general duties of a director; (2) transactions requiring member approval; or (3) contracts with a sole member who is also a director, by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.²⁶⁹ It seems that the statute does not attempt to impose general director's duties on controlling shareholders who control the boards of their subsidiaries. Furthermore, even if a person can be regarded as a "shadow director", a director's general duties may be still not applicable to them. Section 170(5) states that "the director's general duties apply to shadow director where, and to the extent that, the corresponding common law rules or Equitable principles so apply." In the *Ultraframe (UK) Ltd* case²⁷⁰, the judge held that a director's fiduciary duties do not apply to a shadow director, on the grounds that a shadow director, unlike a *de facto* director does not undertake to act on behalf of the company and so does not put him/herself in a fiduciary relationship with the company.²⁷¹ Accordingly, under statute and case law, except in some extraordinary circumstances, UK law does not

²⁶⁷ *ibid* 1144. See also *Peters' American Delicacy Co Ltd v Heath* (1939) 61 C.L.R. 457 at 504, where Justice Dixon explains that: "The power of alteration is not fiduciary. The shareholders are not trustees for one another, and, unlike directors, they occupy no fiduciary position and are under no fiduciary duties. They vote in respect of their shares, which are property, and the right to vote is attached to the share itself as an incident of property to be enjoyed and exercised for the owner's personal advantage."

²⁶⁸ CA 2006, s.251

²⁶⁹ *ibid*

²⁷⁰ [2005] EWHC 1638 (Ch D)

²⁷¹ *ibid*

impose general director's duties towards minority shareholders or the company upon controlling shareholders. In essence, statute and common law show that there is little point in requiring a controlling shareholder to make a decision in the best interests of shareholders as a whole.

Furthermore, another important relief provided by the law to the minority shareholders is the unfair prejudice doctrine. Section 994 of the 2005 Act says that,

“(a) the company’s affairs are being or have been conducted in a manner which is unfairly prejudicial to the interest of its members generally or some part of the members (including at least himself) or (b) that any actual or proposed act or omission of the company (including any act or omission on its behalf) is or would be prejudicial”

However, if the company is a public company, the court in general denies that the “unrecorded legitimate expectation” exists, for the reason that in public company, all material information must be disclosed to potential investor. For example, in *Re Blue Arrow plc*²⁷², Lord Vinelott held that,

“No doubt there are cases where a legitimate expectation may be inferred from arrangements outside the ambit of the formal constitution of the company, but it must be borne in mind that this is a public company, a listed company, and a large one, and that the constitution was adopted at the time when the company was first floated on the Unlisted Securities Market. Outside investors were entitled to assume that the whole of the constitution was contained in the articles, read, of course, together with the Companies Acts. There is in these circumstances no room for any legitimate expectation founded on some agreement or arrangement made between the directors and kept up their sleeves and not disclosed to those placing the shares with the public through the Unlisted Securities Market... I think that the petition, on its face, is so

²⁷² [1987] BCLC

hopeless that the only right course is to strike it out."²⁷³

In addition to that, for private company, the limitation on the shareholder's ratification of directors' breach of duty is another important device to control shareholder's power. In this kind of company, shareholder and director is usually the same person. If there is no limitation on shareholder's power of making ratification of directors' breach of duties, majority shareholder, in such condition, can ratify his or her breach of duty in the position of company's director. In response to this issue, section 239 of 2006 Act prevents the interested directors from voting on a shareholder's resolution to ratify the wrong doing. However, similar to the unfair prejudice doctrine, it may only release very limited influence on public company. The reason is that, in public company, there is generally a clear separation between ownership and management. It means that rare director sits in the general meeting in public company.

One of the major functions of "limited liability" is understandably to make shareholders more remote from each other. In a partnership, business partners owe each other mutual fiduciary duties, as no clear line can be drawn between their personal assets and business assets. By contrast, in large-scale public companies, shareholders can clearly distinguish their personal assets and their corporate investment. As a shareholder's amount of investment is fixed, supervisory costs among shareholders are reduced.²⁷⁴ Furthermore, a shareholder enters into the company in the expectation that other shareholders will vote in their own self-interest. He equally takes the risk that his interests could be adversely affected by other shareholders voting in this way.²⁷⁵ Taking all these factors into consideration, Flannigan points out the lack of "a foundation for the fiduciary regulation of

²⁷³ *ibid* 619

²⁷⁴ R. Flannigan, 'Fiduciary Duties of Shareholders and Directors' (2004) 5 *Journal of Business Law* 277, 285

²⁷⁵ *ibid* 286

shareholder's power".²⁷⁶

By contrast, Cohen highlights that there is a solid base for controlling shareholder fiduciary duties. He argues,

Controlling shareholders have the power to control the property of others; they may make decisions concerning the company's property and influence the right of other shareholders...The majority shareholder can direct a company's actions and may bind the minority by its decision...the law imposes a fiduciary duty on anyone controlling another's property. As controlling shareholders effectively control the company's and minority's property, such a general fiduciary duty should apply to controlling shareholders.²⁷⁷

Additionally, I. Anabtawi explores the same question from a moral perspective. He states,

Greed and selfishness are powerful forces, and they are no less powerful for shareholders than for corporate officers and directors. Corporate law has historically relied on the fiduciary duty of loyalty to constrain greed and selfishness.²⁷⁸

Following these lines of thought, UK company law sets out some limitations on controlling a shareholder's voting power, although these limitations seem to be more lenient than director's fiduciary duties. Firstly, in respect of public companies, transactions between a listed company and its controlling shareholders are governed

²⁷⁶ *ibid*

²⁷⁷ Z. Cohen, 'Fiduciary Duty of Controlling Shareholders: A Comparative View' (1991) 12 *University of Pennsylvania Journal of International Business Law* 325, 380

²⁷⁸ I. Anabtawi & L. Stout, 'Fiduciary Duties for Activist Shareholders' (2008) 5 *Stanford Law Review* 1255, 1307

by the Listing Rules in the Financial Services Authority's Handbook²⁷⁹. Chapter 11 of these Rules requires shareholders to disclose any proposed related-party transaction to other shareholders. This needs to be approved through the votes of non-interested shareholders. More importantly, the concept of "related party" is widely defined so as to include a person who can control ten per cent or more of a company's voting rights, who has the most voting rights in the company or who can exercise substantial control over the company.²⁸⁰

