Directors' Duties and Liabilities in China

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Abbreviations

ALI	American Law Institute
AOA	Articles of association
BOD	Board of directors
BJR	Business Judgment Rule
CEO	Chief executive officer
CJV	Contractual joint venture; cooperative joint venture
CLS	Company limited by shares
CNY	Chinese Yuan (the official currency of China)
CPC	Communist Party of China
CSRC	China Securities Regulatory Commission
D&O	Directors and officers
DGCL	Delaware General Corporation Law
EJV	Equity joint venture
EU	European Union
FDI	Foreign direct investment
FIE	Foreign-invested enterprise
GDP	Gross domestic product
IPO	Initial public offering
LLC	Limited liability company
M&A	Mergers and acquisitions
MBCA	Model Business Corporation Act
MBO	Management buyout
MOFCOM	Ministry of Commerce

NDRC	National Development and Reform Commission
NPC	National People's Congress
NTS	Non-tradable shares
OECD	Organization for Economic Co-operation and Development
PRC	People's Republic of China (mainland China)
SAIC	State Administration of Industry and Commerce
SASAC	State-owned Assets Supervision and Administration Commission
SEC	Securities and Exchange Commission
SGM	Shareholders general meeting
SOE	State-owned enterprise
SPC	Supreme People's Court
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
TS	Tradable shares
TVE	Township and village enterprise
US	United States of America
WFOE	Wholly foreign-owned enterprise
WSOE	Wholly state-owned enterprise

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Chapter 1 Introduction

'Management is a curious phenomenon. It is generously paid, enormously influential and often significantly devoid of common sense.'

--Henry Mintzberg[1]

1.1 Research Background

Companies, or corporations, are ubiquitous business entities worldwide.[2] Our lives are intertwined with numerous companies, domestic or overseas, giants or start-ups. We buy and consume products and services from them; we may work for or invest in them. Browsing the headlines on a webpage or in a newspaper, one often comes across some reports on the recent events and status of eminent companies. The interactions between companies, *i.e.*, transactions, collaboration and competition, constitute the dynamic of the overall economy.

In general, the party which steers a corporate vehicle is the centralized management body—the board of directors.[3] Directors stand at the top of the corporate hierarchy, make discretionary decisions, and control business operations.[4] Associated with such controlling power is the concern with their performance. As early as the 18th century, when the joint-stock company emerged as a royal chartered business entity for overseas trade, Adam Smith, in his famous monograph, observed that directors in joint-stock companies 'manage

[1] Henry Mintzberg, 'Musing on Management: Ten Ideas Designed to Rile Everyone Who Cares about Management', (1996) 74 *Harvard Business Review*, p. 61.
[2] The term 'company' and 'corporation' are used interchangeably in this thesis, unless otherwise stated. Here, both these terms refer to legal entities with structural characteristics: separate legal personality, limited liability of shareholders, transferable shares, centralized management structure, and equity ownership.
[3] The classic model is of a board of directors making major business decisions for the company. Although controlling shareholders or senior management personnel may hold corporate control on individual occasions, the exercise of corporate control is still greatly dependent on the board of directors in general. See Reinier H. Kraakman, John Armour, Paul Davies, Luca Enriques, Henry Hansmann, Gerard Hertig, Klaus Hopt, Hideki Kanda, and Edward Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* Second Edition (Oxford: Oxford University Press, 2009), p. 5. Hereinafter this book is referred to as 'Kraakman *et al.*, *The Anatomy'*.
[4] For a comprehensive survey of the board's role, see Benjamin E. Hermalin and Michael S. Weisbach, 'Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature', (2001) NBER Working Paper No. 8161, available at http://www.nber.org/papers/w8161 (accessed 24/09/2019).

other people's money' and could not be expected to exercise the same degree of caution and vigilance as the directors who owned the companies.[5]

This concern is not entirely unnecessary. Indeed, corporate frauds, scandals, and collapses have never been rare incidences, and sometimes, devastating ramifications may ensue. In the event of failures and collapses, shareholders and creditors suffer investment losses, while employees lose their jobs. Domino effects at the macro-economic level might occur, such as frustration in market confidence, plummeting financial markets, and even economic turbulence. For instance, the appalling accounting scandal and bankruptcy of Enron in the US at the start of this century resulted in losses to shareholders of up to $74 billion, tens of thousands of employees jobless, and a huge shortage in the pension funds of former employees.[6] In 2002, WorldCom was discovered to have committed accounting frauds that had inflated the company's assets by an estimate of $11 billion.[7] This wave of corporate scandals triggered an immediate regulatory response and heated scholarly debate in the US.[8]

More recently, in 2008, Lehman Brothers, the fourth largest investment bank in the world, took the bankruptcy record in the US, far surpassing WorldCom and Enron in scale of assets.[9] The failure of Lehman Brothers was invoked and escalated because of the national housing market slump, as this company mainly engaged in the business of subprime mortgage loans to sustain a dominant position in the market.[10] Commentators attributed the failure and subprime mortgage crisis to the weakness of risk management in the banking sector.[11]

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[5] Adam Smith, *The Wealth of Nation* 1776 Canna Edition (New York: Modern library, 1937), p. 700.
[6] 'The Real Scandal' in *The Economist* (2002), available at http://www.economist.com/node/940091 (accessed 24/09/2019).
[7] 'WorldCom's Collapse: The Overview' in *The New York Times* (2002), available at http://www.nytimes.com/2002/07/22/us/worldcom-s-collapse-the-overview-worldcom-files-for-bankruptcy-largest-us-case.html (accessed 24/09/2019).
[8] The US Congress enacted the Sarbanes-Oxley Act of 2002 to strengthen the information disclosure of publicly listed companies and enhance corporate governance. For an academic evaluation of this Act, see Roberta Romano, 'The Sarbanes-Oxley Act and the Making of Quack Corporate Governance', ECGI working paper (2004), available at http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=596101 (accessed 24/09/2019). For related empirical studies, see Ivy Xiying Zhang, 'Economic Consequences of the Sarbanes-Oxley Act of 2002', (2007) 44 *Journal of Accounting and Economics*, pp. 74-115.
[9] 'Unravelling Lehman Brothers' in *Reuters, the Wider Image* (2013), available at https://widerimage.reuters.com/story/unravelling-lehman-brothers (accessed 24/09/2019).
[10] *Ibid*.
[11] The OECD reported 'The Corporate Governance Lessons from the Financial Crisis' in 2009, available at http://www.oecd.org/corporate/ca/corporategovernanceprinciples/42229620.pdf (accessed 24/09/2019).

Almost every country has encountered its Enron, WorldCom and similar incidents.[12] As economic activities become increasingly complicated, well-conceived schemes and complex business models are structured and arranged to conceal debts, losses, and even illegal gains and payments. The difficulty of combatting management misfeasance and malfeasance is increasing.

A classic debate in the disciplines of management and ethics continues over the reasons for corporate scandals. Are certain individuals or organizational defects to blame?[13] Meanwhile, national regulatory authorities or professional associations formulate numerous guidelines and codes to promote the standard model and best practices for governance.[14] Scholars from various disciplines have analysed the models recommended in the guidelines and codes, both theoretically and empirically.

Corporate law or company law usually offers or confirms a set of methods to mitigate management opportunism, which include prescriptive rules and standards of management behaviour, entry and exit terms for shareholders, and such governance strategies as power to select or remove directors and officers, ratification of management decisions and reward mechanisms.[15] Among others, the method to directly regulate management behaviour is to require or prohibit specific behaviour in legal norms and to leave adjudicators to determine the compliance with legal norms after the fact.

Over the past decades, major EU and Asian countries have introduced and transplanted the concept of fiduciary duties of loyalty and care from Anglo-American corporate law to

[12] Many news reports on corporate scandals, such as 'The Corporate Scandal Sheet', available at http://www.forbes.com/2002/07/25/accountingtracker.html; 'VW and the Never-ending Cycle of Corporate Scandals', available at http://www.bbc.com/news/business-34572562 (accessed 24/09/2019).
[13] Neal M. Ashkanasy, Carolyn A. Windsor, and Linda K. Trevino, 'Bad Apples in Bad Barrels Revisited: Cognitive Moral Development, Just World Beliefs, Rewards, and Ethical Decision-Making', (2006) 16 *Business Ethics Quarterly*, pp. 449-473.
[14] The 1992 UK Cadbury Report (The Financial Aspects of Corporate Governance) was the first corporate governance code in the world, with an emphasis on financial reporting and accountability among all the aspects of corporate governance. The listed companies in the London Stock Exchange are required to comply with this code or to explain the reasons for non-compliance, available at http://www.ecgi.org/codes/documents/cadbury.pdf (accessed 24/09/2019).
Afterwards, major jurisdictions and international organizations subsequently laid down their codes of corporate governance. For index of these codes, visit the ECGI website http://www.ecgi.org/codes/all_codes.php (accessed 24/09/2019).
[15] See Kraakman *et al.*, *The Anatomy*, pp. 21-31. This book provides a generic framework to analyse and compare corporate law in different jurisdictions. The authors use the term 'legal strategies' to refer to the methods commonly deployed in corporate law to address agency problems, and they categorize legal strategies into regulatory and governance strategies, and *ex ante* and *ex post* strategies.

better discipline management.[16] Nevertheless, a common observation is that the successful transplantation of the fiduciary duty principle to a civil law jurisdiction is quite difficult.[17] China, among others, made a comprehensive amendment to its Company Law in 2005 and imported duties of loyalty and care in tandem with shareholders derivative action.[18]

Overall, China's legal system has primarily followed the civil law tradition. The sources of law are the provisions formulated in the statutes and codes, and the judges cannot interpret legal rules to the extent that they almost establish a new law. Thus, it poses a great challenge to Chinese judges to apply the general and inclusive principle of fiduciary duty to specific and ever-changing business practices.

Moreover, the context is unique. As a transitional country, China has undergone a series of reforms and changes in its economic system, market institutions, political regime, and societal spheres. In particular, many giant companies are state-owned or state-controlled, and they have distinct organizational characteristics and management issues in this transitional context. In the private sector, a concentrated ownership structure is commonplace and close connections with local government remain well maintained to obtain favourable policy treatment in the locality.[19]

In the stock market, a great majority of investors are individuals rather than investment institutions in terms of headcount. These individual investors usually have limited access to, and are less capable of analysing market information. Moreover, they usually do not have a well-diversified portfolio to spread or hedge risks, and therefore are more susceptible to corporate frauds and failures.[20] Meanwhile, low efficiency, management scandals, and 'tunnelling' the funds of listed companies are chronic problems that inhibit enterprise development and economic growth.[21] The relevance of fiduciary duties and

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[16] See, *e.g.*, Vassil Breskovski, 'Directors' Duty of Care in Eastern Europe', (1995) 29 *International Lawyers*, pp. 77-97.

[17] Katharina Pistor and Chenggang Xu, 'Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory', in Curtis J. Milhaupt (ed.), *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals* (New York: Columbia University Press, 2003), p. 78.

[18] For the official translation of the Company Law, please visit the website of national legislation authority—National People's Congress (NPC), http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384124.htm (accessed 24/09/2019).

[19] Hongbo Duan and Abdul Razak bin Chik, 'Institutional Environment, Political Connection and Financial Constraints—Evidence from Private Enterprise in China', (2012) 1 *Business and Management Research*, pp. 133-140.

[20] Juan Yao, Chuanchan Ma, and William Peng He, 'Investor Herding Behaviour of Chinese Stock Market', (2014) 29 *International Review of Economics and Finance*, pp. 12-29.

[21] Guoping Li, 'The Pervasiveness and Severity of Tunneling by Controlling Shareholders in China', (2010) 21 *China Economic Review*, pp. 310-323.

liabilities to China's governance problems is an interesting, yet barely explored topic. This thesis addresses the universal concern with management misconduct and doctrinal convergence of directors' duties and liabilities by focusing on the Chinese case.

1.2 Research Questions

Previous studies mostly focused on the design and formulation of the duty and liability rules from a rule-based comparison perspective and identified the differences between Chinese corporate legislation and the state corporate laws in the US. In recent years, the research focus has moved to enforcement practices regarding directors' duties and liabilities.

However, these studies do not enunciate policy goals and the functional rationale clearly or sufficiently. Too often, it was mistakenly assumed that the US model was a one-size-fits-all approach; the contextual discrepancy between different jurisdictions is not given close attention and careful consideration. Consequently, the recommendations proposed to improve directors' duties and liabilities in China might not be grounded in a solid basis.

For the purposes of exposition, this thesis uses the terms 'legal strategy' and 'duty and liability strategy' interchangeably to refer to the legal duties that directors owe to the company or shareholders and legal liabilities for the breach of such duties. In this sense, the legal strategy involves the legal norms to dictate requirements or prohibition of management behaviour and the enforcement mechanism to hold directors liable, mainly through private actions resorting to judicial review.

This thesis attempts to situate this duty and liability strategy in China's context and to employ a generic analytical framework to specifically identify how this legal strategy can and should function in this particular context. As such, the ultimate goal of this thesis is to address the following research question:

How and to what extent does the legal strategy—directors' duties and liabilities—ameliorate the agency problems in China?

The term 'agency problem', deriving from the agency theory, refers to the problems arising from the principal-agent relationship, where agents are granted discretionary powers by the principal and expected to exercise such power in the best interest of the principal.[22] In fact, agents may commit self-regarding acts in different forms at the expense of the principals' interests, which are conceptualized as agency problems. Chapter 2 presents further elaboration on the agency theory, which is the underpinning theory of corporate law.

To pursue the functional investigation of directors' duties and liabilities, this thesis is structured to deal with the following sub-questions:

- What is the rationale of directors' duties and liabilities? Is there any theoretical approach to or a framework for an analysis of this duty and liability strategy?

First, a clear understanding of the rationale and working mechanism of directors' duties and liabilities is needed. Put differently, it is necessary to examine why legal duties and liabilities are imposed on directors and the policy goals to be fulfilled by the duty and liability strategy in relation to managerial conduct. Moreover, a theoretical approach or a framework is necessary to enable the following analysis to assess the usefulness of the duty and liability strategy and recognize the factors conducive to the usefulness of the legal liability strategy.

The economic discipline has provided sufficient explanations for the conflicts of interests in a corporate entity, which are likely to give rise to management wrong-doing. In addition, the economic analysis of law can serve as a tool to examine the impact of legal norms. Thus, the first step is to draw an analytical roadmap with reference to previous economic literature.

- What agency problems are China's companies likely to encounter?

Before a thorough examination of the duty and liability strategy, it is necessary to identify the context in which this legal strategy is put in place, such as the extent of separation of ownership and control and the function of boards of directors in general. Following the logic of the agency theory, this contextual survey boils down to the following aspects: (1) agency problems confronting companies in China; (2) whether and to what degree market mechanisms help to reduce the agency problems; and (3) whether and how internal governance may prevent the agency problems *ex ante*.

- How are directors' duties and liabilities designed and formulated in Chinese corporate legislation?

[22] See *infra* Section 2.3 Agency Theory for definition of agency problems.

This sub-question concerns fiduciary duties and liabilities of directors in China's corporate legislation. Clearly, it is very difficult to codify the fiduciary duties of loyalty and care, originally developed in a body of case law, into statutory provisions. Thus, a doctrinal analysis of the relevant provisions *per se* is meaningful and is also a preliminary step for the functional investigation.

- How are the laws of directors' duties and liabilities working in practice in China? Are directors' liabilities substantially enforced?

Pound has drawn the famous distinction between 'law in books' and 'law in action',[23] which has inspired many legal scholars to study the functioning aspect of law in practice. The effect of legal rules on management practice is largely dependent on how these legal rules are actually interpreted and enforced. Therefore, a survey on the pattern and intensity of the enforcement of directors' duties and liabilities is crucial.

- Considering the current efficacy of this legal strategy, what improvements or adjustments can be made in furtherance of management practices in China?

The central research question consists of two dimensions of inquiries: positive analysis and normative analysis.[24] Namely, this thesis not only examines the present status of directors' duties and liabilities in books and in action, but also attempts to identify the normative status—what this legal strategy should be like in China.

In accordance with the agency theory, the strategy of directors' duties and liabilities is interrelated with other devices and factors that may affect directors' performances, such as internal governance, the dynamics of market mechanisms, and even management culture. Namely, when the market and contractual instruments can effectively incentivise the best performance of directors, the legal strategy would be less desirable. Thus, the normative status of the legal strategy is discussed in consideration of the deterrence and incentives generated by other instruments in a particular context.

Furthermore, this thesis proposes workable adjustments and improvements to bridge the gap between the positive and normative status. Law-making techniques, the authority, competence, and independence of the judges, relevant procedural rules, and the costs of

[23] Roscoe Pound, 'Law in Books and Law in Action', (1910) 44 *American Law Review*, p. 12.
[24] Economists hold the positive-normative dichotomy. Positive studies are mainly about 'what is the case', while normative statement discusses what 'ought to be' like. See Samuel C. Weston, 'Toward a Better Understanding of the Positive/ Normative Distinction in Economics', (1994) 10 *Economics and Philosophy*, pp. 1-17.

enforcement are all relevant factors, and therefore, would be examined in making policy and legal recommendations.

1.3 Academic and Practical Relevance

This study of one legal strategy in one single country has broader significance and provides a consideration to a general theoretical debate. First, this study yields useful insights into the transplantation of the fiduciary duty principle. Some challenges and difficulties arising from the introduction of fiduciary duties and liabilities are common to civil law countries, especially the transitional ones.[25] The experience and lessons that China has gained can be enlightening for other countries in an effort to refine their equivalent rules.

Second, the comprehensive view of China's corporate governance, market infrastructure, and judicial institutions may also shed light on the discussion of other issues in areas of Chinese corporate and securities law, such as the protection of minority shareholders against expropriation by controlling shareholders and securities litigation.

Third, this study presents distinct evidence for the theoretical debate of convergence-persistence. Theoretical observations about the development of corporate governance worldwide identify two competing lines: convergence and persistence.[26] On the one hand, corporate convergence theory explains why convergence occurs worldwide, classifies different types of convergence, and reveals the driving forces that determine the convergence and control the pace of convergence.[27] On the other hand, the path-dependence theory emphasises the role of initial corporate structure and corporate rules in shaping the development trajectory, which is termed as rule driven and structure driven path dependence.[28]

China's experience of corporatization reform and corporate governance development can well exemplify or help refine some propositions of this convergence-persistence debate. One prominent aspect is the transformation of state intervention into state ownership and

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[25] See *supra* note 16 in this chapter.
[26] Jeffrey N. Gordon and Mark J. Roe (eds.), *Convergence and Persistence in Corporate Governance* (Cambridge: Cambridge University Press, 2004).
[27] Ronald J. Gilson, 'Globalizing Corporate Governance: Convergence in Form or Function', in *ibid.*, pp. 125-158. The author describes the convergence at three levels: 'functional convergence (when existing governance institutions are responsive to change without change in the rules), formal convergence (when the legislative framework is adapted) and contractual convergence (when companies have to adapt contractually as domestic institutions are not flexible enough to accommodate change and political obstacles will not allow formal convergence)'.
[28] Lucian Arye Bebchuck and Mark J. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance', (1999) 52 *Stanford Law Review*, pp. 127-170.

how state-owned companies struggle with the wrestling forces of traditional legacy from the central planning era and modernization momentum within the governance structure. Conversely, this theoretical debate also provides an insight into predicting future development and dynamics in China.

Fourth, 'why law matters' and 'how law matters' to corporate governance remain topics of intense discussion.[29] Liberal opinion believes that corporate law only provides default rules to reduce transaction costs among constituent parties, and enables private parties to make their own arrangements through internal charters.[30] The opposing argument emphasises that the quality of corporate law is a determinant of the prosperity of corporations and the securities market.[31] Closely related to this point, the under-development of the securities market and a concentrated ownership structure in transitional countries are linked to the weak enforcement of corporate law. With particular regard to self-regarding actions, it is believed that company law only plays a trivial role in deterring shirking.[32]

This thesis analyses the function of directors' duties and liabilities, one important component of company law, in a transitional country, which enriches discussions on the correlation of corporate law and corporate governance. Moreover, it reveals when, and to what extent, legal duties and liabilities are required to control opportunistic behaviour.

Besides academic relevance, this thesis might also be interesting to investors and professional managers. Chapter 3 provides a comprehensive picture of the local context and Chinese corporate governance, from which investors, domestic or overseas, which start firms or invest in them in China, may obtain information pertaining to market institutions, legal framework and policy issues.

Chapters 4 and 5 together present an estimate of the liability risk that incumbent or prospective directors and officers need to be aware of so as to avoid disputes and monetary liabilities. In addition, investors can predict the average degree of management accountability to take corresponding measures to ensure their investment returns.

1.4 Methodology and Materials

[29] See *infra* Section 2.4 Why Law Matters in Chapter 2.
[30] See *infra* note 45 in Chapter 2 (Easterbrook and Fischel 1991).
[31] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert Vishny, 'Investor Protection and Corporate Governance', (2000) 58 *Journal of financial Economics*, pp. 3-27.
[32] Mark J. Roe, 'Corporate Law's Limits', (2001) 31 *Journal of Legal Studies*, pp. 233-271.

This thesis applies the following research methods to deal appropriately with the central research question and the sub-questions: literature review, economic analysis of law, legal doctrinal analysis, analysis of judicial and administrative decisions, and comparative analysis.

Literature review

Literature review is a prerequisite to scientific research, as it provides an overview of previous studies. This method helps understand the state-of-art of the research subject and identify the starting points of further investigation or the gaps in research.[33] The argument in this thesis is based on multi-disciplinary literature. To illustrate the context in which a law applies, it refers to extensive literature on China's economic environment and corporate governance, and uses corresponding empirical evidence from the disciplines of management, accounting and finance. Meanwhile, it also includes original discussions by economists, since the discipline of economics contributes substantially to the theories of the firm and corporate law.

First-hand literature written in Chinese is also integral to this research and mostly retrieved from the CNKI database.[34] This database is the largest and most comprehensive database of academic journals, official Yearbooks, and major conference papers in China. For readers who do not read Mandarin Chinese, the abstracts in English that most articles have are still accessible.

Economic analysis of law

Law and economics, or the economic analysis of law, is the prevailing scholarship in the company law realm.[35] The reach of this scholarship expands from the US, UK to EU and Asian countries in the trend of corporate convergence.[36] This thesis views the corporate context in China through the lens of the agency theory, which is a branch of economic theories of firms; it particularly identifies the inherent conflict of interests of Chinese

[33] See Jane Webster and Richard T. Watson, 'Analyzing the Past to Prepare for the Future: Writing a Literature Review', (2002) 26 *MIS Quarterly*, pp. xiii-xxiii.
[34] The CNKI (China National Knowledge Infrastructure) database is available at http://www.cnki.net/ (accessed 19/10/2019).
[35] Claire A. Hill and Brett H. McDonnell (eds.), *Research Handbook on the Economics of Corporate Law* (Cheltenham: Edward Elgar, 2012), p. 1.
[36] For UK's interdisciplinary experience in the company law area, see Brian R. Cheffins, 'Using Theory to Study Law: A Company Law Perspective', (1999) 58 *The Cambridge Law Journal*, pp. 197-221.
For acceptance of economic analysis of law in civil law countries, see Robert D. Cooter and James R. Gordley, 'Economic Analysis in Civil Law Countries: Past, Present, Future', (1991) 11 *International Review of Law and Economics*, pp. 261-263.

companies. Meanwhile, this thesis especially mentions the transitional characteristics of Chinese companies and management practices, since the agency theory, based on the US experience, may not fully capture or explain them.

Moreover, it uses the rational choice theory and the concept of incentives in micro-economic discipline to analyse the impact of legal rules on management conduct. The thesis raises a series of relevant issues: the consequences of breach of legal duties for directors; whether liability rules generate substantial deterrence to wrong-doing; and whether prospective plaintiffs decide on filing lawsuits to enforce directors' liabilities in the current circumstances. It adopts a cost-benefit analysis to assess the necessity and efficiency of the duty and liability strategy, especially the liabilities for breach of the duty of care.

Legal doctrinal analysis

This thesis employs doctrinal analysis—the traditional method in legal research—to address the sub-question of how directors' duties and liabilities are specified in the legal norms. China's legal system resembles civil law tradition with legal principles and norms codified in statutes. Therefore, the first step is to determine the statutes relevant to the research subject. The subsequent steps involve the review and discussion of the literal meaning, legislative design, and interpretation of pertinent provisions. Besides, it also investigates the relationship of those provisions and the circumstances of their application. The thesis also reviews legislative drafts, guidelines, policy document, and mainstream opinions in the academic community, to offer interpretative arguments.

Analysis of judicial decisions and administrative penalty decisions

This thesis analyses judicial decisions and administrative penalty decisions to reveal the enforcement pattern of directors' liabilities. In other words, which type of management wrong-doing is likely to invoke formal enforcement in practice? How are the monetary liabilities determined? Moreover, the judicial decisions and administrative penalty decisions reflect the interpretation and practice of laws, even though the primary sources of Chinese law are the statutes, and judicial decisions do not have precedential effect.

The cases are collected from Wolters Kluwer China Law Database and the official website of China's securities authority. Detailed explanations for case collection and more information about the databases are provided in Chapter 5. An all-round analysis of plaintiffs, defendants, claimed damages, disputed issues, and other aspects are made, both qualitatively and quantitatively. Equally important, such analysis exemplifies how adjudicators interpret and apply the legal rules.

It should be noted that the selected cases greatly approximate to, but cannot precisely depict, real enforcement practices, because public access to judicial decisions is not fully granted in China.

Comparative analysis

Mathias Siems describes general comparative methods specifically applicable to the area of corporate law, which include (1) rule-based comparison; (2) functional comparison; (3) classifications of legal systems; (4) comparative law in context; (5) historical comparative perspective; (6) transnational and comparative law; and (7) applied comparative law.[37] Because China's legal system for corporate entities, securities trading, and other related areas replicates the experiences and models of western countries, it is inevitable to make implicit comparisons even for the sole purpose of this country study.

As a starting point, this thesis introduces the original model of the fiduciary duty in the US case laws to illustrate how this legal strategy is imported but formulated differently in China. In addition, this thesis refers to the German model of the two-tier board because of its influence on China's corporate structure. Therefore, there is an implicit rule-based comparison[38] for illustrative purposes.

In addition, previous literature on the economic analysis of directors' duties and liabilities mostly targeted US state laws, and such economic analysis considers the local market institutions and judicial system to evaluate the reasonableness of the current practice of directors' liabilities in the US. As stated, such theoretical analysis is used as a roadmap for the country study of China. Thus, much work in this thesis takes the perspective of a 'historical and functional comparison' and 'comparison in context'.

1.5 Structure

After the introductory chapter, the structure of this thesis is designed as follows. Chapter 2 presents a theoretical view of directors' fiduciary duties and liabilities by following the line

[37] See Mathias M. Siems, 'The Methods of Comparative Corporate Law', in Roman Tomasic (ed.), *Routledge Handbook of Corporate Law* (London: Routledge, 2017), pp. 11-31.
[38] For more explanation of rule-based comparison, see Mathias M. Siems, *Comparative Law* (Cambridge: Cambridge University Press, 2014), p. 95.

of economic thinking. First, it reviews the nature of the firms from a theoretical perspective and the reason for exercise of decision-making power by directors and officers becoming a practical concern. Second, it discusses the justification for legal intervention in management conduct. This issue is often taken for granted by legal scholars. Yet, the economists generally hold that legal intervention comes into play only in the event of contractual failure and market failure, and when the benefit of legal intervention outweighs its cost.[39] Thus, a thorough examination of market disciplining mechanisms and concomitant incentive schemes is conducted to explain ‘why law matters’. Third, this thesis reviews and summarises an analysis of the behavioural impact of duty and liability rules. For this part, the focus is on the monetary liabilities for breach of duty of care. The cost-benefit analysis of the liability regime is examined as well.

Chapter 3 looks into the market and corporate context where directors’ duties and liabilities are implemented, with a focus on the landscape of China’s corporate governance. It first presents a brief overview of enterprise development to help understand the present status of China’s companies. Second, it examines the structural characteristics, including ownership structure, control pattern, and the role of the board. Associated with these structural characteristics, it then identifies the generic management problems. Third, it undertakes a general evaluation of the development and function of China’s stock market to reveal the market pressure for directors. This chapter also discusses the working of typical incentive schemes in China, enumerated in Chapter 2.

Chapter 4 examines the ‘law in book’ specific to directors’ duties and liabilities in China through the following steps: (1) identify the source of law; (2) review the development trajectory of company, bankruptcy, and securities legislation; (3) identify the regulatory approach and general structure of directors’ duties; (4) explain the meaning and implication for each prong of directors’ duties; (5) reveal the legal nature of liability; (6) clarify the elements that establish the liabilities; (7) introduce the cause of actions, typically that of a derivative action; (8) delineate the duty of directors in listed companies to disclose information; (9) and investigate directors’ duties to the creditors in case of insolvency.

Chapter 5 mainly analyses the judicial decisions and administrative sanctions to capture how directors’ duties and liabilities are enforced and administered. First, it illustrates the

[39] N. Gregory Mankiw, *Principle of Microeconomics* fourth edition (Mason: Thomson South-Western, 2007), p. 9.

interpretation and application of legal text with reference to the judicial opinions and administrative penalty decisions. Second, it collects and analyses data to demonstrate the utility of private litigation and administrative investigation. Third, it identifies and examines the reasons for the current enforcement practices, such as the procedural hurdles and judicial incompetence. The ultimate goal of this chapter is to uncover the degree of liability risk that directors in China face today.

Chapter 6 brings together the findings drawn from the previous chapters, applies the agency theory, and makes functional observations on whether the degree of deterrence arising from legal liabilities to directors is sufficient and appropriate in that context. Moreover, this chapter draws conclusions and makes recommendations for necessary and feasible improvements and adjustments to enhance the function of directors' duties and liabilities in China.

1.6 Scope of Study and Limitations

This thesis is generally concerned with the issue of incentivising directors and officers to pursue the best interests of the company and the shareholders. Its primary focus is on how legal duties and liabilities address this issue. Indeed, a myriad of duties and liabilities are imposed on directors and officers to strengthen the regulations pertaining to the external impact of corporate activities such as environmental protection, production safety, and market order and competitiveness. However, this thesis primarily examines the internal relationship between directors and shareholders. Hence, it will not include the designing and enforcement of those duties and liabilities for the ultimate goal of controlling corporate activities from a public welfare perspective.

With regard to fraud, theft, corruption, and other egregious acts, which directly damage the interests of companies and shareholders, criminal law is one important type of legal control. However, this thesis does not touch upon criminal offences committed by directors, since criminal punishment is peripheral to corporate governance and involves multiple policy goals, such as market order and economic safety, rather than efficient management. Note that the intentional omission of criminal liabilities of directors does not negate the utility of deterring undesirable management behaviour.

This research examines the operation of a newly imported legal strategy and its role in China. Although the theoretical framework and the model of the legal strategy are primarily based on US case law, this thesis does not employ separate chapters to make equally specific analysis of the US model. Even the implicit comparison only intends to shed light on China's practices rather than assess the efficiency of the original model in the US. Moreover, this thesis does not address the justification for transplanting the US model into China, but only examines the function and impact of such transplantation in China.

Another gap in this thesis is examining the influence of the legal provisions of directors' duties and liabilities on management behaviour through informal or extra-legal channels. This research only identifies how the violation of legal provisions triggers private litigation or administrative investigation through case studies. However, it does not explore the factors conducive to voluntary compliance. Besides, it is well worth studying the extent of the reputational concern for directors and companies. For prominent companies and professional managers, economic losses arising from a damaged reputation might be far more than the cost of monetary penalties. Future studies can employ questionnaires and interviews to obtain first-hand information from practitioners, which may result in some new issues and lead to an innovative contribution.

Chapter 2 Law and Economics of Directors' Duties and Liabilities

2.1 Introduction

It is a common practice to prescribe how directors and officers perform their functions in firms as legal duties, and hold them liable for any breaches of such legal duties. Despite subtle differences among various jurisdictions, this chapter aims to present a theoretical view of this legal strategy, namely, to understand the functional rationale, analyse the working mechanisms, and assess the efficacy of this legal strategy.

This chapter fulfils these tasks by following the scholarship of law and economics, which arguably occupies a dominant position in the realm of company law.[1] Economic theories vitalize the studies of company law in two inter-related ways. First, economic theories provide significant insights into corporate activities and lay down the fundamental framework for such studies as the regulation of corporate activities. Second, economic analysis is a useful tool to discern the impact of legal rules on individual behaviour. Such potential impact is often considered in the formulation and implementation of legal rules.

The remainder of this chapter is structured as follows. Section 2.2 examines corporate entities to explain why they are most frequently used and identifies the role of a board of directors in corporate activities. This section has two sub-sections: the first revisits the economic theories about the nature of the firm; the second portrays the legal characteristics of the companies and of their major constituent parties. Section 2.3 reviews the agency theory, which identifies and addresses the problems associated with managerial behaviour. Section 2.4 deals with why law matters to managerial behaviour and recognizes substantial room left by contract failure and market failure in addressing the agency problems. Section 2.5 analyses how legal duties and liabilities play a role in promoting the desirable performance of directors, factors that contribute to the usefulness of legal duties and liabilities, and the functional boundary of legal liabilities. Section 2.6 presents the concluding remarks.

2.2. Law and Economics of Corporate Entities

[1] See *supra* note 35 in Chapter 1.

Companies, or corporations, are the most common vehicles for business around the world.[2] People are accustomed to their lives filled with the supplies of products and services by numerous companies. Giant global companies have built empires of wealth even mightier than some states. The complex and dynamic phenomena specific to companies have aroused extensive research interests. This section first reviews the economists' exploration into why firms exist and then presents a functional rationale for the structural characteristics of companies.