In addition to procedural rules, the case law also imposes some limitations on a shareholder's voting power. One important case in this regard is *Cook v. Deeks*²⁸¹. This case is about directors (also members of the same company) who entered into a contract in their own names on the condition that they should be able to enter into a contract for the company. The Privy Council held that this action could not be ratified by controlling shareholders on the grounds that, under the rules of equity, the profit that derives from the contract belongs to the company. Lord Buckmaster held that,

men who assume the complete control of a company's business must remember that they are not at liberty to sacrifice the interests which they are bound to protect, and, while ostensibly acting for the company, divert in their own favour business which should properly belong to the company they represent.²⁸²

The Court of Appeal in *Allen v Gold Reefs of West Africa Ltd*²⁸³ establishes a principle that the power to alter Articles of Association must be exercised "*bona fide* for the benefit of the company as a whole", because this power enables a majority to bind a minority.²⁸⁴ In *Brown v British Abrasive* case,²⁸⁵ majority shareholders

²⁷⁹ See, Listing Rules in the Financial Services Authority's Handbook <<http://www.fsa.gov.uk/pubs/hb-releases/rel100/rel100lr.pdf>> accessed 20th July 2011

²⁸⁰ *ibid.* See Listing Rule chapter 11

²⁸¹ [1916] 1 AC 554

²⁸² *ibid* 564

²⁸³ [1900] 1 Ch 656 (CA)

²⁸⁴ *ibid*; and see P. Davies (n 4) 654

²⁸⁵ [1919] 1 Ch. 290.

holding 98 per cent of shares in the public company attempted to squeeze out the minority shareholder by altering the Articles of Association. The judge held that, the purpose of this alteration was to enable the majority shareholders to undermine the minority shareholder's interests rather than for the benefit of the company as whole. As a result, the resolution is dismissed by the court's injunction.²⁸⁶

Another similar case is *Clemens v. Clemens Bros. Ltd*²⁸⁷. Here, a private company was owned by the plaintiff and her aunt, Miss Clemens. The plaintiff's aunt owned 55 per cent of the shares in the company, and the plaintiff held 45 per cent. According to the articles of the company, existing shareholders had pre-emptive rights when another member wished to trade her shares. On this basis, the plaintiff had reasonably expected that the company would be wholly controlled by herself after her aunt's death. Miss Clemens decided to increase the capital by issuing new shares to non-shareholding company directors. Unsurprisingly, the proposal of a capital increase was passed by Miss Clemens's vote at general meeting. Although it was found that the resolution *was* in the best interests of the company, the court held that the object of the resolution was to deprive the plaintiff of a level of control in the company, and the resolution was therefore dismissed. Foster J held that,

I think one thing which emerges from the cases to which I have referred is that in such a case as the present Miss Clemens is not entitled to exercise her majority vote in whatever way she pleases...To use the phrase of Lord Wilberforce, the right is "subject...to Equitable considerations...which may make it unjust...to exercise in a particular way".²⁸⁸

The above cases show that there is no universal principle for the limitation of majority shareholder voting power. The court tends to accept that every case in this category is varied. The court's review of majority shareholder voting is therefore

²⁸⁶ *ibid*

²⁸⁷ [1976] 2 ALL ER 268 (Ch D)

²⁸⁸ *ibid* 282

usually a fact-specific assessment.²⁸⁹ Nevertheless, the court's principal consideration in limiting majority shareholder voting power is not elusive. In the cases highlighted above, the courts have been inclined to question whether a shareholder's voting power is being used for a "proper corporate purpose". Sealy confirms the existence of "proper corporate purpose doctrine" in controlling controlling shareholders voting powers in the UK:

The *Clemens v Clemens Bros Ltd* and *Re Halt Garage (1964) Ltd* appear to impose vaguer limitation on the member's voting powers: first, that votes must not be used 'oppressively', and second, that they must be used for 'genuine' purpose...it is true that shareholders are not constrained by fiduciary duties: unlike directors, they do not have to deny their own interests and favour those of the company or other shareholder. But it is not clear why they should not be subject to the same limitations that routinely apply elsewhere to those given a power to exercise--in those cases it is not controversial that, to be valid, the power must be exercised *bona fide* and for proper purpose.²⁹⁰

5.3.2.2 The US Approach

Different from the UK's approach, the approach taken by US law recognises fiduciary duties for majority shareholders. In *Pepper v. Litton*,²⁹¹ a US court confirmed that majority or controlling shareholders bear fiduciary duties to minorities. In this case, the court held that,

A director is a fiduciary... So is dominant or controlling stockholder and a group of stockholders...their dealings with the corporation are subject to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good

²⁸⁹ R. Flannigan (n 274) 286

²⁹⁰ L. Sealy & S. Worthington (n 4) 243

²⁹¹ 380 U.S 295 (1939)

faith of a transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested herein.²⁹²

The US courts generally allow minorities to show that it was possible to achieve the same legitimate aim in a way which was less harmful to them, where a majority can indicate a legitimate business aim for their activities.²⁹³ In Delaware, the approach adopted by the court in judging shareholder fiduciary cases is similar to that of corporate opportunity cases mentioned in the previous section. In *Weinberger v. UOP INC*,²⁹⁴ the Delaware judiciary developed an "entire fairness standard" in cases concerning controlling shareholder fiduciary duties. The standard includes two tests; namely, fair dealing and fair price. In order to prove that an interested transaction was entirely fair to the corporation and its minority shareholders, a controlling shareholder must prove to the court's satisfaction that the transaction took place at a "fair price" and that was accomplished through "fair dealing".²⁹⁵ With respect to fair dealing, the court stressed both the obligation of candour on the part of the parent company, and the importance of a process which reflects an arm's length transaction, where each party has the right to say no. Regarding fair price, the court endorsed the liberalised appraisal standard²⁹⁶ adopted by the Delaware legislature to determine this issue.²⁹⁷ Nevertheless, the decision of whether dealing or a price is fair in any given case is largely dependent on the factual evidence and the judge's discretion in each case.²⁹⁸ As Gilson states, "unfortunately, the court provided no real guidance as to how the two elements of fairness interacted."²⁹⁹ The Delaware approach to majority shareholder duties is again more flexible and uncertain than the UK's approach.