2.2.1 The Nature of the Firm

For generations, economists have discussed the nature of the firm and developed competing theories, which shed light on the understanding of corporate activities.[3] Each strand of theory contains voluminous literature. This sub-section focuses on the milestone works to sketch the line of theories that subsequent scholars commonly follow. The core ideas and concepts of the following economic theories are frequently used to analyse the activities of companies and constituent parties.

Neo-classic economic theory of the firm

Neo-classic economics viewed firms as market players and assumed that firms are managed to maximize profits.[4] How production is organized within a firm was not investigated. According to neo-classic economics, the supply and demand of a product in the market would reach an equilibrium status, trading at a certain price with a certain amount. Via countless transactions in the market, production is efficiently co-ordinated and resources allocated to the best use. Firms are merely 'black boxes' with input of resources and output of products.

Early works on the nature of the firm

Why do firms exist at all? Coase first asked this question in his seminal work, *Nature of the Firm,* in 1937.[5] This question and related inquiries—the choice of market or firm and the boundary between the market and firm are common threads through ensuing discussions. In other words, economists have continued asking why some transactions are

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[2] See *supra* note 2 in Chapter 1 for the clarification about the use of term 'company' and term 'corporation'.
[3] See Oliver Hart, 'An Economist's Perspective on the Theory of the Firm', (1989) 89 *Columbia Law Review*, p. 1757.
[4] See Jean Tirole, *The Theory of Industrial Organization* (Massachusetts: The MIT Press, 1998), p. 15. The author reviewed the neo-classical economic theory of the firm and approved of its usefulness in explaining strategic interactive activities between firms in an imperfectly competitive market.
[5] Ronald H. Coase, 'The Nature of the Firm', (1937) 4 *Economica*, pp. 386-405.

taking place in a firm while other transactions happen in the marketplace. Coase inventively identified that the use of the price system incurs the costs of information discovery in the marketplace. Negotiation and conclusion of transactions and policing and enforcing the contractual obligation all give rise to substantial costs. This is the conceptual origin of transaction cost. A firm has the authority to direct and co-ordinate production in place of market price mechanisms, and thus, saves transaction costs. Yet, the firm confronts internal management costs. When the market transaction cost outweighs the internal management cost, it is more efficient to organize production within a firm. Thus, comparative cost[6] determines where the boundary between market and the firm is delineated.[7]

Coase's work did not receive follow-up discussions until the 1970s. Alchian and Demsetz held an opinion about firms that is not entirely consistent with Coase.[8] They saw no difference between a firm's 'power of fiat, authority, disciplining action' and the counterparts of any contracting parties in the market. In their opinion, a firm is a contractual structure with a central party, which enters separable contracts with input owners, and these contracts are subject to continuous renegotiation.[9] Such a structure enables the shared use of inputs and team production, generating higher productivity than the sum of the parts.[10] Meanwhile, team production gives rise to the 'metering problem' and 'incentive problem'.[11] To be specific, it is very difficult or even impossible to measure individual contributions and their output, and to determine the corresponding rewards in the scenario of team production. Accordingly, input owners are likely to shirk their duties due to insufficient incentives. They pointed out two possible solutions for the incentive problems: external competition may deter shirking; one specialist monitors individual productivity and holds the position of the residual claimant.[12]

[6] See *infra* note 16 in this chapter. In this argument, Oliver E. Williamson used, 'comparative costs of planning, adapting, and monitoring task completion under alternative governance structure'.
[7] See also Oliver E. Williamson and Sidney G. Winter (eds.), *The Nature of the Firm: Origins, Evolution, and Development* (New York: Oxford University Press, 1991), p. 4.
[8] Armen Alchian and Harold Demsetz, 'Production, Information Costs, and Economic Organization', (1972) 66 *American Economic Review*, pp. 777-795.
[9] *Ibid.*, p. 794.
[10] *Ibid.*, p. 780.
[11] *Ibid.*, p. 778.
[12] *Ibid.*, pp. 781-783.

These pioneering works[13] conveyed the dissatisfaction with the neo-classic economic view of the firm. They perceived the firm as a 'nexus of contracts' and an alternative to the market to organize production. They provided explanations for the existence of the firm by expounding on why firms are more efficient, or in other words, more productive than market institutions, from different perspectives. This line of propositions paved the way for further investigation. Amongst others, three major branches of theories, complementary to each other, emerged, as follows.[14]

Transaction cost approach

Oliver Williamson espoused Coase's idea and carved out the transaction cost theory to the study of business organizations.[15] This approach takes transactions as the analytical units and compares different governance structures, especially the market versus the firms in terms of the capacity to economize on transaction cost.[16] Before comparison, Williamson looked into the transactions and elicited three critical dimensions: '(1) uncertainty; (2) frequency with which transactions recur; and (3) degree to which durable, transaction specific investments are required to realize least cost supply'.[17]

The third dimension—transaction-specific investment, or termed as asset specificity, is the core conception in Williamson's work, which had never been formulated before. Asset

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[13] See also the controversial work by Frank H. Knight, *Risk, Uncertainty, and Profit* (Boston: Hart, Schaffner & Marx; Houghton Mifflin Co, 1921). Knight identified the differences between risk and uncertainty, stressed the judgment in addressing uncertainty, and finally explained the existence of organization by the judgment of entrepreneurship. Regardless of the controversy, Knight started a strand of theory in parallel to Coase—the theories of entrepreneurship.

[14] Other branches include: (1) implicit contract theory of the firm, see George Baker, Robert Gibbons, and Kevin J. Murphy, 'Relational Contracts and the Theory of the Firm', (2002) 117 *Quarterly Journal of Economics*, pp. 39-84. They demonstrate that the firm sustains relational contract in a different way from the market does and the parties to a firm are more inclined to perform implicit terms because of the concerns of relationship maintenance.

(2) the firm viewed as a communication network, see Jacob Marschak and Roy Radner, *Economic Theory of Teams* (New Haven: Yale University Press, 1972). The firm enjoys the benefits of specialized information processing and the aggregate communication network. The firm emerges when such benefit outweighs the cost of communication.

[15] A series of works by Williamson advance the main body of the transaction cost theory: Oliver E. Williamson, 'Transaction-cost Economics: The Governance of Contractual Relationship', (1979) 22 *Journal of Law and Economics*, pp. 233-261; Williamson, 'The Economic of Organization: The Transaction Cost Approach', (1981) 87 *American Journal of Sociology*, pp. 548-577; Williamson, *Economic Institutions of Capitalism* (New York: Free Press, 1985).

For noteworthy contributions by other scholars to the transaction cost theory, see Douglas C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990) and Ronald H. Coase, 'The Nature of the Firm: Influence', (1998) 4 *Journal of Law, Economics, and Organizations*, pp. 33-47.

[16] Williamson (1981), *ibid.*, p. 574. 'Governance structures that have better transaction cost economizing properties will eventually displace those that have worse, *ceteris paribus*'.

[17] *Ibid.*, p. 555.

specificity refers to a situation in which one party has made investments to facilitate long-term or recurring transactions; yet, such investment is neither transferrable in the market nor valuable in other transactions.[18] Quite often, human assets, physical assets, and site-specific assets can be specifically related to recurring transactions, which reduce the cost of input into production.[19]

One may reasonably assume that 'human agents are subject to bounded rationality'[20] and 'some agents are given to opportunism'.[21] The corollary is that the opportunistic party may appropriate part of the transaction-specific asset which was invested in by the other party due to an incomplete contract.[22] In comparison with the market, the firm has the advantages in reducing opportunism due to common ownership, access to the information, and relative ease of resolving disputes among different input suppliers.[23] The transaction cost theory is widely used to explain organizational phenomena and becomes the cornerstone of management discipline, notwithstanding a barrage of criticism.[24]

Property right approach

Grossman and Hart (1986) and Hart and Moore (1990) formulated the property right approach to the nature of the firm using economic models.[25] The main idea of this approach is viewing the firm as a collection of the assets it owns and controls. Grossman and Hart argued that ownership conferred residual rights of control over the asset. To be specific, the residual right of control implies the power to decide the utilization of assets for contingences, which the contract cannot spell out, and comes with bargaining power over the allocation of the surplus and quasi rent within the transactions. Then the party without ownership over the asset may not obtain the *ex post* return proportionate to the *ex*

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[18] *Ibid.*
[19] *Ibid.*
[20] *Ibid.*, p. 553. Williamson referred to Herbert Simon, whose works had developed the idea of bounded rationality. See Herbert Simon, *Models of Man* (New York: Wiley, 1957), *Administrative Behaviour* (New York, Macmillan, 1961), and 'Rationality as Process and as Product of Thought', (1978) 68 *American Economic Review*, pp.1-16.
[21] *Ibid.*
[22] *Ibid.*
[23] *Ibid.*, p. 559.
[24] See, e.g., Sumantra Ghoshal and Peter Moran, 'Bad for Practice: A Critique of the Transaction Cost Theory', (1996) 21 *The Academy of Management Review*, pp. 13-47. This paper warns of dangerous prescriptions drawn from the transaction cost theory for management practice, but also presents the surveys of extant applications and criticism of this theory.
[25] Sanford Grossman and Oliver Hart, 'The Cost and Benefits of Ownership: A Theory of Vertical and Lateral Integration', (1986) 94-4 *Journal of Political Economy*, pp. 691-719; and Oliver Hart and John Moore, 'Property Rights and the Nature of the Firm', (1990) 98-6 *Journal of Political Economy*, pp. 1119-1158.

ante investment and even have to face the holdout problem with the ownership party.[26] Eventually, the lack of sufficient incentives would lower the investment of the non-ownership party in the transactions. The transfer of ownership from one party to another accordingly encourages an acquirer's investment but discourages investment by the party acquired. This argument elucidates the cost and benefit of ownership and explains the economic reason for the vertical integration of firms.

Hart and Moore further developed this theory and considered the effects of incentives on employees. When one firm acquires another, the former may only selectively fire the latter firm's employees or 'fire' a combination of the assets and employees within the latter firm. They emphasize that ownership of assets should be assigned to the party that is indispensable to the transaction and who in turn encourages the investment of the indispensable party.[27] In sum, the property right approach not only reveals efficient asset assignment but also helps predict the optimal size of the firm.

Agency theory

As stated in the previous chapter, Adam Smith was the first one who suspected that directors may not exercise the same vigilance as the partners in a 'copartnery' do.[28] Until the US depression in the 1930s, Berle and Means investigated 200 of the largest non-banking corporations and observed that, 'the property owner who invests in a modern corporation so far surrenders his wealth to those in control of the corporation'. They alleged that the separation of ownership and control 'destroys the very foundation on which the economic order of the past three centuries has rested'.[29] In 1965, Manne innovatively argued that the threat of a takeover scheme could assure efficient management, and thereby, provide protection to small, non-controlling shareholders,[30] when the agency theory did not take shape.

[26] *Ibid.* (Grossman and Hart 1986)
[27] See *supra* note 25 in this chapter for Hart and Moore.
[28] See Adam Smith, *supra* note 5 in Chapter 1, p. 700.
'The directors of such [joint-stock] companies, however, being the manager rather of other people's money of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own…Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.'
[29] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932), p. 8.
[30] Henry G. Manne, 'Merger and the Market for Corporate Control', (1965) 73 *The Journal of Political Economy*, pp. 110-120.

Inspired by the contractual perspective and transaction cost concept, Jensen and Meckling formalized the agency theory of the firm in 1976.[31] This theory generally concerns any co-operation between two or more people, not only the narrowly defined principal-agent relationship, since the risk preference and interest of different parties often diverge.[32] The idea of monitoring and verifying individual performances is largely consistent with the observations on team production by Alchian and Demsetz.[33]

Meanwhile, Fama explained why the separation of security ownership and control, although with agency problems, could still be an efficient form of organization.[34] He considered risk bearing and management as separate factors for production and noted that the separation of security ownership and control would facilitate the specialization of risk bearing and management. By diversifying their investment portfolio, diffused shareholders in large companies become efficient risk-bearers.[35] Managers are disciplined and incentivized by a range of sources inside and outside their firms. Because the central topic of this thesis is related to management performance, a subsection is devoted to the elaboration of the agency theory.

The agency theory has developed into the prevailing theory framework for corporate law and corporate governance. As aptly summarized, the major goal of company law is to improve organizational efficiency, *i.e.*, ameliorate agency problems.[36] Besides, the agency theory has provided insights into information and risk, and it has been broadly applied in other disciplines such as management, finance, and even political science.[37]

2.2.2 Structural Characteristics and Constituent Parties

As commonly recognized, companies around the world have five universal structural characteristics: separate legal personality, limited liability, transferable shares, centralized

[31] Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', (1976) 3 *Journal of Financial Economics*, pp. 305-360.
For more general model of economic agency theory, see Stephen A. Ross, 'The Economic Theory of Agency: The Principal's Problem', (1973) 63 *American Economic Review*, pp. 134-139. For institutional agency theory, see Barry M. Mitnick, 'The Theory of Agency: The Policing Paradox and Regulatory Behavior', (1975) 24 *Public Choice*, pp. 27-42.
[32] *Ibid.*, Jensen and Meckling, p. 311.
[33] *Ibid.*
[34] Eugene F. Fama, 'Agency Problems and the Theory of the Firm', (1980) 88 *Journal of Political Economy*, pp. 288-307
[35] *Ibid.*
[36] Kraakman *et al.*, *The Anatomy*, p. 28.
[37] Susan P. Shapiro, 'Agency Theory', (2005) 31 *Annual Review of Sociology*, pp. 263-284.

management under a board structure, and equity ownership.[38] These inter-related characteristics are often provided in the corporate statutes, intended to facilitate the co-operation of management and finance. Meanwhile these legal characteristics reflect a balanced scheme of risk allocation between major players in a company.

Separate legal personality

A company has its separate legal personality, although many parties are working or making investments therein. This separate personality is legally artificial but similar to the status of an individual human being in law. A company owns its property, enters into contracts, and files a lawsuit or is sued in its own name. As such, individuals join the undertakings by entering into contracts with the firm.

This legal personality also implies the demarcation of the assets of the company and that of constituent parties. For one thing, a company's creditors have no right to a claim over the personal assets of constituent parties, nor do the creditors of shareholders or managers have a claim over the company's assets. Combined with the feature of limited liability, the equity investors would not be personally liable for the debt of their company. The investment risk for shareholders is no more than their actual amount of capital contribution.

For another, asset separation encourages creditors' investment. The size of the company's assets indicates the company's credit. Creditors enforce their claims of debts based on the company's assets. Without the shield of separate personality, shareholders could randomly siphon the company's assets, which would probably impair the interests of the company's creditors and increase the cost of raising debt.[39]

Limited liability

Limited liability means that shareholders are liable for the company's debt to the amount of their capital contribution. The limited liability of shareholders is a device to avoid high risk. One company may divide the lines of production and set up several subsidiaries to engage in divided parts of production. The parent company is liable for the subsidiaries only to the amount of the divided investment.[40]

Shareholders contribute funds into the company with nothing but a promise of a share of future profit over the lifespan of the company. If the company makes no profit,

[38] Kraakman *et al.*, *The Anatomy*, p. 5.
[39] *Ibid.*, pp. 5-9.
[40] *Ibid.*, pp. 9-11.

shareholders gain nothing, merely being able to cash in their shares. Yet it is not certain that the value of their shares is lower or higher than that of their investments at the outset. If the company goes bankrupt, creditors have priority to claim a fraction of the extant assets, whereas none is left for shareholders.[41] Any extra liability risk may greatly frustrate investment willingness, and in turn, increases the difficulty and cost of obtaining equity finance. Moreover, the company's creditors are also less interested in the security pledged by the shareholders' personal assets because it is rather costly and difficult to monitor the value of such an asset.

Transferable shares

Shareholders can neither withdraw their investment at will nor claim their investment with a stipulated return following a scheduled agenda, as creditors do.[42] However, they may transfer their shares to a third party with or without restrictions. In so doing, they are entitled to cash in their investment plus the corresponding returns or losses. The liquidity of shares increases the interest of shareholders and reduces investment risk. Thus, shareholders are able to diversify their investment portfolio to spread investment risk.[43] Meanwhile, companies continue with their undertakings regardless of the change in shareholders.[44]

Equity ownership

As mentioned above, shareholders are the residual claimants of the company's earnings. Consumers, employees, suppliers, and other creditors may claim the fixed payment of debt prior to shareholders. This means that shareholders lose nothing more than the amount of their investment but enjoy the net profit of the firm without upper limit. Shareholders expect most of the net profit of the firm, whereas creditors merely care about the firm's solvency. As such, shareholders' interests are mostly aligned with the company's interests, and hence, they have the strongest incentive to monitor business operations, and

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[41] For comparison between debt and equity and optimal finance structure, see Mathias Dewatripont and Jean Tirole, 'A Theory of Debt and Equity: Diversity of Securities and Manager-shareholder Congruence', (1994) 109 *The Quarterly Journal of Economics*, pp. 1027-1054.
[42] *Ibid.*
[43] The basic assumption of individual investors, especially consumer-investors in the securities market, is being risk averse. See D. Cass and J. E. Stiglitz, 'Risk Aversion and Wealth Effects on Portfolios with Many Assets', (1972) 39 *The Review of Economic Studies*, pp. 331-354.
[44] Margaret M. Blair and Lynn A. Stout, 'Specific Investment: Explaining Anomalies in Corporate Law', (2006) 31 *Journal of Corporation Law*, pp. 729-730.

accordingly, retain the residual right of control.[45] In particular, shareholders vote to elect board members and to approve transactions of crucial importance. They obtain dividends proportionate to their respective contributions, unless otherwise stipulated.

Centralized management under a board structure

Centralized management is a necessary solution to the lack of expertise, rational apathy, and collective action problems associated with dispersed shareholders in large or publicly listed companies.[46] Quite often, shareholders do not have the specialized knowledge, skills, and experience for running a business. They are merely providers of equity finance. Shareholders collectively make decisions by following the one-share one-vote principle. They become indifferent to the voting results when they only hold small stakes in a large company and their preference is barely decisive. In addition, an intelligent decision incurs considerable costs of investigation, information processing, and consultancy. It is more sensible for shareholders to be free riders rather than to bear costs disproportionate to the outcome of a decision, which affects their share of wealth. Consequently, a board of directors, or a similar body, is instituted to exercise delegated power and to monitor subordinate managers.

Closely held companies, with only a few shareholders, may have a board of directors that is loose and less independent, because each shareholder holds a larger fraction of the company's shares, and accordingly, has a stronger incentive to control. Controlling shareholders are prone to pulling the strings; the board of directors, in turn may make decisions more favourable to controlling shareholders.

2.3 Agency Theory

The agency relationship is between one party and the other party who acts on behalf of the former one. The former party is the principal and the latter party is the agent. Such an arrangement is universal, since anyone can be subject to the constraints of time, energy, or expertise, for certain tasks and matters, whilst others may have comparative advantages. In corporate scenarios, professional managers are charged with business operations; employees are assigned to front-line jobs.

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[45] Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991), p. 7. For further argument about the features of residual claims, see Eugene F. Fama and Michael C. Jensen, 'Agency Problems and Residual Claims', (1983) 26 *Journal of Law and Economics*, pp. 327-349.

[46] Bernard S. Black, 'Shareholder Passivity Re-examined', (1990) 89 *Michigan Law Review*, pp. 520-608.

The agency theory rests upon three reasonable assumptions. First, the principal and the agent are both economic rational persons. Namely, they are making choices to maximize their own utilities.[47] Consequently, their interests and objectives are likely to diverge. Even a sharp conflict of interests may occasionally occur. Second, the agent is more risk averse than the principal, because the managerial agent cannot freely diversify his or her human capital to different undertakings, as the principal does with his or her equity investment. Third, it is difficult and costly to assess the agent's performance.[48]

2.3.1 Agency Problems

Accompanying this relationship is a series of agency problems. On the one hand, because of information asymmetry, one party has difficulty in identifying the genuine skills, experience, and capacity of the agent candidates, choosing the most qualified candidate, and in negotiating and writing appropriate terms and conditions.[49] Even in the course of service, the principal cannot fully observe the actual efforts and actions of the agent. Worse still, merely from the outcome of the service, the principal finds it not easy to verify and evaluate the agent's behaviour, since external factors, some beyond the agent's control, may also affect, or even decide, the outcomes.

On the other hand, assuming that both the principal and agent are rational, their goals and interests frequently diverge. Quite often, the agent only shares a small fraction of the wealth outcome of his or her decisions and efforts. Accordingly, they lack the incentive to devote more effort than their share of the outcome. The less the agent shares in the wealth outcome, the more the interests of the agent and principal diverge.[50] Hence, the agent is prone to engaging in self-regarding activities rather than fully maximizing the principal's interest, since the principal may have no idea if the agent is actually performing the service and to what extent the agent's efforts and capacities are relevant to the outcome.[51]

To resolve the agency problems, the principal may take measures to monitor the agent's performance and align the agent's interest with his or her own. It is commonly recognized

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[47] For the literature on the rational choice theory, see, e.g., Kenneth J. Arrow, 'Economic Theory and the Hypothesis of Rationality', in John Eatwell, Murray Milgate and Peter Newman (eds.), *The New Palgrave: A Dictionary of Economics* (1987), pp. 25-39.
[48] Kathleen M. Eisenhardt, 'Agency theory: An Assessment and Review', (1989) 14 *Academy of Management Review*, p. 57.
[49] For the literature on adverse selection in the market, see George A. Akerlof, 'The Market for Lemons: Quality Uncertainty and the Market Mechanism', (1970) 84 *The Quarterly Journal of Economics*, pp. 488-500.
[50] Easterbrook and Fischel, see *supra* note 45 in this chapter, p. 91.
[51] Bengt Holmström, 'Moral Hazard and Observability', (1979) 10 *The Bell Journal of Economics*, pp. 74-91.

that the more information the principal has to assess the agent's performance, the more likely the agent is to serve the principal's interest.[52] The internal governance, such as board of directors, reporting system, and independent directors are instituted to play a scrutinizing role.[53] Yet, the question 'who monitors the monitor',[54] and an insufficient flow of information, call for alternative solutions.

Besides these monitoring mechanisms, incentive schemes are devised to align the success of the firm with the agent's personal remuneration. The agent is incentivised via a payment linked to the signal of the firm's performance, including cash compensation, bonuses, stock option, and equity ownership.[55] In particular, stock options and equity ownership mean that directors and officers have an ownership stake in the companies they manage, which encourages managerial performance.[56] According to some empirical studies, incentives generated by equity ownership are larger than other types of performance-based payment.[57] However, the equity schemes may also encourage undesirable behaviour, such as the manipulation of information disclosure and accounting records. Besides, managers are discouraged from taking risks.[58]

Jensen and Meckling defined agency cost as the sum of monitoring expenditure by the principal, the bonding expenditure by the agent, and residual losses.[59] The agent undertakes bonding expenditure to guarantee that the agent's conduct will not harm the principal's interest and compensate harm, if any.[60] The residual loss is defined as the reduction in the principal's welfare after all, due to the divergence of interests between the principal and the agent.[61]

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[52] Eugene F. Fama and Michael C. Jensen, 'Agency Problems and Residual Claims', (1983) 26 *The Journal of Law and Economics*, pp. 327-349.
[53] See *supra* note 37 in this chapter.
[54] Easterbrook and Fischel, see *supra* note 45 in this chapter, p. 9.
[55] For empirical studies on incentive schemes, see Michael C. Jensen and Kevin J. Murphy, 'Performance Pay and Top-management Incentives', (1990) 98 *The Journal of Political Economy*, pp. 225-264; Michael C. Jensen and Jerold L. Zimmerman, 'Management Compensation and the Managerial Labor Market', (1985) 7 *Journal of Accounting and Economics*, pp. 3-9.
[56] David J. Denis, Diane K. Denis, Atulya Sarin, 'Agency Problems, Equity Ownership, and Corporate Diversification', (1997) 52 *The Journal of Finance*, pp. 135-160.
[57] Jensen and Murphy, see *supra* note 55 in this chapter.
[58] See, e.g., WM. Gerard. Sanders and Donald C. Hambrick, 'Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance', (2007) 50 *Academy of Management Journal*, pp.1055-1078; and Christopher S. Armstrong, David F. Larcker, Gaizka Ormazabal, and Daniel J. Taylor, 'The Relationship between Equity Incentives and Misreporting: The Role of Risk-Taking Incentives', (2013) 109 *Journal of Financial Economics*, pp. 327-350.
[59] Jensen and Meckling, see *supra* note 31 in this chapter.
[60] *Ibid.*
[61] *Ibid.*

2.3.2 Contractual Incompleteness

The principal-agent relationship is of a contractual nature. Yet, bounded rationality,[62] transaction cost, and information asymmetry all combine to make a perfectly specified contract almost impossible.[63] Bounded rationality derives from an intuitive doubt about the classic rational choice theory. People do not always make rational choices to maximize their own utility. One obvious reason is that people only have limited cognitive capabilities. In the contractual area, people are not able to foresee all possible future contingencies and calculate every corresponding reaction in advance.[64] For the very unlikely contingency, it is also too costly to bargain and write down detailed instructions from the perspective of the transaction cost theory. As mentioned, information asymmetry is a major factor that creates adverse selection in bargaining and a moral hazard problem in the performance of principal-agent contracts.[65]

In the corporate scenario, specified instructions are often not desirable. It's professional analysis, calculation, and judgement that create profit and win business advantage. In this sense, managers need discretion to employ their skills, experience, and business acumen to determine what is best to their firms in certain circumstances, rather than following some *ex ante* clauses, especially instructed by less skilful parties.

According to the property right theory of the firm, incomplete contracts leave the asset-specific investment unresolved, and hence, managers may face the hold-up problem from shareholders.[66] Sometimes, to incentivize entrepreneurship, shareholders need to give up detailed provisions and to delegate part of the residual right of control to managers. The theory of capital structure is also based on how control right should be allocated if the contract is incomplete.[67]

2.3.3 Imperfect Market Disciplining Mechanisms

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[62] Herbert A. Simon, 'Rationality in Psychology and Economics', (1986) 59 *The Journal of Business*, Part 2: The Behavioural Foundations of Economic Theory, pp. S209-S224.
[63] Kathryn E. Spier, 'Incomplete Contracts and Signalling', (1992) 23 *RAND Journal of Economics*, p. 432.
[64] See Eric Maskin and Jean Tirole, 'Unforeseen Contingencies and Incomplete Contracts', (1999) 66 *Review of Economic Studies*, pp. 83-114; and Jean Tirole, 'Incomplete Contracts: Where Do We Stand?', (1999) 67-4 *Econometrica*, pp. 741-781.
[65] See *supra* note 51 in this chapter.
[66] Patrick W. Schmitz, 'The Hold-up Problem and Incomplete Contracts: A Survey of Recent Topics in Contract Theory', (2001) 53-1 *Bulletin of Economic Research*, pp. 1-17.
[67] Philippe Aghion and Patrick Bolton, 'An Incomplete Contracts Approach to Financial Contracting', (1992) 59 *The Review of Economic Studies*, pp. 473-494.

In general, the external market continuously generates informative signals of the firms' performance at relatively low cost, which in turn, disciplines the actions of directors and senior managers. Scholars argue that the disciplining mechanisms can efficiently reduce agency cost, and hence, the separation of ownership and control is characteristic of the corporate entity.[68] Moreover, incentive schemes use market signals to set the remuneration package and obtain maximal managerial efforts. However, external market disciplining mechanisms have their respective limitations and pre-conditions, not to say the problems arising from market failures and inconsistent behavioural influence by related incentive schemes.

Product market

The general argument about the impact of the product market is that market competition forces managers to reduce inefficiency and increase productivity to survive.[69] Increasing competition can mitigate agency problems by making more information accessible to the principals, and the principals are enabled to more accurately monitor and evaluate management conduct.[70] Unlike the above general argument, Schmidt's U-shape model demonstrates that increasing competition causes a reduction in profit, which lowers the value of managerial efforts, and managers require more monetary incentives to work hard. When increasing competition amounts to a threat of liquidation, managers will reduce costs to help the firm survive and keep their own jobs and remuneration.[71]

For directors and managers in the firms who sustain the monopoly status, the pressure from the product market is less intense. Monopolies usually do not have competent substitutes, or competitors. Quite often the market barriers keep away potential competitors, and the monopolies can maintain a high level of profit in the long term.[72] Sloppy management may not be translated into low revenue for the firm; in fact, it may even escape observation. Recent empirical evidence draws consistent findings with this general argument and implies that 'firms in non-competitive industries, where lack of competitive

[68] Easterbrook and Fischel, see *supra* note 45 in this chapter.
[69] Armen Alchian, 'Uncertainty, Evolution and Economic Theory', (1950) 58 *Journal of Political Economics*, pp. 211-221; and George J. Stigler, 'The Economies of Scale' (1958) 1 *Journal of Law and Economics*, pp. 54-71.
[70] See Bengt Holmström, 'Moral Hazard in Teams', (1982) 13 *The Bell Journal of Economics*, pp. 324-340; Barry J. Nalebuff and Joseph E. Stiglitz, 'Information, Competition, and Markets', (1983) 73 *American Economic Review*, Papers and Proceedings, pp. 278-283.
[71] Klaus M. Schmidt, 'Managerial Incentives and Product Market Competition', (1997) 64 *The Review of Economic Studies*, pp. 191-213.
[72] N. Gregory Mankiw, *Principle of Microeconomics* fourth edition (Mason: Thomson South-Western, 2007), pp. 310-314.

pressure fails to enforce discipline on managers, should benefit more from good governance'.[73]

Capital market and incentive schemes

The more efficient disciplining force is the capital market.[74] First, directors and officers in listed companies are exposed to the competition for equity capital. Poor performance increases the cost of raising equity capital. Public investors are not willing to buy shares unless they are assured that their investment would be well managed. The greater the assurance, the higher the share price goes. For this reason, companies adopt a corporate governance system to check controlling power which directors and officers might exercise in a self-regarding manner.[75] Second, the share price is a timely and informative signal of a firm's performance and also an indicator of managerial performance. Incentive schemes and managerial labour market refer to this low-cost signal for setting the remuneration or opportunity wages.

However, share price is not a perfect indicator of the quality of a managerial decision.[76] This signal primarily indicates a firm's performance, even if it is not current or recent performance, but largely the perceived prospect of profitability. The firm's performance is determined by many factors other than managerial effort and that are even beyond the control of managers. A single decision or event may trigger the fluctuation in share prices, but is more usually due to the random synergy of systematic risk and idiosyncratic factors.[77] Moreover, directors and senior managers, through the choice of information disclosure pertaining to accounting profit, financial performance, and some other business arrangements, can lawfully manipulate the share price, to some extent.[78] The incentive scheme linked to the share price may invoke short-termism and other problems.

Managerial labour market

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[73] Xavier Giroud and Holger M. Mueller, 'Corporate Governance, Product Market Competition, and Equity Prices', (2011) 66 *The Journal of Finance*, pp. 563-600.
[74] Easterbrook and Fischel, *supra* note 45 in this chapter.
[75] Oliver Hart, 'Corporate Governance: Some Theory and Implications', (1995) 105 *The Economic Journal*, pp. 678-689.
[76] Merritt B. Fox, Randall Morck, Bernard Yeung and Artyom Durnev, 'Law, Share Price Accuracy, and Economic Performance: The New Evidence', (2003) 102 *Michigan Law Review*, pp. 331-353.
[77] Spamann, see *infra* note 152 in this chapter.
[78] David Aboody and Ron Kasznik, 'CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures', (2000) 29 *Journal of Accounting and Economics*, pp. 73-100.
Daniel Bergstresser and Thomas Philippon, 'CEO Incentives and Earnings Management', (2006) 80 *The Journal of Financial Economics*, pp. 511-529.

Similar to the pressure from the product market on companies, senior managers are faced with competition from their peers both inside and outside their companies.[79] Concerned with their career development, managers actively pursue the best sales, profits, and other similar goals of the firms they currently serve, so that future employers may price their value high, or say, their opportunity wage is high. When firms do not reward the performance of managers properly, the latter may leave for better offers.[80] Because managers work as a team and have a stake in the success of the team and the firm, the internal monitoring between different layers of managers and among top managers naturally takes place.[81]

However, the information and signals of the value of human capital on the managerial labour market are imprecise and indirect, mostly dependent on the indicators of the firms' performance and share price reactions. Thus, the managerial labour market may partly mitigate the managerial incentive problem, but have its limitations due to information obscurity.

Market for corporate control

In general, the threat of the market for corporate control, to some extent, forces managers to work well, and accordingly, ameliorates the agency problems.[82] An under-performing or under-valued firm in the capital market is likely to become the acquisition target of those who believe they can manage the firm more efficiently and make more profit. After the take-over, the incumbent directors and officers would be replaced. Considering such an external threat, directors and officers increase their efforts and efficiency to avoid personal losses arising from a take-over.[83] Some scholars even view the market for corporate control as an arena where an alternative managerial team competes for the right to manage corporate resources, and hence, a component of the managerial market.[84]

A counter claim argues that the threat of takeover also means a possible over-rule of managerial effort and less private benefit, and managers are incentivised to make less effort in evaluating projects and make less firm-specific investment, which is of course

[79] Fama, see *supra* note 34 in this chapter.
[80] *Ibid.*, p. 292.
[81] *Ibid.*, p. 293.
[82] See Manne, *supra* note 30 in this chapter.
[83] David S. Scharfstein, 'The Disciplinary Role of Takeovers', (1988) 55 *The Review of Economic Studies*, pp. 185-199.
[84] Michael C. Jensen and Richard S. Ruback, 'The Market for Corporate Control: the Scientific Evidence', (1983) 11 *Journal of Financial Economics*, p. 7.

also harmful to the firm's value and shareholders' interests.[85] In this sense, the disciplining function of the market on corporate control remains contentious.