²⁹² *ibid* 360

²⁹³ *Stanley J. Wikkes vs. Springside Nursing Home, Inc. & others*

²⁹⁴ 457 A.2d 701 (Del. 1983)

²⁹⁵ I. Anabtawi & L. Stout (n 273) 1264

²⁹⁶ A liberalized appraisal standard meant that after the Delaware Supreme Court liberalized valuation methods to include any relevant factors, the courts began using the discounted cash flow methodology which is based 'on the premise that the value of a company is equal to present value of its projected future cash flows': (See M. Aiken 'Minority Shareholder's Rights in Dissension - How Does Delaware Do It and What Can Louisiana Learn' (2004) 50 *Loyola Law Review* 231, 258)

²⁹⁷ R. Gilson & J. Gorden, 'Controlling Controlling Shareholders' (2003-2004) 152 *University of Pennsylvania Law Review* 758

²⁹⁸ Z. Cohen (n 277) 388

²⁹⁹ R. Gilson & J. Gorden (n 297) 758

Furthermore, like a director's fiduciary duties, majority shareholder decisions are also protected by the business judgment rule. Only if the minority can prove that the majority's decision involves "self-dealing", does the burden of proving the fairness of the transaction shift to the majority shareholder.³⁰⁰

5.3.2.3 Concluding Remarks

So far, it is clear that, rather than addressing how shareholders treat each other, the aim of imposing duties on controlling shareholders is to achieve a subtle balance between controlling shareholder interests and minority shareholder interests. On one side, fiduciary duties should not prevent a controlling shareholder from rationally pursuing his own interests. On the other side, it is unwise to ignore the possibility that a minority shareholder's legitimate rights could be aggrieved by controlling shareholder abuse.

A short comparative observation between the UK and the US has led us to understand the difficulties of imposing duties with proper intensity on controlling shareholders in these subtle situations. On one hand, a loose duty may not effectively constrain a controlling shareholder's opportunistic behaviour. On the other hand, an over-strict duty may restrict their voting power unfairly. Thus, the following questions arise:

1. In order to formulate a general principle geared towards controlling shareholder duties, can China directly transplant US-style fiduciary duties into its legal regime?
2. If US style fiduciary duties do not work in China, can China introduce the concept of a shadow director from UK law in order to circumvent troublesome controlling shareholder duties?
3. Finally, are the procedural rule and the proper purpose test outlined in UK company law workable in the Chinese context?

³⁰⁰ Z. Cohen (n 272) 388

5.3.3 Towards A General Principle for Controlling Shareholder Duties

5.3.3.1 Could US-style Shareholder Fiduciary Duties Work in China?

The US, especially the Delaware case law, has developed a set of duties of loyalty for controlling shareholders. Therefore, it must be ascertained whether China can directly import these US style shareholder fiduciary duties into its own company law system. Firstly, some scholars argue that the US or Delaware approach to controlling shareholder fiduciary duties is based on the unique legal education system in the US, and highly reliant on the individual judicial discretion. Even, other common law jurisdictions, such as the UK or Canada, may therefore have difficulties applying US-style fiduciary duties in judicial practice.³⁰¹ As highlighted, there is a significant gap between the efficiency of court systems in China and the US. As a result, Chinese judges may not be capable of correctly applying the complicated legal rules developed by the US court system to deal with China's local cases.³⁰² Secondly, culturally speaking, US style fiduciary duties are based on a local inclination towards "other-regarding behaviour". The breach of fiduciary duties is not only deterred by legal sanction, but sometimes by market sanctions.³⁰³ Therefore, where a culture of altruism is lacking among market participants, such a transplant is unlikely to be workable. Similarly, another study by Xi indicates that China lacks a sound institutional and cultural foundation for implementing US style shareholder fiduciary duties.³⁰⁴

5.3.3.2 Would the Shadow Director Work in China?

³⁰¹ J.G. MacIntosh, J. Holmes & S. Thompson, 'Puzzle of Shareholder Fiduciary Duties' (1991) 86 Canadian Business Law Journal 86

³⁰² See section 5.2.5.2.2.2, above at 213.

³⁰³ L. Stout, 'On the Export of US-style Corporate Fiduciary Duty to Other Cultures: Can a Transplant Take' UCLA Research Series 02-11 (May 21st 2002) 8

³⁰⁴ C. Xi, 'Foreign Solution for Local Problem? The Use of US style of Fiduciary Duty to Regulate Agreed Takeover in China' (2008) 11 Journal of Chinese Economy and Business Studies 408

UK law's concept of a "shadow director" may not be effective in the face of China's problems. Firstly, a clear boundary between the powers of shareholders and directors is the pre-condition upon which judges can clarify the capacity of a company's members in a specific case. The *Company Law 2005* specifies that the shareholders meetings shall exercise the following functions and powers:

- (1) to decide on the business policy and investment plan of the company;
- (2) to elect and recall directors and supervisors whose posts are not taken by the representatives of the staff and workers, and to decide on matters concerning the remuneration of directors and supervisors;
- (3) to examine and approve reports of the board of directors;
- (4) to examine and approve reports of the supervisory board or supervisors;
- (5) to examine and approve the annual financial budget plan and final accounts plan of the company;
- (6) to examine and approve plans for profit distribution of the company and plans for making up losses;
- (7) to adopt resolutions on the increase or reduction of the registered capital of the company;
- (8) to adopt resolutions on the issuance of company bonds;
- (9) to adopt resolutions on matters such as the merger, division, transformation, dissolution and liquidation of the company;
- (10) to amend the Articles of Association of the company;
- (11) to exercise other functions and powers provided for in the Articles of Association.³⁰⁵

The board of directors is accountable to the shareholders meeting and shall exercise the following powers:

- (1) being responsible for convening shareholder meetings and presenting reports

³⁰⁵ *Company Law* article 38 (2005)

thereto

- (2) implementing resolutions adopted by the shareholders meeting;
- (3) determining the company's operational plans and investment programs;
- (4) preparing annual financial budget plans and final accounting plans of the company;
- (5) preparing profit distribution plans and plans to cover company losses;
- (6) preparing plans for increasing or reducing registered capital of the company or issuing company bonds;
- (7) drafting plans for merger, division, change of corporate form or dissolution of the company;
- (8) determining the structure of the company's internal management;
- (9) appointing or removing the general manager of the company, appointing or removing, upon the general manager's recommendation, deputy managers of the company and the officer in charge of finance, and determining the remuneration for those officers;
- (10) formulating the basic management scheme of the company; and
- (11) exercising other powers stipulated by the Articles of Association.³⁰⁶

Under China's company law, the general meeting takes charge of the essential management of the company. By contrast, the board has the power to manage the company's business objectives, and takes charge of personell resources. The law requires a separation between management and ownership in companies. However, in taking a companies' ownership structure into consideration, it is undeniable that it is a widespread business custom in China that majority shareholders control the board of directors.³⁰⁷ Accordingly, there is no clear boundary between director powers and shareholder powers in many cases.

³⁰⁶ *Company Law* article 47 (2005)

³⁰⁷ K.P. Zhang, 'Jianlun Zhongguo Shangshi Gongsi Zhili de Tezheng---Zhengfu Guquan, Xingzhengquan Shuangchong Kongzhixia de Shangshi Gongsi Zhili' [The Major Characteristics of Corporate Governance in China's Listed Companies---A Corporate Governance Regime Controlled by State Shareholder and Administrative Power], In P.Z. Gan, J.B. Lou (eds.), *Gongsi Zhili Zhuanlun* [Studies on Corporate Governance] (Beijing Daxue Chubanshe 2009) [Perking University Press 2009] 209

Secondly, China's company law includes the concept of a "*de facto* controller", which conflicts with the concept of a "shadow director" from an ideological perspective. The regime of shadow director is built upon an institutional arrangement that "the company's business is necessarily in the hands of the board".³⁰⁸ It radically conflicts with the institutional arrangement adopted by Chinese company law, which is based upon general meeting is the supreme organ in company.³⁰⁹ According to the *Company Law 2005*, a *de facto* controller refers to a person who is not a shareholder of the company, but has virtual control over corporate actions through investment in, agreement with or other arrangements with the company.³¹⁰ In order to reflect socialist ideology, this legal provision implies the State shareholder is the ultimate controller of large-scale company. As one Chinese lawyer describes, most of China's large public companies are governed by a regime, namely "shareholder control under administrative power".³¹¹ In Chinese company law, the shareholders' meeting is usually considered to be the highest power organ in the enterprise.³¹² These kinds of terminology manifest the untouchable position of "big-brother directorship" underpinned by powerful State ownership. In these conditions, if the law categorises a controlling shareholder as a "shadow director" in certain conditions, it implies that, legally the controlling powers of large-companies' would be centralised in the hands of boards of directors rather than State shareholders. This would clearly conflict with the government's socialist ideology, which places emphasis on the overwhelmingly dominant position of State ownership. Consequently, both ownership structure and governmental ideology mean that the legislation needs to follow "shareholder-centralism". Consequently, the concept of a "shadow director" is unlikely to be applicable in China.

³⁰⁸ P. Davies (n 4) 410

³⁰⁹ See (n 17) above.

³¹⁰ *Company Law*, article 217 (2005)

³¹¹ See K.P. Zhang, (n 307) 209

³¹² T.L. Hong, 'Corporate Governance Issues in PRC Companies' (2000) 11 *International Company and Commercial Law Review* 87, 89

5.3.3.3 A More Workable Procedural Rule and a General Principle of Proper Purpose?

Compared to the procedural protection provided by the Listing Rules in the Financial Services Authority's Handbook, China's company law stipulates a mandatory limitation on controlling shareholder voting power, but fails to clarify by what procedure this limitation should be imposed on controlling shareholders. The only procedural protection, except the class-voting regime, that can be found in the Chinese company law system is the requirement that all corporate loans or guarantees provided to members or related parties should be approved by the general meeting.³¹³ A non-interest shareholders' approval is not required. The reason for this loose protection is partly because the "class voting regime" has already provided a strong procedural protection for minority shareholders. However, as mentioned above, it is expected that the split shareholding structure will be unified in the future.³¹⁴ Therefore, a more detailed and effective procedural rule based on non-interested shareholder approval should be introduced into China's legal system.

Furthermore, China's company law system has not introduced a "proper purpose test" like that of UK law into its legislation. The law only approaching this issue states that a block-holder shall not "use his controlling position to injure other shareholders' interests".³¹⁵ Nonetheless, this doctrine is too demanding to be obeyed by block-holders. It is impossible for the interests of different groups of shareholders to be 100 per cent homogeneous, especially in public-held companies consisting of a State shareholder, institutional investors and portfolio shareholders. Block-holders generally prefer to approve corporate activities, which generate long-term benefits. By contrast, most portfolio shareholders prefer activities that boost share value

³¹³ *Guidelines for Articles of Association*, article 41(5)

³¹⁴ See Chapter IV, section 4.1.2.2.2, above.