The dynamic of the market for corporate control is largely dependent on the market development and regulatory environment. A well-functioning securities market, *per se*, generates robust signalling and disciplining functions via share prices, which is also a pre-requisite to efficient take-over activities. Instead, potential bidders might be less active to initiate take-overs in a stock market that lacks sensitive price signals and adequate liquidity.

Meanwhile, laws and regulations in different jurisdictions may create a pro-, anti-, or unbiased attitude towards take-overs.[86] Legal rules govern the issues broadly regarding the defence tactics for take-overs, bidding procedures, financing channels, and provide the apparatus to balance the interests of the major parties in take-over transactions.[87] Thus, the frequency and gains of take-overs are greatly influenced by relevant laws and regulations that may sustain multi-faceted policy goals.[88]

2.4 Why Law Matters

Incomplete contracts give rise to the authority, or managerial discretion, to address future contingencies, yet they also leave room for managerial opportunism. The market mechanism plays an important role in disciplining internal management. However, the behavioural influence of the market mechanism is conditional and imperfect. Then the question of whether legal intervention is necessary and socially desirable attracts scholars' attention.

The standard view of 'law matters' is constructed by the empirical studies of La Porta, Lopez-de-Silanes, Shleifer and Vishny (LLSV).[89] LLSV investigated 49 countries, classified them into English, French, German, or Scandinavian groups by the standard of

[85] Marco A. Haan and Yohanes Riyanto, 'The Effect of Takeover Threats on Shareholders and Firm Value', (2006) 59 *The Journal of Economic Behavior & Organization*, pp. 45-68.
[86] Luca Enriques, Ronald J. Gilson, and Alessio M. Pacces, 'The Case for an Unbiased Takeover Law (with an Application to the European Union)', (2013) The European Corporate Governance Institute (ECGI) working paper, no. 212.
[87] See, e.g., Lucian A. Bebchuk and Allen Ferrell, 'Federalism and Takeover Law: The Race to Protect Managers from Takeovers', The National Bureau of Economic Research (NBER) Working Paper (1999) 7232.
[88] Roberta Romano, 'A Guide to Takeovers: Theory, Evidence and Regulation', (1992) 9 *The Yale Journal on Regulation*, pp. 119-180. The author summarises and classifies theoretical explanations for takeovers and provides a guide to policymakers regarding the effects of some regulations in the US.
[89] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert Vishny, 'Legal Determinants of External Finance', (1997) 52 *Journal of Finance*, p. 1131; Andrei Shleifer and Robert Vishny, 'A Survey of Corporate Governance', (1997) 52 *Journal of Finance*, pp. 737-783.

legal origin, indexed and measured the legal protection of outside shareholders by the 'Anti-director Rights Index', and compared the depth, size, and market valuation of the capital markets. Based on the empirical evidence, they argued that the legal protection of investors against expropriation by managers and other insiders is associated with effective corporate governance and development of the capital market. Hundreds of subsequent papers used their 'Anti-director Rights Index' to measure the level of shareholder protection.[90] 'Law and finance' extends to 'law, finance, and economic growth', which argues that a robust financial market may promote economic growth by allocating sources of capital to efficient use.[91]

They found that the legal protection of outside shareholders and creditors, or potential financiers, is critical to the development of the capital market, and common law jurisdictions offer shareholders more protection than do civil law countries, and accordingly, have a deep and liquid stock market and dispersed ownership structure.[92] If legal protection is insufficient for outside shareholders, then the separation of ownership and control could be diminished and access to equity funds is limited to companies, because investors are concerned with expropriation by inside controllers and become less willing to provide funds.[93]

The LLSV studies are very influential and invoke continuous follow-up discussions, although the methodology is subject to criticism. Firstly, legal scholars criticized their way of explaining, measuring, and comparing legal rules and pointed out their weak evidence regarding the enforcement of legal rules.[94] Some scholars doubted whether their selection of variables was relevant and whether these variables could represent the effective protection that legal institutions provide to outside shareholders.[95] In response to the criticism, the LLSV scholars improved the 'Anti-director Rights Index' with two extra indexes under the securities laws and formulated an 'Anti Self-dealing Index' with another

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[90] *Ibid.*
[91] *Ibid.* See also Colin Mayer and Oren Sussman, 'The Assessment: Finance, Law, and Economic Growth', (2001) 17 *Oxford Review of Economic Policy*, pp. 457-466.
[92] *Ibid.*
[93] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Vishny Robert, 'Law and Finance', (1998) 106 *Journal of Political Economy*, pp. 1113-1155.
[94] John C. Coffee, JR., 'Law and Market: The Impact of Enforcement', (2007) 156 *University of Pennsylvania Law Review*, p. 244. The author also noted that the major difference between the US and the rest of the world is the intensity of enforcement.
See also Nicholas L. Georgakopoulos, 'Statistics of Legal Infrastructures: A Review of the Law and Finance Literature', (2006) 8 *American Law and Economic Review*, pp.62-80.
[95] Holger Spamann, 'The Anti-director Rights Index Revisited', (2006) 23 *The Review of Financial Studies*, pp. 467-486.

author.[96] They drew a consistent conclusion that common law jurisdictions provide better investor protection and better access to equity funds for firms than do civil law countries.

Second, there is no definite causal link between the legal protection of outside shareholders and the ownership structure. The legal protection of outside shareholders may take other forms in different contexts, which the standardized index may not encompass.[97] Moreover, legal protection for shareholders is not the sole factor responsible for the degree of separation of ownership and control. For instance, Sweden has a well-developed securities market, while the ownership structure is concentrated. As such, it is hardly convincing that the concentrated ownership is due to poor investor protection.[98]

Third, the literature on 'law and finance' does not address the use of mandatory and enabling rules. In contrast, legal scholars do not doubt the necessity of legal norms but are concerned with the reasonable scope of private autonomy. Furthermore, there is no serious discussion on instances of regulation with mandatory rules and allowing private parties to opt out of default rules.

Roe holds a different opinion, revealing the functional limitation of corporate law, and attempts to explain why a well-developed securities market may co-exist with concentrated ownership.[99] Roe divides managers' opportunistic behaviour into 'stealing' and 'shirking' and argues that the corporate law may sufficiently deter 'stealing' but does much less to 'shirking'.[100] If agency cost were high when control separates from diffused shareholders, but low when control does not, the block-holder would persist even when the company law provides good protection to outside shareholders from insiders' control.

2.5 Function of Directors' Duties and Liabilities

The economic analysis of directors' duties and liabilities in this section is embedded in the fiduciary duty principle in the US, since the state jurisdictions have developed a rich and

[96] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'What Works in Securities Law?', (2006) 61 *Journal of Finance*, pp. 1-32.
Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'The Law and Economics of Self-Dealing', (2008) 88 *Journal of Financial Economics*, pp. 430-465.
[97] Theodor Baums and Kenneth Scott, 'Taking Shareholder Protection Seriously? Corporate Governance in the U.S. and Germany', (2005) 53 *The American Journal of Comparative Law*, pp. 31-75.
[98] Ronald J. Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Taxonomy' (2006) 119 *Harvard Law Review*, pp. 1641-1679.
[99] Mark J. Roe, 'Corporate Law's Limits', (2002) 31 *The Journal of Legal Studies*, p. 235.
[100] *Ibid.*

sophisticated body of case law, which is in wide use in many countries.[101] For expository purposes, this thesis does not describe in detail the state variety, legal technicality, and the evolution of relevant rules and standards.

2.5.1 The Fiduciary Duty Principle in General

Given that a private management contract[102] cannot instruct all the proper and desirable managerial actions for every future contingency,[103] the fiduciary duty principle nevertheless bridges the gap in such an incomplete contract and deters managerial misfeasance and malfeasance via an *ex post* liability regime. That is, judges interpret and apply the fiduciary duty principle in consideration of all the facts and circumstances to determine whether the directors' performance complies with the normal and reasonable requirement of the shareholders, if they had been able to foresee such facts and circumstances.[104] The legal liability for the breach of fiduciary duty mainly takes the form of out-of-pocket payment. Accordingly, directors and senior managers need to watch their actions, irrespective of any stipulated requirement or instructions in the contract.

Thus, the fiduciary duty principle, at least, partially reduces the transaction cost that negotiating and writing a management contract may incur. The parties to the management contract do not need to address the unimportant and rare instances that the fiduciary duty principle can govern after all.[105] Once they are already making capital contributions to the firm, outside investors have no feasible way to renegotiate the provisions to curb mismanagement. Nevertheless, the fiduciary duty principle serves as a shield against mismanagement.[106]

The usefulness of the fiduciary duty principle is contingent on judicial discretion and competence.[107] Judges need to have the business experience and relevant knowledge to apply the general principle to a particular scenario with merely after-the-fact evidence, and determine the propriety of decision-making. People may doubt whether it is suitable to let

[101] For comparative literature, see, e.g., Luca Enriques, 'The Law on Company Directors' Self-Dealing: A Comparative Analysis', (2000) 2-3 *International and Comparative Corporate Law Journal*, pp. 297-333.
[102] Hereinafter, the term 'management contract' generally refers to any provisions with regard to managerial actions and compensation, which in practice, may be included in a managerial labour contract, company's articles of association, and other internal rules.
[103] See *supra* Section 2.3.2.
[104] Robert H. Sitkoff, 'The Economic Structure of Fiduciary Law', (2011) 91 *Boston University Review*, p. 1043.
[105] *Ibid.*
[106] Easterbrook and Fischel, see *supra* note 45 in this chapter, p. 93.
[107] Sitkoff, see *supra* note104 in this chapter, p. 1044.

judges complete the contract, especially those involving complicated business transactions. The sub-section concerning the duty of care will further discuss this issue.

Closely related to judicial competence is the question of whether judges have the discretion to interpret the general terms of the fiduciary duty and to make subsidiary standards and rules to enrich the meaning of the principle, as business practice is changing. For instance, the corporate opportunity doctrine and business judgement rules have all been developed in the case law and later codified into the statutes. This reduces the uncertainty within the inclusive but vague term.[108] However, judges in civil law countries are not empowered to interpret the legal provisions beyond the word of the law, which is deemed as one factor that might impair the effectiveness of transplanting the fiduciary duty principle.[109]

The intensity of deterrence generated by the fiduciary duty principle is determined by the magnitude of liability and the likelihood of liability awards. The fiduciary duty has two prongs—the duty of loyalty and the duty of care, respectively, dealing with 'stealing' and 'shirking'.[110] In general, shirking mainly affects the production of corporate wealth while stealing diverts the corporate wealth to personal pockets after it is produced. 'Stealing' usually occasions more personal gains to wrong-doers than 'shirking'; however, 'shirking' may cause more losses to the firm.[111] This differentiation between 'stealing' and 'shirking' results in substantial differences in the judicial review standard, and the magnitude of liability from a breach of the duty of loyalty to a breach of the duty of care, in case law.

2.5.2 Duty of Loyalty

Directors and senior managers are chiefly in charge of the business operation of their firms. They may take the chance to misappropriate the company's assets or part of its value for their own personal ends, which is simply 'stealing'. The company's assets broadly include funds, land, patents, and even extends to valuable information, business opportunities and other enterprise resources.[112] Theft along with fraud are not readily spotted and detected by market mechanisms and the *ex post* market penalty does not suffice to deter a large one-shot theft. Simply constraining the authority as a contractual safeguard against

[108] *Ibid.*
[109] See *supra* note 17 in Chapter 1, Pistor and Xu (2003), pp. 77-106.
[110] Roe, see *supra* note 99.
[111] Easterbrook and Fischel, see *supra* note 45 in this chapter, p. 98.
[112] Robert Cooter and Bradley J. Freedman, 'An Economic Model of the Fiduciary's Duty of Loyalty', (1990) 10 *Tel Aviv University Studies in Law*, p. 300.

misappropriation is often not a sensible option. For instance, a flat ban on self-dealing transactions also deprives the company of deals that can be profitable. Even though the management contract may prohibit various forms of misappropriation, it is still not difficult for directors to circumvent the provisions under perfect cover.

In US case law, the duty of loyalty signifies that 'corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests'.[113] It is also held that 'directors can neither appear on both sides of a transaction, nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit, which devolves upon the corporations or all stockholders'.[114] Another classic expression in the Weinberger case by the Delaware Supreme Court states that 'the rule that requires an undivided and unselfish loyalty to the corporation demands that there should be no conflict between duty and self-interest'.[115] In short, the duty of loyalty generally requires directors to act in the 'sole' interest of the companies they serve and refrain from engaging in any transactions involving any conflict of interests.[116]

The liability for breach of the duty of loyalty, one determinant for the deterrent effect, usually involves compensation for the damages caused to the firm and paying back the proceeds arising from the breach to the firm, or for example, the wrongful gains disgorgement in US law.[117] The idea is to make misappropriation and self-dealing financially futile for the wrong-doers *ex post*.

From the directors' perspective, a breach of the duty of loyalty may incur a sum of costs, including: (1) the time and efforts of concealing the self-regarding act; (2) compensation for the company's losses, and in some cases, shareholders' losses; (3) litigation expenditure; (4) losing their firm-specific investment and remuneration, after being dismissed; and (5) reputation losses. Notably, the loss of reputation is a very severe penalty that could even ruin their future career paths as senior officers. Thus, the magnitude of liability for the breach of the duty of loyalty would not be insufficient for deterrent purposes, even without a punitive element.

[113] Guth v. Loft, Inc., 5A. 2d 503, 510 (Del. 1939).
[114] Aroson v. Lewis, 473 A. 2d 805, 812 (Del. 1984).
[115] Weinberger v. UOP, Inc., 457 A. 2d 701 (Del. 1983).
[116] Robert Cooter and Bradley J. Freedman, 'The Fiduciary Relationship: Its Economic Character and Legal Consequences', (1991) 66 *New York Law Review*, p. 1074.
[117] See, e.g., Cameco, Inc. v. Gedicke, 157 N.J. 504 (1999).

However, the deterrent effect can easily be compromised by the low probability of detection and proving the wrong-doing. Obviously, shareholder plaintiffs have less information pertaining to the detailed facts of misappropriation or self-dealing than the directors, and therefore, proving a breach of the duty of loyalty is more difficult than defending against such an allegation. In the light of this, the subsidiary rules for the breach of the duty of loyalty requires that interested directors engaging in self-dealing make full disclosure of material facts, including the (potential) conflict of interest and the possible influence on the transaction, to obtain the approval by a majority of disinterested shareholders (or disinterested directors).[118] The approval of disinterested shareholders is regarded as 'the purest case of an arm's length endorsement of the transaction'.[119]

Should a dispute arise, the plaintiff shareholders rebut the presumption of the business judgement rule by proving that the challenged decision involved a conflict of interests.[120] Then the burden of proof shifts to the defendant directors. The defendant directors need to prove that they have fulfilled the disclosure requirement.[121] If the disinterested party did not approve the deal with full disclosure, the directors, engaging in self-dealing anyway, have to prove 'the entire fairness' of the transaction, and the court would conduct a merit review to determine whether there is a breach of the duty of loyalty.[122]

2.5.3 Duty of Care

The other element of the fiduciary duty principle is the duty of care. The meaning and standard of the duty of care are not as straightforward as the duty of loyalty, and substantial variation exists among state jurisdictions. The distinction between the conduct standard and liability standard is blurred on some occasions.[123] Many scholars have

[118] Since the regulatory approach for usurping corporate opportunities and engaging in the same business as the firm emphasizes full disclosure and the approval by disinterested party, the following functional explanation takes only self-dealing transaction as example.
[119] Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, 'The Law and Economics of Self-dealing', (2008) 88 *Journal of Financial Economics*, p.436.
[120] See *infra* note 129 in this chapter and the accompanying text.
[121] See Wendt v. Fischer, 243 N.V. 439, 154 N.E. 303 (1926).
[122] See, e.g., Delaware General Corporate Law (DGCL) s. 144 or California Corporations Code s. 310.
[123] John F. Olson and Aaron K. Briggs, (2011) 74 'The Model Business Corporation Act and Corporate Governance: An Enabling Statute Moves toward Normative Standards', (2011) 74 *Law and Contemporary Problems*, p. 36. The main controversy is whether the conduct standard of due care is identical to the liability standard or standard of judicial review.

attempted to clarify the ambiguity of the duty of care; however, many nuances remain poorly understood.[124]

The duty of care is delineated with a focus on the standard of due care, or reasonable care. The Delaware Supreme Court holds an objective standard, 'the amount of care which ordinarily careful and prudent men would use in similar circumstances'.[125] However, the Model Business Corporation Act (MBCA) changed to a subjective version recently, 'the care that a person in a like position would reasonably believe appropriate under similar circumstances'.[126]

Business judgment rule

In addressing the claims pertaining to directors' liabilities for the breach of the duty of care, the courts hold a deferral approach to the directors' decision and create the business judgement rule (BJR), which shields the directors against personal liability under certain conditions.[127] The BJR 'is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and with the honest belief that any action taken was in the best interests of the company'.[128] The plaintiffs bear the burden of proof to rebut the presumption, and if they fail to do so, the courts would not substantively review the business decisions that were challenged.[129]

The BJR has evolved through frequent application in new and complicated transactions, and legal scholars, in the meanwhile, have commented on the nature and proper use of the BJR.[130] One typical formulation of the BJR contends that:

> 'Courts do not measure, weigh or quantify directors' judgement. We do not even decide if they are reasonable in this context. Due care in the decision-making context is a process of due care only … Thus, directors' decisions will be respected by the courts unless the

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124 See, e.g., Stephen M. Bainbridge, 'The Business Judgement Rule as Abstention Doctrine', (2004) 57 *Vanderbilt Law Review*, pp. 83-90.
125 See Graham v. Allis-Chalmers Mfg. Co., 188 A. 2d 125, 130 (Del. 1963).
126 See the MBCA § 8.30 (b) (2008). The MBCA is formulated and amended by the Committee on Corporate Laws of the American Bar Association Section of Business Law. This Act is very influential in state corporate laws and has is followed by twenty-four states, either fully or partially.
127 Lori McMillan, 'The Business Judgement Rule as an Immunity Doctrine', (2013) 4 *William & Mary Business Law Review*, p. 524.
128 See Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).
129 Stuart R. Cohn, 'Demise of the Directors' Duty of Care: Judicial Avoidance of Standards and Sanctions through the Business Judgement Rule', (1983) 62 *Texas Law Review*, p. 603.
130 See, e.g., Daniel R. Fischel, 'The Business Judgement Rule and the Trans Union Case', (1985) 40 *The Business Lawyer*, pp. 1437-1455; William T. Allen, Jack B. Jacabs, and Leo E. Strine, Jr., 'Realigning the Standard of Review of Director Due Care with Delaware Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem', (2002) 96 *Northwestern University Law Review*, pp. 449-466.