³¹⁵ *Guidelines for Articles of Association*, article 39

immediately.³¹⁶ Not surprisingly therefore, majority shareholder decisions are sometimes likely to pursue long-term benefits at the expense of immediate benefits. To some extent, portfolio shareholders' interests, especially those with a strong intention to sell their shares in the short term, may be adversely affected by a majority's controlling position. Here, the majority shareholders may breach their duties in accordance with the principles in the CSRC's *Guidelines for Articles of Association*. However, such a majority shareholder's decision could not attract legal responsibility. Indeed such a shareholder naturally has the power to vote in favour of their best interests for a proper corporate purpose (prompting company's long-term growth), rather than the best interests of another particular group of shareholders. As Davies states, "votes are proprietary rights, to the same extent as any other incidents of the shares, which the holder may exercise in his own selfish interests even if these are opposed to those of the company."³¹⁷

In consequence, it is necessary to narrow this doctrine down into a more precise and accurate form. This can be achieved by establishing a general principle under which controlling shareholders, who can control the decisions of the general meeting by their voting power, should use their votes for a "*bona fide* and proper purpose". Under this principle, even if a minority shareholder is injured by the majority's controlling power, the duties will be not breached, when their controlling power is used for a "proper corporate purpose". Finally, the conflict of interests between controlling shareholders and the company should be regulated by both substantive and procedural rules. Substantively, in addition to various conflict of interest transactions specified by the current legal system, the law should recognise that, a controlling shareholder is legally bound to act for a proper corporate purpose. A "fraud" against minority shareholders should be strictly prohibited. Moreover, China's corporate law system should adopt more demanding procedural rules under which conflict of

³¹⁶ For the reasons as to why majority shareholders prefer long-term investments and portfolio investors prefer short term investments, see R. Gilson, 'Corporate Governance and Economic Efficiency: When Do Institutions Matter?' (1996) 74 Washington University Law Quarterly 327

³¹⁷ P. Davies (n 4) 653

interest transactions between controlling shareholders and a company should be subject to disinterested shareholder approval.

5.3.4 Concluding Remarks

This part attempts to build a theoretical underpinning for controlling shareholders' duties in China's legal system by answering several questions. It points out the difficulties of transplanting the concept of a "shadow director" and US-style fiduciary duties into China's legal system. It builds a two-tier principle which guides the application of controlling shareholder duties. One tier is the "proper purpose principle". The other is "disinterested shareholder approval".

Beyond these technical issues, the study of controlling shareholder's duties reveals a vital defect in China's company law system. Controlling shareholder duties may appropriately govern issues in China's stock market, if we disregard some enforcement problems. However, it fails to provide a structured legal regime with a good level of theoretical consistency. It seems that the only purpose of the law is to solve practical problems. However, the result of solving practical problems using a piece-meal approach to adopting new legal rules is that the law suffers from the serious problems of lacking of sustainability and consistency. Consequently, one of the fundamental barriers in the way of achieving an efficient legal framework is how to equip the law with a reasonable degree of theoretical depth. This raises the problem of how to use a general principle to connect and manage detailed legal rules, which are responses to specific problems in practice.

5.4 Summary of Principle Suggestions

Following the theoretical findings of Chapter IV, this chapter makes a series of practical contributions to understanding China's legal reform of corporate governance.

The following will summarise the major practical suggestions that this chapter has

made.

5.4.1 Director's Fiduciary Duties

5.4.1.1 Director's Duty of Good Faith

The current company law system does not lay down a clear rule for a director's duty of good faith under the regime of directors' fiduciary duties. The bright-line rules provided by directors' fiduciary duties are under inclusive. Therefore, the following recommendations are made:

1. An overriding principle under which a director should act in the *bona fide* best interests of the company should be established;

1.1 The interests of the company should be interpreted as the long-term interests of the shareholders as a whole;

1.2 A director's decision should be presumed to be made in good faith unless one of the following criteria has been met:

1.2.1 the existence of any undisclosed conflict of interest (direct or indirect) on the part of the director; or

1.2.2 where there are any improper purposes of the director's decision, and two basic tests for determining improper purposes should be established;

1.2.2.1 the director exercises his power unconstitutionally or for a purpose which is inconsistent with the initial purpose for which the power is delegated to the director by the Articles of Association;

1.2.2.2 the business decision is a patently unreasonable or irrational, is not found on the director's honest belief that he is acting in the best interests of the company.

5.4.1.2 Nominee Director's Fiduciary Duties

Current fiduciary duties do not impose a series of duties on nominee directors. The absence of such duties for nominee directors in Chinese public companies means that the behaviour of nominee directors' is under-regulated. The following recommendations are therefore made.

A nominee director is presumed not to be in breach their fiduciary duties by taking their nominator's interests into consideration or acting in accordance with their nominator's instruction, unless one of the following circumstances is present:

1. in so doing the director does not have a bona fide belief that he is also promoting the interests of the company as a whole; or
2. no honest and reasonable director could have formed the view that in so doing the director was also promoting the interests of the company as a whole.

5.4.1.3 No Conflict Rule

5.4.1.3.1 The Ambit of Self-dealing Transaction

Although current company law lays down several rules governing self-dealing transactions, the ambits of a self-dealing transaction are still ill-defined. The definitions of "family members" and "connected relationship" are too narrow to regulate the problems that exist in the in Chinese context. The following suggestions ate therefore made:

1. The meaning of "family members" should therefore be specified. In order to be consistent with the Accounting Standards, all close family members should be deemed to be "connected persons". This concept should refer to:

- a) a director's spouse
- b) a director's children and step children
- c) a director's parents and grandparents
- d) a director's brother and sister
- e) a director's aunt and uncle
- f) a director's cousin.

2. The concept of "connected relationship" should cover both a director's close relatives and the companies in which a director has considerable direct or indirect financial interest. Thus, the "connected relationship" should further extend to the following entities:

- a) a director's family members;
- b) a firm or unincorporated business vehicle in which a director or his family member is a partner or has substantial interests in (e.g. shares or debt);
- c) a person acting in his capacity as agent in an agent-principal relationship where the principal is a director or a person who is connected with a director by virtue of (a) and (b);

d) a business partner of a director or a business partner of a person connected with a director by virtue of (a) (b) and (c);

e) a legal person or other unincorporated vehicle in which the partner is a firm in which a director or his connected person by virtue of (a) (b) and (c), is a partner.

3. Transactions between a director or his connected person and the subsidiaries of the company he serves should also be subject to mandatory disclosure.

5.4.1.3.2 The Content of Director's Disclosure

Current company law does not clarify what a director should disclose to the general meeting, when he or she has a conflict of interest with the company in a proposed or existing transaction. This leads to the following recommendations.

1. A director must disclose the "existence and the nature" of a conflict of interests.

2. If the amount of the director's interest is able to be quantified, the director must disclose the existence and the amount of the interest.

3. If the amount of the director's interest is not quantifiable, a director must disclose the information that the board would normally consider in a transaction of this type.

4. A director should only be entitled to retain the interests from self-dealing transactions which are appropriately disclosed.

5.4.1.3.3 Corporate Opportunities Doctrine:

Under the current law, the ambit of "corporate opportunity" remains vague. It is still unclear what standards judges should rely on in corporate opportunity cases. This vagueness also applies to the disclosure rule regarding the corporate opportunity doctrine. Furthermore, no provision clarifies whether a resigned director is entitled to use a mature opportunity outside his former directorship.

1. Establishing a Capacity-based Test

1.1 A director who works as an agent of the company should be subject to a duty of self-denial. As a result of his capacity, he should not be not allowed to make any secret profits without the company's authorization.

1.2 Liability should be triggered by proving that a "profit" has been made from holding a director's position.

2. Establishing a mandatory procedural rule

2.1 A director or senior executive should not be able to take advantage of a corporate opportunity, unless

1. he or she first offers that corporate opportunity to the corporation and makes disclosure concerning the conflict of interest and the corporate opportunity; and
2. the corporate opportunity is rejected by the corporation.
3. liability for resigned director

3.1 In establishing an objective standard for the liability of resigned director, if a director has an informational upper-hand in certain transaction, a presumption of impropriety should arise where such a director exploits any business opportunity, after his resignation and without prior to transaction disclosure of that information (conflict of interests) to the company. In such circumstances, a director should have to provide evidence to rebut this presumption of impropriety.

3.2 Establishing more concrete objective standards demand the support of empirical research. Empirical research might be able to measure how long a commercial secret generally retains its value in Chinese commercial practice.

5.4.2 Majority Shareholder Fiduciary Duties

Although the CSRC's *Guidelines for Articles of Association* and Company Law 2005 impose several limitations on the actions of controlling shareholders, they fail to formulate a general principle, which connects these limitations to controlling shareholder voting power. This leads to the following recommendations:

- 1 an overriding principle that a controlling shareholder is legally bound to act for a proper corporate purpose should be established; and
- 2 more demanding procedural rules under which conflict of interest transactions between controlling shareholders and a company should be subject to disinterested shareholder approval should be developed.

Chapter VI. Conclusion

This dissertation starts by examining the relationship between ownership structure and corporate governance problems in China. It culminates in a set of detailed proposals, as to how to improve agency-cost controlling strategies by selectively transplanting rules or institutions from the UK to China. The central chapters of this dissertation have advanced important theoretical arguments by answering a series of research questions. They compare the practical effects of the formal convergence model with those of the functional convergence model, using case studies to generate a rationale behind the outcomes of these models. They have gone on to illustrate the cultural, ideological and historical determinants of the current reform approach of the Company Law adopted in China. In this final chapter, this dissertation will summarise the theoretical implications of this research.

6.1 Developing the Scholarship on China's Legal Reform of Corporate Governance

As highlighted in the first chapter, existing scholarship on China's legal reform of corporate governance tends to argue that the intense conflict between China's socio-cultural context and Western rules creates a reform path based on formal convergence, which does not work in the Chinese context.¹ However, in order to draw this sort of conclusion, an accurate understanding of China's political and cultural context, and how it influences the evolution of company law is necessary.

By taking a historical perspective, this dissertation accounts for a further complication of the context in which Chinese company law is evolving. A culture based on wide-spread clientelism and a political system based on corporatism stands in the ways of the wholesale adoption of Western rules of company law. However,

¹ See chapter I above, 1.2.2, 11-12

from a historical point of view, the tangled web in which China's company law is developing is more intricate than this argument suggests. A shortage of local commercial culture and knowledge make it difficult for China's company law system to abandon the "legal transplant approach". A large number of Western rules and institutions have been introduced into China's company law regime. These rules and institutions constitute a complementary system. Abolishing the existing company law regime triggers unaffordable sunk costs. Furthermore, China is no longer immune to the pressure from modern-day globalization. It has been forced to promote the competitiveness of its domestic corporate governance regime. Instead of maintaining the blind cultural superiority² of bygone times, today Chinese legislators and legal end-users have a pragmatic and even humble attitude towards advanced Western legal techniques and the legal cultures behind them. Indeed, the adoption of a Western legal regime is believed to be a necessity for consistent economic development and strong national welfare. Due to pressure from globalization, the Chinese context, especially some economic elements still bearing planned economic characteristics, is subject to reform. Consequently, some transplanted rules are not expected currently to fit in with existing economic factors, although they may facilitate a change in those factors. Sometimes, a conflict between a transplanted rule and its local context triggers a radical change in elements of the economic infrastructure. Finally, domestic investors and foreign investors, as powerful public interest groups, need the company law system to achieve certain international standards in shareholder protection. Consequently, Chinese policy-makers must face a range of complex technical, political and cultural issues in the legal reform of corporate governance. The issues include:

- overcoming the disadvantages resulting from limited local knowledge and the weak culture of commercial law;

² E.g. Emperor Qianlong dismissing the British ambassador with the comments "we have never valued ingenious articles, nor do we have the slightest need of your country's manufactures". see R. Peerenboom, *China Modernizes: Threat to the West or Model for the Rest* (Oxford University Press 2008) 282

- considering the complementarity between a newly-implemented rule and the existing legal system;
- facing the tough challenge from globalization;
- fulfilling the legal elites' demand for theoretical perfection;
- ensuring a newly-implemented rule has the potential to facilitate the proposed economic reform; and
- balancing the interests between State ownership and individual investors.

In practice, it would be extremely difficult, if not impossible, to design legal rules, which can fulfil the multiple-legislative-objectives pursued in such a complicated context. Indeed, designing perfect context-appropriate legal rules is not the only aim of China's legal reform of corporate governance. The conflict between law and context therefore is inevitable.