> directors are self-interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose, or reach their decision by a grossly negligent process that includes the failure to consider all the material facts reasonably available'.[131]

Referring to the above statement, some scholars view the BJR essentially as a standard of review, *i.e.*, an abstention doctrine.[132] Unless certain conditions are met, the courts would refrain from second-guessing the merit of the business decisions.[133]

In addition, an alternative and more traditional view considers the BJR as a liability rule, asserting that the BJR provides the tests that the court can directly apply to determine the liability issue.[134] The Delaware Supreme Court holds the BJR 'as both a procedural guide for litigants and a substantive rule of law'.[135] Accordingly, the liability standard for breach of duty of care is not mere negligence but lowered to gross negligence and even recklessness.[136] Yet, some courts and commentators are against the adoption of a gross negligence standard for the breach of the duty of care.[137]

Despite the inconsistency in the case law related to the BJR, legal scholars commonly consider that the policy rationale of the BJR is to strike a workable balance between discretion and liabilities.[138] It is well acknowledged that holding directors liable for the failure of their business decisions would stifle their innovation and thwart risk-taking, and directorial discretion would be virtually fettered. Directors will only choose a safe plan with low profits to avert personal legal liability, even though they are fully aware that a risky project may generate more returns to the company they serve.[139] Thus, the BJR is meant to maintain directorial discretion and even allow for honest mistakes.[140]

Limiting liability provision, indemnification, and insurance

[131] Brehm V. Eisner, 746 A. 2d 244, 264 (Del. 2000).
[132] Bainbridge, see *supra* note 124.
[133] See *supra* note 127 in this chapter, pp. 534-536.
[134] Melvin Aron Eisenberg, 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law', (1993) 62 *Fordham Law Review*, p. 437.
[135] See *supra* note 131, quoted in Cede & Co. v. Technicolor, 634 A. 2d 346 (Del. 1993).
[136] Bainbridge, see *supra* note 124 in this chapter, p. 94.
[137] See, e.g., Theroit v. Bourg, 696 So. 2d 1008 (La. 1997) and *supra* note 127.
[138] See *supra* note 127 in this chapter, p. 526.
[139] Bainbridge, see *supra* note 124 in this chapter, p. 85.
[140] See the transcript of a forum on personal liability of directors held at Harvard Law School and moderated by Lucian Bebchuk, 'Directors' Liabilities', (2006) 31 *Delaware Journal of Corporate Law*, p. 1015.

Furthermore, business practices and state corporation statutes devised and confirmed a range of schemes to limit a director's personal liabilities.[141] These private schemes are usually subject to the statutory constraint that only negligence or no-fault liabilities can be covered.[142] The articles of association, by-laws, or other internal agreements of corporations are enabled to set a cap on the amount of, or stipulate the percentage of, directors' personal payment for monetary liabilities or settlement.[143] Many corporations provide indemnification plans and/or purchase liability insurance for their directors and officers as part of their remuneration package.[144] The defence cost of negligence claims and monetary liability for the losses are largely covered by insurance and perhaps marginally assumed by the corporations or directors.

Debate on the role of monetary liability

As a result of the above schemes and the BJR, directors' actual out-of-pocket payments for liability are greatly reduced and even eliminated. Some commentators object to the virtual exemption of legal liability and emphasize the significance of legal liability to curb directors' irresponsibility.[145] However, the mainstream theory maintains that legal liability only plays a minimal role in controlling 'shirking' for the following reasons.[146]

First, judges are not business experts[147] and not sufficiently competent to assess the extent to which the challenged decisions are reasonable, or verify directors' efforts and diligence. Besides, a business decision 'involves intangibles, intuitive insights or surmises as to business matters such as competitive outlook, cost structure, and economic and industry trends, and is not susceptible to systematic analysis'.[148] In addition, judges suffer

[141] For a summary of influential pattern of indemnification laws, see Alfred F. Conard, 'A Behavioral Analysis of Directors' Liability for Negligence', (1972) *Duke Law Journal*, p. 900.
[142] As this thesis only examines directors' accountability to the firms they serve and the shareholders therein, it does not discuss how statutory liabilities, such as environmental liabilities and tax penalty, and the liability that the third parties, such as employees and consumers, claim are indemnified and insured.
[143] See, e.g., DGCL 102 (b) (7) and American Law Institute (ALI) Principles of Corporate Governance 7.19.
[144] Joseph P. Monteleone and Nicholas J. Conca, 'Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues', (1996) 51 *The Business Lawyer*, pp. 574; and Roberta Romano, 'What Went Wrong with Directors' and Officers' Liability Insurance?' (1989) 4 *Delaware Journal of Corporate Law*, pp. 1-33.
[145] Lisa M. Fairfax, 'Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty through Legal Liability', (2005) 42 *Houston Law Review*, p. 395.
[146] Easterbrook and Fischel, see *supra* note 45 in this chapter, pp. 92-96.
[147] See Dodge v. Ford Motor Co., 170 N.W.668, 684 (Mich. 1919).
[148] Douglas M. Branson, 'The Rule that isn't a Rule: The Business Judgement Rule', (2002) 36 *Valparaiso University Law Review*, p. 637.

from hindsight bias.[149] They tend to conclude that the directors were taking an unduly high risk, since the bad outcome *ex post* materializes the risk at the time of decision-making. Thus, directors are likely to 'be penalized for taking a proper risk but with bad luck'.[150]

Second, full liability for losses caused by a decision not carefully made is counter-productive. Business decisions may turn out to be a failure because of a host of factors beyond the control of decision makers. In public companies, such failure may involve astronomical losses. Holding risk-averse directors liable for all of the losses may bankrupt them. No one risks personal assets to be a director.[151] Even if someone remains on the board, the deterrence benefit of full liability is far less than what a company pays for taking such legal risks.[152]

Third, the enforcement of directors' liability through formal litigation procedure incurs high costs. The litigation cost includes out-of-pocket costs, *i.e.*, litigation fee, attorney fee, and service expenses, and the opportunity costs of the parties to the suits. The opportunity costs of directors' participation in lawsuits can hardly be ignored, involving the time and attention that could be devoted to enhancing the firm's value.

Finally, the legal liability for breach of the duty of care is not desirable, because other mechanisms can efficiently incentivise the best efforts of directors.[153] In capital markets, share price closely reflects the performance of public corporations and is also used to measure the performance of directors and is linked to their remuneration.[154] Hence, directors are also exposed to the risk of losing jobs and income if they fail to maximize the firm's value, since the labour market and the market for corporate control are working with share price information.[155] Besides, the internal governance mechanism is operating to check and balance the power of execution, and thus, control managerial opportunism.

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[149] Jeffrey J. Rachlinski, 'A Positive Psychological Theory of Judging in Hindsight', (1998) Cornell Law Faculty Publication, paper 801, available at http://scholarship.law.cornell.edu/facpub/801 (accessed 15/12/2019).
[150] See *infra* note 152 in this chapter, p. 352.
[151] Oliver Hart, 'An Economist's View of Fiduciary Duty', (1993) 43 *The University of Toronto Law Journal*, p. 301.
[152] Holger Spamann, 'Monetary Liability for Breach of the Duty of Care?', (2016) 8-2 *Journal of Legal Analysis*, p. 339.
[153] Ronald J. Gilson, 'A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers', (1981) 33 *Stanford Law Review*, pp. 819-824.
[154] Daniel R. Fischel and Michael Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis', (1986) 71 *Cornell Law Review*, pp. 267-268.
[155] See *supra* Section 2.2.3.

A further clarification of the mainstream opinion was made very recently.[156] The crucial message appears inconsistent with the mainstream opinion, holding that 'properly calibrated partial liability would unambiguously improve the incentives of directors and managers'.[157] However, the argument against liability is also tenable when the litigation cost is high and the benefit of judicial evaluation is low. In sum, the desirability of monetary liability is contingent on its relative cost and benefit in certain contexts.

In particular, judicial evaluations are direct and relatively independent signals of directors' action, although not perfect. By contrast, share prices and accounting profits primarily indicate the firm's profitability, but only indirectly reflect the directors' performance, and are weakly correlated with the directors' decisions. Moreover, (lawful) manipulation by directors and officers, of issues such as discretionary disclosure, the choice of accounting standard or some sales actions, may lead share prices and accounting figures, to be even more imprecise with regard to the directors' performance.[158] Regardless of this, incentive schemes normally use share prices and accounting figures as signals of directors' actions and link the payment to these signals. This is criticized for inducing managerial myopia and other similar problems.[159]

Besides, judicial decisions are made with internal and specific information that the parties to the private actions would bring before the courts, whereas the stock price is a compound of external valuation based on disclosed and market information. The combined use of complementary information improves the precision of incentives and offsets the biases. Specifically, the use of liability may allow the compensation to be less sensitive to the firm's value, and hence, reduce the level of directors' exposure to the corresponding risk when only the stock price is the sole signal. However, in the meanwhile, the incentive impact is not discounted. In other words, judges are able to differentiate, if not always, whether the drop in the firm's value is attributable to the directors. Directors, in turn, have extra incentives to exercise due care to increase the firm's value for fear of *ex post* personal liability. Shareholders do not need to afford the increase in directors' compensation to intensify the incentives.[160] Thus, it is optimal to input the court signals into incentive

[156] Spamann, see *supra* note 152, pp. 337-373.
[157] *Ibid.*, p. 338.
[158] *Ibid.*, p. 339.
[159] See Lucian Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Massachusetts: Harvard University Press, 2004).
[160] Spamann, see *supra* note 152 in this chapter, p. 347.

schemes 'through appropriate weights and adjustments', when litigation is relatively costless.[161]

Monetary liability is the financial payoff and acts as a penalty for the failure to fulfil the duty of care. Yet, as previously mentioned, personal liability for the entire losses due to the sub-optimal decisions imposes too much risk on directors.[162] To balance against the extra risk imposed on directors, it is argued that tailoring personal liability to the circumstances of the corporation, market environment, director's risk aversion, and so on, is similar to designing standard equity- or accounting-based incentives.[163] In this sense, capping liability, and indemnifying and insuring partial liability, are sensible attempts to calibrate appropriate liability risk.[164]

Furthermore, it is clarified that monetary liability does not deter but encourages efficient risk-taking. The legal doctrine *per se* requires directors to maximize the interests of the company with due care. Since in the commercial world the best return from investments or transactions is usually associated with risk-taking, playing safe is not fulfilling the duty of care.[165] It has been assumed that the courts are biased against risk-taking because the bad outcome naturally materializes the risk at the time of decision-making. Yet, the empirical evidence about judicial hindsight bias is mixed in general and even rare in particular relevance to corporate disputes.[166] Even if such bias does exist, the instructions of not penalizing excessive risk-taking can be incorporated in the design of liability rules.[167]

Undoubtedly, litigation incurs high costs. As mentioned, litigation costs include the opportunity cost of filing or participating in the lawsuits as well as out-of-pocket payments through legal proceedings. Moreover, it is not easy to maintain the optimal level of private actions to the point that the increasing benefit of improving deterrence equals the

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[161] *Ibid.*, p. 338. The author makes this argument based on the 'informativeness principle' from contract. The central message of this theory is 'if a second signal of the agent's action can be drawn at no additional cost, the optimal incentive scheme uses both signals'
For more about the 'informativeness principle', see Bengt Holmström, 'Moral Hazard and Observability', (1979) 10 *Bell Journal of Economics*, pp.74-91; Steven Shavell, 'Risk Sharing and Incentives in the Principal and Agent Relationship', (1979) 10 *Bell Journal of Economics*, pp. 55-73; Patrick Bolton and Mathias Dewatripont, *Contract Theory* (Cambridge: MIT Press, 2005); and Jean-Jacques Laffont and David Martimort, *The Theory of Incentives: The Principal-Agent Model* (Princeton: Princeton University Press, 2002).
[162] See Spamann, *supra* note 152 and the accompanying text.
[163] Spamann, see *supra* note 152, pp. 344-345.
[164] *Ibid.*
[165] *Ibid.*, p. 351.
[166] Chris Guthrie, Jeffrey J. Rachlinski, and Andrew J. Wistrich, 'Blinking on the Bench: How Judges Decide Cases', (2007) 93 *Cornell Law Review*, pp. 1-43.
[167] Spamann, see *supra* note 152, p. 352.

increasing litigation costs in a jurisdiction, since legal proceedings are instigated by private parties whose major goal is to seek a personal remedy.[168] Therefore, it is necessary to adjust the procedural rules for allocating the burden of proof and litigation expenses.

In sum, the utility and design of monetary liability for a breach of duty of care can be well explained from the cost-benefit perspective. The benefit of liability incentives cannot be ignored and would complement other schemes and mechanisms to better incentivise directors. However, the relative value could be low, if more precise, efficient signals are already in place, and the litigation cost is high. Conversely, when the internal governance structure is weak and even vulnerable, when conflicts of interests are severe, and when judges are expert at finding complex facts and rendering appropriate judgements; it would be sensible to employ a liability regime to address agency problems.

2.6 Conclusion

The widespread popularity of corporate entities is primarily attributable to the structural characteristics that facilitate fund raising and management specialization. The agency theory has revealed that the widening gulf between managers' personal interests and those of the firms, and the information asymmetry between shareholders and managers may give rise to managerial opportunism. This makes the issue of incentivising managers to pursue the best interests of the firm and shareholders a topic of heated debate and extensive investigation.

Internal agreement may institute monitoring forces and adopt incentive schemes to align the managers' personal interests with those of their firms'. Yet, incentive schemes can only reduce the divergence of interests but not eliminate it. External market mechanisms help discipline management without incurring extra costs. The capital market, product market, and the managerial labour market combine to generate informative signals to indicate managerial performances. However, these signals contain random noises; furthermore, the disciplining function is dependent on many conditions that ensure the efficient functioning of the market. Therefore, there seems to be a niche for alternative strategies that can ensure managerial commitment to the company and investors.

The literature on law and finance contends that the legal protection of outside investors is critical to the development of the stock market, which is accepted as a tenable belief.

[168] Steven Shavell, 'The Social versus the Private Incentive to Bring Suit in a Costly Legal System', (1982) 11 *The Journal of Legal Studies*, p. 334.

Amongst others, the right to challenge the decisions of directors through litigation is considered as a major element of anti-director rights. In line with the logic in the literature, the duties and liabilities of directors are not dispensable. Yet, legal scholars raise doubts about their understanding of law and the accuracy of their valuation of law in different jurisdictions.

A more specific point of view holds that the judicial review and opinions present an independent and direct signal of the management decision(s) at issue, and the award of liabilities is essentially construed as the deterrence for particular wrong-doing. The desirability of a liability strategy is just a cost-benefit issue. When the relative benefit of deterring impact outweighs the cost of obtaining judicial opinions, it is sensible to calibrate the monetary liability for directors in a similar way to the arrangement of incentive schemes. The relative benefit of judicial review is contingent on the efficient and informative nature of other signals, especially the share prices. When the share prices are sensitive to management decisions and corporate status, the benefits of a judicial review reduce.

The fiduciary duty principle, inclusive and flexible, can bridge the gap in an incomplete management contract to govern the manner in which directors make business decisions in varying circumstances. Civil liabilities serve as deterrence to self-regarding behaviour, and simultaneously, as a remedy for the losses sustained by the company and shareholders. This means that directors are not free from accountability only because there is no specific requirement stipulated in the contract *ex ante*, since any improper management behaviour may trigger a judicial review under the fiduciary duty principle.

The fiduciary duty of loyalty and monetary liabilities have unique merit in deterring one-shot thefts and various forms of self-dealing amounting to theft. This type of wrong-doing is usually associated with concealment, and market mechanisms cannot immediately take in the information until discovered. Moreover, personal gains arising from these one-shot deals probably exceed the market penalties. Accordingly, the design of liability for breach of the duty of loyalty needs to take the information advantages that wrong-doers possess, and the under-deterrence of other mechanisms into account.

The monetary liability for the breach of the duty of loyalty usually encompasses damages to the companies, plus the disgorgement of unlawful gains. To overcome the difficulty of detecting self-dealing transactions, interested directors are usually required to disclose the material facts to disinterested directors or shareholders so that self-dealing can be negotiated at arm's length. Accordingly, the rules related to the allocation of the burden of proof tilt the balance towards the company and shareholder plaintiffs. Defendants need to prove that they have made full disclosure of a potential conflict of interest and its likely impact on the dealing. If they failed to do so, the courts would look into the substance of the dealing to determine whether it is entirely fair to the company.

The fiduciary duty of care is more elusive and sophisticated. In case law, the liability standard is like a pendant swinging forewards and backwards. A series of private arrangements in practice almost waive the personal liability for the breach of the duty of care. Some scholars believe that the use of liability as deterrence is ineffective and inefficient, but market mechanisms are efficiently disciplining and incentivising directors to maximize the firm's value. This opinion has recently been altered: market signals are imperfect and properly calibrated partial liability improves the incentives of directors and managers to maximize the interests of the company. The only reason for the complete exclusion of liability is high litigation cost, rather than the chilling impact on efficient risk-taking.

Chapter 3 Corporate Governance and Board of Directors in China

3.1 Introduction

The primary objective of this chapter is to explore the context where the duty and liability rules are to be applied. The contextual picture encompasses corporate governance and the market environment in China. In general, corporate governance essentially concerns how a company is governed and a board of directors is usually the central governance body in a company. Therefore, the role and function of the board of directors can be better examined within the realm of corporate governance.

The concept and system of corporate governance have been adopted in China for no more than two decades.[1] The dynamic of directorial and governance practice still bears the imprint of the models in the central planning era. Thus, Section 3.2 classifies the enterprises in two standards to give readers some familiarity with China's enterprise sector. Section 3.3 conducts a historical review of enterprise development to understand how the traditional legacy remains influential. Section 3.4 shifts the focus onto the current generic patterns of ownership and control and associated conflicts of interests in Chinese companies, which condition the boards' functions and status. In addition, this section also examines how the boards of directors may function in the internal governance system and whether the internal monitoring forces can effectively control managerial opportunism.

Market mechanisms, as Chapter 2 illustrates, generate signals to incentivise management conduct. Moreover, the market disciplining function and precision of market signals are relevant to the desirability of the legal liability as well. Section 3.5 undertakes a functional assessment of the capital market and the disciplining signals. Following the contextual investigation within companies and across markets, Section 3.6 concludes.

3.2 Categorization of Enterprises

Chinese enterprises have evolved in a transitional age characterized by spectacularly rapid economic growth,[2] transformation of the economic system,[3] and increasingly deeper

[1] See *infra* section 3.3.1.3.

[2] The average annual growth rate of GDP from 1979 to 2012 is 9.8%, according to data issued by the National Bureau of Statistics of the PRC. See more information on its official website http://www.stats.gov.cn/tjsj/ndsj/2013/html/Z0102e.htm (accessed 14/11/2019), and see also the GDP growth

integration into the world market.[4] The enterprises, the major players in economic activities, are becoming vibrant, diverse, and complex in many ways. For instance, the number of Chinese enterprises on the list of Fortune Global 500 has increased from three in 1995 to 120 in 2018, a massive surge in only two decades.[5] Parallel to these giant company groups, many small and medium-sized firms are rising to prominence in technology innovation in new industries.[6] Notably, the Alibaba Group, an online commerce company, raised $25 billion on the New York Stock Exchange in 2014, setting the record for the largest IPO ever.[7]

Without sorting and classifying the enterprises, any further exploration from any perspective, and for any purpose, would be inaccurate and confusing. However, the classification can hardly be clear-cut and tenable all the time, since the transitional economy has bred hybrid forms and regional variations, and the enterprise sector has undergone continuous evolution.[8] To facilitate the discussions later in this chapter, this section uses the following criteria to classify Chinese enterprises: ownership standard and legal form standard.

3.2.1 Ownership Standard

A common method used to categorize China's enterprises is by ownership standard. The use of this standard has its theoretical rationale: ownership of a firm represents the right to control the firm and the right to gain the firm's net profit. This determinant considerably conditions the distribution of decision-making power, the share of interest, and risk

rate of the PRC from 2010 to 2017 on the website https://www.statista.com/statistics/263616/gross-domestic-product-gdp-growth-rate-in-china/ (accessed 14/11/2019).

[3] The economic reforms involve nearly every dimension of economic activities and have direct or indirect impact on the enterprise operation. Owing to the scope limitation of this study, it will only discuss the reform measures regarding enterprise organization.

[4] From 2002 to 2011, the total volume of imports and exports increased from 620.77 to 3 641.86 trillion US dollars, at an average annual growth rate of 21.7%. From 2009, China has ranked the second largest economy in foreign trade volume globally. See more information on the official website of General Administration of Customs of the PRC http://www.customs.gov.cn/publish/portal0/tab48022/info393418.htm (accessed 14/11/2019).

[5] Fortune Global 500 ranks companies by total revenue in the fiscal year. See the 2018 list on http://fortune.com/fortune500/list/ (accessed 14/11/2019).

[6] This argument has its evidence at the policy level. A special government fund was set up to support technological innovations of STFs (small technology-based firms) 科技型中小企业技术创新基金 The typical cases are available at http://www.innofund.gov.cn/2/dxal/list.shtml (accessed 14/11/2019).

[7] See, one news report about Alibaba's IPO in the US stock market on http://www.reuters.com/article/2014/09/22/us-alibaba-ipo-value-idUSKCN0HH0A620140922 (accessed 14/11/2019).

[8] See *infra* Section 3.3 for elaboration of these dynamic features of China's enterprise sector.

assumption among corporate participants.[9] In a practical sense, the enterprise legislation and policies are not entirely unified in China even though efforts have been made to level the playing field for all market players.[10] Many official reports and statistics adopt the ownership standard to evaluate economic performance and economic contribution of each type of enterprise.[11]

State-owned enterprises (SOEs)

In the central planning era (1956-1978), only public ownership (*gongyou*) was recognized as conforming to socialist ideology, and therefore legally confirmed. Based on public ownership, only two types of enterprises existed at that time: the SOEs and the collectively owned enterprises.[12] In contrast, any economic entity privately owned was incongruous in that era.

The SOEs are nominally owned by the entire population of China.[13] The state claims to exercise ownership on behalf of all people, and the SOEs are actually controlled by government agencies. Individual citizens are not entitled to any interest or dividends arising from the nominal ownership of the SOEs.

As the focal point of the policy agenda, the SOEs have undergone a series of reforms after the launch of the Opening-up and Reform policy (from 1978 to the present). One major change is that after gradual and marginal privatization, the SOEs nowadays are defined by whether the government, either local or central, has actual control. The other change is the emergence of giant SOE groups or the SOE conglomerates that have

[9] See *supra* note 25 in Chapter 2.
[10] Donald C. Clarke, 'Legislating for a Market Economy in China', (2007) 191 *The China Quarterly*, pp. 579-581.
[11] See *infra* Section 3.3.
[12] The Constitution of the PRC has defined the economic system and emphasized the status of the state-owned economy.
Article 6. The basis of the socialist economic system of the People's Republic of China is socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people…
Article 7. The State-owned economy, the sector of the socialist economy under the ownership of the whole people, is the leading force in the national economy. The State ensures the consolidation and growth of the state-owned economy.
See the currently effective version and previous versions of the Constitution of the PRC at http://law.wkinfo.com.cn/document/show?collection=legislation&aid=MTAxMDAwMDAwNjU%3D&showType=0 (accessed 27/11/2019).
[13] *Ibid*., Art.7.

occupied such crucial industries as energy, banking, telecommunication, infrastructure construction, and national securities.[14]

Collectively owned enterprises (or Collective enterprises)

Collectively owned enterprises refer to enterprises jointly owned by a particular group of people, usually the residents in the community or the workers in the enterprises. Collective ownership means that one particular group of people share the profit as well as the means and raw materials of production.[15] However, it is not possible to proportion collective ownership to individuals, who in turn, cannot transfer their shares freely.

Unlike SOEs, mostly located in urban areas, collective enterprises are pervasive in rural areas such as towns and villages. For this reason, township and village enterprises (TVEs) are often used to represent collective enterprises.[16] The villagers elect their committees to govern public affairs within the community,[17] and therefore, villagers' committees play an active role in managing the TVEs. The workers in the urban collective enterprises jointly own their enterprises and have internal bodies, *i.e.*, employees' congress, to exercise control.

In the 1980s, collective enterprises outperformed the SOEs and became the engine of economic growth in China. Such economic success attracted scholars accustomed to

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[14] For the organization structure within the SOE groups and the party-state control, see Li-Wen Lin and Curtis J. Milhaupt, 'We Are the (National) Champions—Understanding the Mechanisms of State Capitalism in China', (2013) 65-4 *Stanford Law Review*, pp. 697-732.

[15] See *supra* note12, The Constitution Law of the PRC,
Art. 8 'Rural collective economic organizations implement a two-tier system that combines unified and separate operation on the basis of household contracts. The various forms of the rural co-operative economy, such as production, supply and marketing credit and consumers' co-operatives, belong to socialist economy sector under the working people's collective ownership. Working people who are members of rural economic collectives have the right, within the limits prescribed by law, to farm private plots of cropland and hilly land, engaged in household side-line production and raise privately owned livestock.
The various forms of co-operative economy in cities and towns, such as those in the handicraft, industrial, building, transport, commercial and service trades all belong to the socialist economy under collective ownership by the working people.
The state protects the lawful rights and interests of the urban and rural economic collectives and encourages, guides, and helps the growth of the collective economy.

[16] TVEs Law of PRC (1996), available at http://www.gov.cn/banshi/2005-06/01/content_3432.htm (accessed 21/11/2019).

[17] The villagers' committee is a grass-root autonomous organization in China, in charge of affairs concerning the land use and the distribution of other assets collectively owned by all villagers. Accordingly, the villagers' committee plays an active role in TVEs collectively owned by their villagers. See the Organic Law of Villagers' Committees of the People's Republic of China http://www.china.org.cn/english/government/207279.htm (accessed 21/11/2019).

traditional property rights, to explore how the obscure property right and hybrid form of organization achieve success.[18]

Foreign-invested enterprises (FIEs)

To attract foreign investment, the Chinese central authority launched the Opening-up policy in 1978,[19] and gradually established a separate system of laws and regulations for enterprises with foreign investment.[20] At the outset, foreign investors tended to co-operate with local partners via joint ventures either by contract or by equity to enter this new market. When foreign investors became more familiar with the market environment and cultural differences, they began to opt for wholly foreign-owned enterprises.[21] In other words, the enterprises wholly or partially owned by individuals or entities outside the People's Republic of China (PRC) are FIEs.

On the one hand, the FIEs have enjoyed ultra-national treatment in the areas of income tax, land use, and project approval procedure for almost three decades. On the other hand, the government authority controlled the inflow of foreign direct investment through a series of examination and approval procedures. In recent years, the government has adjusted the regulatory framework to ensure the equal treatment of domestic and foreign investment and has selectively liberalized market entry to foreign investment.[22]

Private enterprises

Private enterprises, in this thesis, only refer to those owned and run by domestic private parties, excluding the FIEs. This delimitation is also consistent with the use of the terms 'private sector' and 'private economy' in the policy circulars and official documents in China. Private business in any form was not permitted in the central planning era (1956-

[18] See, for instance, Martin L. Weitzman and Xu Chenggang, 'Chinese Township-Village Enterprises as Vaguely Defined Cooperatives', (1994) 19 *Journal of Comparative Economics*, pp. 121-145;
David Li, 'A Theory of Ambiguous Property Rights in Transition Economies: The Case of the Chinese Non-State Sector', (1996) 23-1 *Journal of Comparative Economics*, pp. 1-19.

[19] See *infra* note 37.

[20] See Peter Howard Corne, *Foreign Investment in China: The Administrative Legal System* (Hong Kong: Hong Kong University Press, 1997).

[21] Ken Davies, 'China Investment Policy: An Update', (2013) OECD Working Papers on International Investment, OECD Publishing http://www.oecd-ilibrary.org/finance-and-investment/china-investment-policy_5k469l1hmvbt-en (accessed 21/11/2019).

[22] The negative list of the accessible markets for foreign investment, first tested in Shanghai pilot free trade zone, and is currently applicable nationwide. The FIEs do not need to go through pre-approval procedure any more to engage in the sectors out of the negative list. In December 2016, the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM) issued Revised Draft Foreign Investment Industrial Guidance Catalogue (seeking public comment), available at http://www.ndrc.gov.cn/yjzx/yjzx_add.jsp?SiteId=122 (accessed 21/11/2019).

1978). When the economic reform was adopted, the private economy gradually gained legitimacy but still endured long-term policy suppression. Nevertheless, the growth has been explosive due to the strong market adaptability.

Table 3.1 illustrates the number and distribution of the enterprises of different types by the end of 2017. The number of private enterprises has increased to a total of 16,204,143, accounting for 89.53 % of the enterprise sector. In sharp contrast, SOEs, collectives, and foreign-funded enterprises occupy small fractions of 1.80%, 1.38%, and 1.24%, respectively. Notably, 6.05% of all enterprises do not have controlling shareholders, falling in the group of other enterprises.

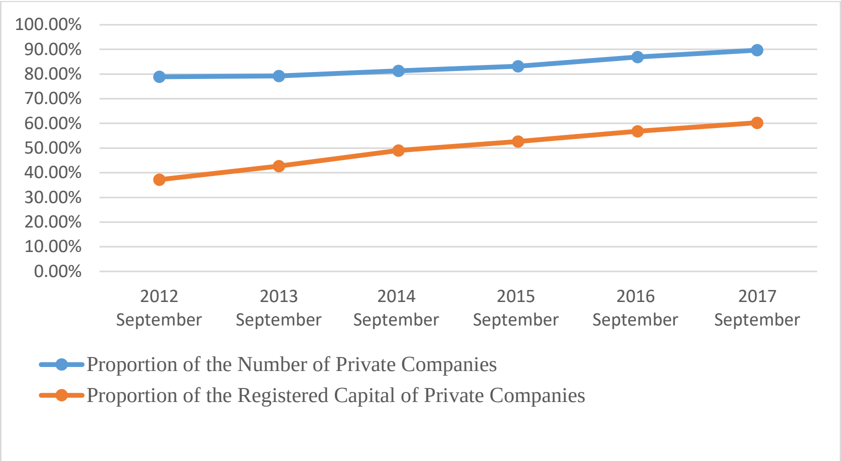
Table 3.1 Number of China's Enterprises by Ownership Standard (2017)

Number of Enterprises	State-holding	Collective-holding	Private-holding	Foreign-holding	Others
18 097 682	325 800	249 946	16 204 143	224 731	1 093 062
100%	1.80%	1.38%	89.53 %	1.24%	6.05%

Source: China Statistical Yearbook, 2018, Table 1-7, http://www.stats.gov.cn/tjsj/ndsj/2018/indexeh.htm.

The other recent set of data, issued by the regulatory authority in charge of registration of enterprise establishment, shows that private business has been growing fastest by measurement of numbers and registered capital in aggregate. In particular, the number of private companies has increased 146.0% and the registered capital of the private companies has increased 454.7%, from 2012 September to 2017 September. Consequently, the proportion of private enterprises in the whole enterprise sector has been continuously rising (See Figure 3.2).

Figure 3.2 Proportion of Private Companies to all Companies (2012-2017)



Source: 'Analysis into the Development of Market Players from 2012 to 2017' by State Administration for Market Regulation of the PRC.