Secondly, the influence of local context on the development of company law in China is also complex. China's political and cultural context not only hampers the adoption of Western rules, but also the endogenous development of company law through functional convergence. Nearly one hundred years ago, Yan Fu, a preeminent Chinese scholar of the Qing Dynasty commented:

Anglo-American companies have well designed institutional structures, as they come from constitutionally democratic countries. In contrast, the Chinese people are living under a dictatorship. They have no idea of personal right and fairness. Therefore, the Chinese cannot create any equivalence, which can compete with the Western style company.³

This insightful comment provides an explanation for the development of China's company law in 21st century. In modern China, some core features of the political and cultural context have not significantly changed from how they were one hundred

³ F. Yan, *Tian Yan Lun* [Evolution and Ethics] (1897) 105

years ago. Even today China has not established a political regime concretely based on liberal democracy. However, healthy commercial law culture requires political soil that does not restrict or disturb its development. In China, there is no civil society in which NGOs or individuals are allowed to play an active role in supervising large public companies. Additionally, the regulatory regime is over-reliant on administration, which simplifies the direction of the growth of commercial law culture. The current political regime makes China's commercial law culture too weak and impoverished to support endogenous development of the company law system. Consequently, although China has experienced rapid economic development in the last three decades, leading to the Chinese economic system occasionally being labelled a "Chinese model",⁴ this model is still not complete in modelling an effective modern company law system without the support of Western experience. As discussed in former chapters, the newly-revised *Company Law 2005* rarely contributes any institutional innovation through functional convergence.

To conclude, by summarizing the principal findings of previous chapters, this dissertation tries to draw a clearer and more accurate picture of China's legal reform of corporate governance. The multiple targets of this reform together with the complex political background in which it takes place mean that the "formal convergence model" is the only feasible and pragmatic approach available in the Chinese context.

6.2 Some Theoretical Implications for Theories of Comparative Corporate Governance

In addition to adding a new dimension to the scholarship of China's corporate governance regime, this research generates some important insights for theories of comparative corporate governance. China takes a formal convergence approach to its legal reform of corporate governance. This supports legal scholars' explanations of the

⁴ See generally R. Peerenboom (n 2)

formal convergence model, which focus on the congruence of underpinning economic components⁵ and the force of global competition⁶. Firstly, China's case supports the "convergence through congruence" argument. The Western style rules adopted by the 1993 Company Law are introduced to meet the demands of the newly-implemented "socialist market economy." The transplanted rules of 2005's company law are responses to China's full engagement with globalization. The increasing number of foreign listed companies, the invitation of foreign investors into the domestic market, and the reform of the banking system and property law, all draw the economic context surrounding company law in China closer to that of Western jurisdictions. As a result, the law is becoming increasingly similar to that of the Western world.

Secondly, China's case supports the "competition argument". Policy-makers take an instrumental view of company law reform. They believe that the law does not only react to, but forges context. Adopting technically advanced rules can facilitate economic development and promote the competitiveness of China's domestic firms in the global market.

Nonetheless, these two considerations do entirely account for China's adoption of the formal convergence model. There may be some other "convergence forces" in a transition economy. Firstly, the legal end-user's attitude towards foreign law is important for the reception of a transplanted rule. As Foster argues, commercial law is not necessarily bound to, or dissociated from, culture or social processes: whether or not it is "culture-specific" depends on the attitude towards it of those in a position to influence its successful reception.⁷ Chinese lawyers generally have a critical attitude towards the socialist legal tradition and regard path-dependent forces, such as

⁵ M. Siems, *Convergence in Shareholder Law* (Cambridge University Press 2008) 250-290

⁶ H. Hansmann and R. Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Journal* 439 and Siems (n 5) 297

⁷ N. Foster, 'Transmigration and Transferability of Commercial Law in a Globalized World', In E. Orucu & A. Harding (eds.), *Comparative Law in the 21st Century* (Kluwer Academic Publishers 2001) 69

over-concentrated State ownership, as the origin of poor shareholder protection.⁸ By contrast, lawyers have a more positive attitude towards rules or institutions transplanted from Western jurisdictions, which are more likely to occasion a fundamental structural change in the local context. Secondly, it is necessary to know whether a jurisdiction has a well-established commercial law culture, before declaring functional convergence as the more suitable model for the legal reform of corporate governance in that jurisdiction. As highlighted above, in China, local knowledge and traditional institutional structures are not rich and flexible enough to respond to the changed economic context. China does not have a commercial culture or tradition that is strong or flexible enough to deal with newly-emerged problems arising from the intense pressure of globalization. Due to this lack of experience, the perfect functional equivalence to fit China's context may be not available to legislators. Therefore, when the government reforms China's economic structure towards a "market economy" model, transplanting legal rules or institutions from Western jurisdiction is inevitable. Gilson's explanation of the difference between formal convergence and functional convergence highlights that the situation encountered in China reflects formal convergence. He writes:

[F]unctional convergence, [is] when existing corporate governance institutions are flexible enough to respond to the demands of changed circumstances without altering the institutions' formal characteristics; formal convergence, when an effective response requires legislative action to alter the basic structure of existing governance institutions...⁹

Finally, the initial conditions in which the law develops significantly influences the path along which the law further evolves. If the development of law is locked into a model, it is economically inefficient to abolish this developing model, even if it

⁸ X. Tang, 'Konggu Gudong De Shouxin Yiwu Cong Meiguo Fa Shang Yizhi' [Block-holder's Fiduciary Duties: Transplanting from the US] In B.S Wang (eds.), *Zhuanxing Zhong Gongsifa De Xiandaihua* [Modernizing Company Law in Transition Context] 535

⁹ R. Gilson, 'Globalizing Corporate Governance: Convergence of Form or Function' (2001) 49 *American Journal of Comparative Law* 329, 356

conflicts with some core components of its context. Consequently, the adoption of a formal convergence model can result from "efficiency path-dependence". As such, a formal convergence model may be triggered by the following combining forces in a transitional economy:

- the congruence of some key elements of economic infrastructure with that of Western jurisdictions;
- pressures from the competition of the global market;
- policy-makers and legal end-users tending to adopt a pragmatic attitude towards Western legal culture, which is assumed to be superior or at least more market-economy friendly;
- the notion that advanced Western law is an instrument for deepening the reform of economic infrastructure and improving the competitiveness of domestic firms;
- an absence of rich local knowledge and resources from which to develop an effective company law regime through functional convergence, making formal convergence the only available and practical method for legal reform; and
- legal reform starting from and therefore already being locked into the formal convergence model, which it is too economically inefficient to change.

6.3 Practical Contributions

Beyond this series of theoretical arguments, this dissertation makes some practical contributions to China's legal reform of corporate governance. It suggests a bundle of proposals, which are aimed to improve agency-cost controlling strategies by effectively adopting rules of UK company law. These reform proposals follow the formal convergence model. By reviewing a wide-range of UK and occasionally US case law and legislation, this paper highlights the legal rules, institutions or interpretations that can improve the effectiveness of Chinese company law. It has gone on to discuss how to integrate these elements into China's existing legal regime,

and how to transform them into an effective model for controlling China's corporate governance problems. By proposing the reform of some important company law rules for controlling agency cost, this paper has generated some findings which inform China's company law reform using the formal convergence model:

- Accurately understanding the law in a parent jurisdiction is a precondition for the formal convergence model. This understanding cannot be limited to the positive law, but extends to the legal theory behind positive law.
- Extracting the "Chinese problem"¹⁰ from the universal corporate governance problem is a key part of the formal convergence model. This process determines which part of the transplant rule will be selectively adopted and which part will be not. Alternatively it can determine how to modify a transplanted rule in order to solve problems with Chinese characteristics.
- It is important always to take weak legal enforcement and weak institutional support into consideration. In such cases law should contain more detailed and manageable legal rules rather than vague standards or principles.
- In a transitional economy like China, the law should regard "commercial morality" and the safety of transactions in the market as a superior value to economic efficiency and effectiveness. A one-sided focus on the latter may cause market disorder, especially in conditions where commercial morality is not well established.

6.4 China's Legal Reform of Corporate Governance: History tells the Future

As mentioned in the first chapter, China is an extraordinary interesting case for testing the comparative corporate governance theories, not only because it is the

¹⁰ E.g. see chapter V 5.2.5.1, the discussion on the "clan-based commercial problem" in self-dealing transactions. Self-dealing transaction is a universal corporate governance problem, which exists in most jurisdictions. However, the "clan-based commercial problem" in self-dealing transaction is a "Chinese problem", which is not the major concern for most Western jurisdictions.

second largest economy in the world, but also it remains the socialist regime in a political sense. In addition to that, as a transitional economy, many important factors of China's political and cultural context are subject to reform. All these characteristics make China's future development of corporate governance regime to be complicated and difficult to predict. This research not only maps out an accurate picture of the political-cultural context surrounding China's corporate governance, but also formulates a solid correlation between China's political-cultural context and its legal reform of corporate governance. The major findings of this research enable us to make some valuable predictions of the future development of the corporate governance regime in one of world's major economic entity.

It seems that China's legal reform of corporate governance is in a dilemma. On one hand, powerful government control and consequent State ownership still appears to be dominant. This supports consistent economic development in China and occasionally creates some powerful competitors in the global market, at least in the last three decades. Deeply-embedded political and cultural factors make it difficult to rid China's legal system of the "rule of man". On the other side, economic development that comes with wide-spread official corruption, extremely unfair distribution between rich and poor, and "race to bottom" official policies is unlikely to be sustainable. Therefore, the current regime could be forced to move towards a "rule of law system".

One possible scenario is that China's large companies will finally be governed by a "rule of law" system. China's current mode of economic development is ultimately unsustainable¹¹ and by further exposing its negative aspects to the general public, its demise may loom closer. Both domestic and foreign investors may become impatient with China's model of economic growth, which is based on corruption, government

¹¹ For this point, see generally G. Chang, *The Coming Collapse of China* (New York: Rondam House 2001), and for more recent comments on the negative aspects of China's economic development, see J. Anderlini, China's Growth Model 'Unsustainable', December 23rd, 2010, *Financial Time* and T. Carpenter, 'Reassessing China's Rise: Knowns and Unknowns' on Cato institution's website at http://www.cato.org/pub_display.php?pub_id=12937 accessed 20th July 2011

connections and unfair competition. This increasing public unease and apprehension may force both the central government and local governments to redefine their roles in supervising large public companies. Otherwise, the government and the Party's legitimate position will be seriously threatened. Consequently, although corporatism and clientelism may still play a role in China's public company corporate governance regime, a fairer playing field will be provided by implementing a more substantial "rule of law" system. Finally, the government might be able to achieve the Chinese dream of harmonious society through the "rule of law" system. Under this system, weakening the government's role in the regulatory regime will lead to a prosperous commercial law culture. Accordingly, a more powerful cultural dynamic which enables China's company law to achieve international standards by enacting functionally equivalent rules may emerge.

The other possible scenario is that both domestic and foreign investors will finally get used to China's development model based on corporatism and clientelism. Fragmented economic reforms may be still capable of maintaining economic development at a relatively high level whilst also maintaining social stability. As R. Peerenboom argues, "Chinese citizens may be willing to accept shortcomings if they feel steady progress is being made. They may feel the government is doing its best, or at least reasonably well, given the circumstance."¹² Foreign investors may remain content with the existing system if the Chinese government provides a bundle of attractive preferential policies. Legal reform would remain superficial, not significantly affecting deeply-embedded political and cultural elements. Transplanted rules would remain window-dressing. In some cases, Western legal rules would serve some fragmented economic reforms proposed and oriented by the State, but would not found any substantial political-economic reform. It is a little surprising to predict that a system based on corporatism, clientilism and a weak legal system may capable of maintaining sustainable economic development in the Chinese context. However, as

¹² R. Peerenboom (n 2), 288

one Western Economist explains, China may be "the mother of all black-swans".¹³ A company law regime, under such conditions, must still however, adhere to transplanting Western rules into China's legal system to achieve some international standards, as there is little room for developing a wholesome local commercial law culture.

¹³ See V. Katsenelson, 'China: The Mother of All Black Swans', a presentation available at <<http://contrarianedge.com/2010/02/12/china-the-mother-of-all-black-swans/>> accessed 20th July 2011

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