3.2.2 Legal Forms

There is a dichotomy of legal forms for enterprises in Chinese civil law.[23] One group is enterprise legal persons; the other group is comprised of firms that do not enjoy the legal status independent from their investors. Enterprise legal persons have their own assets and funds, independently enter into contracts, and assume civil liabilities to the extent of their assets and funds. In 1994, the first Company Law came into force, introducing modern corporate form. Obviously, companies enjoy independent legal personalities, and hence, are called company legal persons. In practice, companies register with the local government authority and obtain the 'business licence for an enterprise legal person'. The latter group of business enterprises includes individual industrial and commercial entities, individual proprietorship enterprises, and partnership enterprises. Usually, investors are jointly and severally liable for these firms' debts. Only limited partners in partnership enterprises assume limited liability as do shareholders in companies; however, they do not have the statutory control power, as do the general partners.[24]

Nowadays, a vast majority of enterprises has been established as companies. According to the official statistics, 2,368,950 enterprises were registered as limited liability companies

[23] Chapter III Section 2 Enterprise as Legal Person in 民法通则(General Principle of the Civil Law of the PRC) The 'General Principle of the Civil Law' is equivalent to the general principle in Civil Code.
[24] Partnership Enterprise Law of the PRC (2006 revision), Chapter III Limited Liability Partnership Enterprises http://www.lawinfochina.com/display.aspx?lib=law&id=5428#menu8 (accessed 12/11/2019).

(LLC) in 2017, 151,259 registered as companies limited by shares (CLS).[25] The LLCs and the CLSs have common legal features: (1) independent legal personality; (2) investors' limited liabilities; (3) transferability of shares; (4) mandatory two-tier board structure. The major differences between the LLCs and the CLSs, in legal texts, used to be the registration requirement, *i.e.*, the capital threshold and the number of shareholders. The statutory minimum amount of capital and the quorum of shareholders of the LLCs were both smaller than those of the CLSs. In 2014, the minimum capital contribution was annulled.[26] Capital contribution is not the yardstick to distinguish LLCs from CLSs. Besides, a CLS can raise funds by issuing shares to a certain group of people and the shareholders of a CLS can freely transfer their shares to a third party. The listed companies are sub-type of the CLSs who offer and issue shares to the public in stock markets and whose shares are traded in stock markets.

Nevertheless, the LLCs are suitable for relatively small businesses. The organizational structure can be more flexible. Several investors with mutual trust start their business. If one shareholder of an LLC wants to transfer his or her shares, he or she ought to inform other shareholders of the share transfer first. Subject to the same terms and conditions of the transfer, other shareholders have priority over any third party outside the LLC to purchase shares.[27]

The CLSs are devised to raise capital from a wider scope of investors, including getting listed in the securities market. The capital of a CLS is divided into shares and each share has equal value and an equal vote. How much capital one shareholder contributes is calculated in the number of shares he or she holds. In this way, it is feasible to have enormous investors joining the firm with clear statutory rules of voting rights and interests. Concomitant with the shareholding system, the CLSs are required to have a more standardized internal governance structure. Moreover, the listed CLSs are also subject to transparency requirements and many other regulations in order to maintain a well-functioning securities market. According to the recent annual official report by the

[25] The data is from Table 1-8 in 2018 Annual Statistics compiled by the National Bureau of Statistics of China http://www.stats.gov.cn/tjsj/ndsj/2018/indexeh.htm (accessed 12/11/2019).
[26] See *infra* no. 27 in Chapter 4.
[27] See Art.71 the Company Law of PRC (2014).

securities authority, by the end of 2017, 3,485 companies have been listed on the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE).[28]

3.3 Historical Review of Enterprise Development

Against the backdrop of economic transition, the evolution of the enterprise sector demonstrates the following characteristics. First, the enterprise evolution is closely inter-related with the fiscal reforms, industrial policies and market development. Second, the enterprise sector exemplifies China's overall transitioning pattern, government-oriented, gradual, and experimental.[29] Consequently, different regions and areas have been undergoing varying stages of transformation, and regional variation is expanding.[30] Third, with market forces such as price, property right, and competition becoming stronger, the spontaneous transformation at enterprise level has begun to echo with the top-down approach, calling for further policy initiatives.[31] This section traces the development of each type of enterprise and aims to reveal the legacy that persists among today's companies. This section will also briefly examine the institutional changes and reform policies that have direct and important impact on changes in enterprises.

3.3.1 SOE Reforms

The evolution of the SOEs is mainly shaped by the reform policies. These policies, on the one hand, touch upon the dimension of internal governance to improve the efficiency and competitiveness of the SOEs. On the other hand, efforts were made, for example, to adjust the industry distribution, relieve the burden of overhead, and propel moderate privatization. To identify organizational features of the SOEs, this section focuses more on the former aspect and divides the reform process into two stages: primitive attempt and corporatization.

3.3.1.1 Prior to the reforms

[28] See 2017 Annual Report of the CSRC, available at http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb/201809/P020180907609864959832.pdf (accessed 22/11/2019).
[29] Linda Yueh, *Enterprising China—Business, Economic & Legal Development since 1979*, (New York: Oxford University Press, 2011), p. 4.
[30] Victor Nee, 'Organizational Dynamics of Market Transition: Hybrid Forms, Property Rights, and Mixed Economy in China', (1992) 37-1 *Administrative Science Quarterly*, pp. 1-27.

[31] Xu Chenggang, 'The Fundamental Institutions of China's Reforms and Development', (2011) 49 *Journal of Economic Literature*, pp. 1076-1151.

From 1949 to 1978, the newly established People's Republic of China (PRC) followed a central planning system, in which the central government allocated and coordinated supply and demand. Administrative fiat was the sole means to organize economic activities. The SOEs were merely units affiliated to the government agencies, manufactured the designated quotas of products or services, and provided welfare to their employees with assigned inputs and capital. In general, the regulatory function, enterprise management, and sustaining social welfare were mixed and distorted in this period.[32]

For each major industry, one bureau of authority was instituted at the central level. The bureau authority and its local branches coordinated upstream and downstream enterprises within the industry, and were in charge of the nomination and evaluation of the SOEs' leaders. The state, as a whole, seemed like a large firm in which each enterprise was only a production unit under the direction of the central authority.[33]

At the same time, the SOEs assumed heavy policy burdens. One was to maintain urban employment; the other was to provide a wide range of social welfare to labourers. Large and medium-sized SOEs provided housing, medical care, and education to their staff, amounting to 'cradle-to-grave benefits'.[34] Employees in the SOEs earned equal wages regardless of the quality and quantity of their work. Moreover, they had no fear of losing their jobs because of idleness or lack of skills, and therefore, a job in an SOE was akin to having an 'iron rice bowl'. In this regard, economic incentives are not key factors to motivate the devotion and diligence of ordinary employees.

Similarly, the leaders in the SOEs were not concerned with maximizing profit but mainly fulfilling the output targets, as enterprise revenue was not a criterion in evaluating their performances. Other major tasks included coordinating the relationship between cadres and employees and earning appreciation from senior authorities, mostly the government agency. The leaders of the SOEs were virtually government officials and Party cadres. These aspects were more decisive for their promotion to a more politically powerful position. The enterprise culture at that time was bureaucratic and ideological,[35]

[32] Barry Naughton, 'Hierarchy and the Bargaining Economy: Government and Enterprise in the Reform Process' in David M. Lampton (ed.), *Bureaucracy, Politics, and Decision Making in Post-Mao China* (Berkeley: University of California Press, 1992), pp. 245-279.
[33] Donald Clarke, 'Corporate Governance in China: An Overview', (2003) 14 *China Economic Review*, pp. 494-507.
[34] Hua Jinyang, Paul Miesing, and Li Mingfang, 'An Empirical Taxonomy of SOE Governance in Transitional China', (2006) 10 *Journal of Management Governance*, p. 403.
[35] Theodore Groves, Hong Yongmiao, John Mcmillan, and Barry Naughton, 'Autonomy and Incentives in Chinese State Enterprises', (1994) 109-1 *The Quarterly Journal of Economics*, pp. 183-209.

and the ideologist indoctrination played a far more important role in motivating the staff to reach production goals than economic rewards.[36]

3.3.1.2 Reforms in managerial autonomy (1978-1992)

The central planning system established major industries from scratch. However, the low efficiency of the SOEs and the state deficit were quite severe. Moreover, a ten-year political campaign—the Cultural Revolution—exacerbated the political control and ideology block, leading to a stagnation of the overall economic system and societal chaos. Confronted with intense economic and social pressure, the Communist Party of China (CPC) announced the commencement of economic reforms at its Third Plenum of the Eleventh Central Committee in 1978,[37] and from then on, the nation entered a new era.

With regard to the SOEs, extensive efforts were made to devolve managerial power from government agencies to enterprises from 1978 to 1992. At inception, the SOEs began to gain decision-making power over business matters that were explicitly listed in the administrative regulations.[38] Moreover, the SOEs were permitted to produce more than the designated quota and to retain the profit from such extra output; meanwhile, the designated quotas were maintained at low levels. On the margin, SOEs began reacting to the market forces. This strategy was aptly termed the 'growing out of plan'.[39] From 1983, the SOEs did not need to submit profits to the government but pay income tax, and could accumulate the net profit as an enterprise fund.[40]

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[36] Oiva Laaksonen, 'The Management and Power Structure of Chinese Enterprises during and after the Cultural Revolution; with Empirical Data Comparing Chinese and European Enterprises', (1984) 5-1 *Organization Studies*, p. 5.

[37] The Third plenum of the Eleventh Central Committee of the CPC declared that the goal of the central authority should be shifted from political struggle to economic development. To this end, a series of policies were subsequently issued and summarized under the umbrella term 'Economic Reform and Opening-up' policies, which have turned a new page in China's development and paved the way for continuous economic growth.
More information about the original version of resolution at this meeting is available at http://cpc.people.com.cn/GB/64162/134580/134581/ (accessed 10/11/ 2019).

[38] In 1979, the State Council issued 关于扩大国营工业企业经营管理自主权的若干规定(Regulations on Expansion of Autonomous Managerial and Operational Power of the State-owned Industrial Enterprises) wherein production and sales, internal governance structure, employees recruitment, fund use, and refusal of political apportionment were all recognized as the realm of enterprises' autonomous power.

[39] Barry Naughton, *Growing out of the Plan: Chinese Economic Reform 1978-1993* (Cambridge: Cambridge University Press, 1995).

[40] In 1983, the State Council approved 关于国有企业利改税的试行办法 (Promoting Measures of Replacement of Profit Submission with Tax Payment) drafted by the Ministry of Finance. All the large and medium-sized SOEs would pay the enterprise income tax at the rate of 55% of profit. After-tax profit, if still large, could be distributed between the enterprise and its superior authority, or could be paid as adjustment tax to the government.

To boost enterprise vitality, in 1984, the CPC asserted that the SOEs should be independent of the government and responsible for their own profits and losses.[41] A series of attempts were made through the 1980s to delineate the relationship between the government and SOEs, including 'contract-based responsibility system' and 'shareholding system'.

The contract-based responsibility system drew up an operational contract between the government agency and one SOE. In the legal sense, the SOEs started to have an independent legal personality, termed as 'enterprise legal persons'.[42] The government authority was the owner of the state-owned assets and the SOE was in charge of running the assets. The operational contract between the state and the SOEs was the embryonic form of separation of ownership and control in China's enterprises. This contract set forth the scope of managerial power, profit distribution between the government and the enterprise, and other matters. The SOEs were obliged to perform their duties according to the contract.

To ensure the execution of the operational contract, the general manager of an SOE was held responsible for the enterprise's performance. The general manager took on sole leadership and had the final decision-making power, while internal committees and production departments would simply provide information and consultancy to the general manager. This is also recognized as one-man management.[43]

The major responsibility of the SOEs was to ensure profit making and submit the stipulated portion of profit to the government agency. Failing to do so in one year, the SOEs had to pay the difference from the next years' profit. However, a prominent problem emerged. What would be the base line of profit submission? This issue provoked continuing disputes between the SOEs and government agencies. When an SOE made greater profits in consecutive years, the government authority tended to increase the ratio

[41] The Third Plenum of the Twelfth Central Committee of CPC promulgated 'CPC's Resolution on the Economic System Reform', which laid down the guiding principles for reform measures in major areas, and in particular, emphasized the focus of the SOEs reforms.
'The significant part of economic reform is to advance SOEs' vitality, especially the large and medium-sized SOEs. Administrative authorities should be segmented from the management of SOEs. The SOEs will be independent in operation and responsible for their own profits and losses. Enthusiasm, initiatives, and creativity of production should be sufficiently encouraged on parts of the SOEs.' The full text of the Resolution is available on the CPC's official website, http://cpc.people.com.cn/GB/64162/134902/8092122.html (accessed 21/11/2019).
[42] See *supra* note 23 in this chapter.
[43] Wang Baoshu and Cui Qinzhi,论国营企业厂长的法律地位 (Argument on the Legal Status of General Manager of SOEs), (1984) 5 法学研究(*Chinese Journal of Law*), pp. 49-56.

of profit to be turned over. This means that the more outstanding the performance of an SOE, the heavier their burden would be. Taking Capital Steel as an example, its profit was continuously increasing. The government authority adjusted the ratio of turned-over profit several times, from 5% to 6.2%, and finally to 7%. Capital Steel did not accept the ratio adjustment. Regardless, the Beijing Finance Bureau directly subtracted around 100 million CNY from the bank account of Capital Steel as profit submission.[44] Conversely, it could also be possible that an enterprise, suffering continuous losses, was unable to make up for the gaps in previous years.[45]

The other problem was the rampant management wrong-doing. The role and function of general managers were closely regulated; however, the liability or extra-legal consequences they would assume for the losses to the enterprise caused by their improper performance of the function was unclear. Besides, the operational contract was for a fixed term of several years. The general managers were encouraged not to pursue long-term goals for the enterprises in case of major changes after the expiration of the operational contract.[46] Making small gains at large or future cost, speculative investment, asset stripping, and diversion of enterprise funds to the managers' personal pockets was frequent. Meanwhile, the remaining government intervention hindered efficient business decision-making. This range of problems has been depicted as 'insider control under administrative intervention'.[47] In 1993, the central authority accordingly called a halt to the contract responsibility system.

In parallel, some SOEs started to issue shares to raise funds as early as 1983, despite political reticence and ideological constraint.[48] For one thing, the idea that private parties would hold shares of the SOEs was simply not ideologically compatible with socialism and

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[44] 国企股份制改革：风雨三十年 (Shareholding Reform of SOEs: Three Decades Trails and Hardship) in 中国改革论坛网 http://www.chinareform.org.cn/economy/enterprise/Practice/201112/t20111202_129053.htm (accessed 20/11/2019).

[45] Anthony Y. C. Koo, 'The Contract Responsibility System: Transition from a Planned to a Market Economy', (1990) 38-4 *Economic Development and Cultural Change*, pp. 797-820.

[46] Wang Yanlin and Tian Yinzhi, 关于厂长负责制的若干问题 (Several Issues on Management Responsibilities System), (1986) 2 法学评论 (*Law Review*), pp. 44-47.

See also Harry G. Broadman and Geng Xiao, 'The Coincidence of Material Incentives and Moral Hazard in Chinese Enterprises', Development discussion Paper No. 606, Harvard Institute for International Development, Harvard University.

[47] Zhang Weiying, 'China's SOE Reform: A Corporate Governance Perspective', Institute of Business Research Working Paper, No. 1998 E04, Peking University.

Qian Yingui, 'The Institutional Foundation of China's Market Transition', World Bank Annual Conference on Development Economics in April.

[48] In 1983, Shenzhen Bao'An United Investment Enterprise with shareholding system was established.

the state-owned economy. For another, the SOEs did have a pressing need of capital, since their source of funding was shifted from direct government grants to banking loans.[49] Scholars actively participated in the debate on the nature of the state-owned economy and the control of the SOEs.[50] Meanwhile, experiments in the shareholding system were carried out in pilot enterprises and areas.[51] Until 1992, official documents concerning accounting, management personnel and other internal mechanisms of shareholding enterprises were issued to guide the reform experiments.[52]

In 1990, the Shanghai and Shenzhen stock exchanges were established so that the SOEs could issue their shares to the public and have their shares traded in a stock market. In 1992, the securities regulatory authority at the central level—China Securities Regulatory Committees (CSRC) was established. Equivalent to the Securities Exchange Commission (SEC) in the US, the CSRC is in charge of regulating and supervising the issuance and transactions of securities and other related activities in the securities market.[53] Also in this year, nine SOEs were selected and approved for reform into CLSs to be listed onto the Hong Kong stock exchange.[54]

To sum up, the period from 1978 to 1992 saw the breakthrough of a planned economic system and primary transformation of SOEs. Management autonomy was gradually granted to the SOEs; the central authority recognized the necessity of separation between

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[49] See Yi Gang, 'The Intrinsic Logic of China's Banking Industry Reform' in Fang Cai (ed.) *Transforming the Chinese Economy* (Leiden: Brill, 2010).

[50] Li Yining is the first Chinese economist to advocate 'restructuring SOEs into shareholding enterprises'. Li and his colleagues Cao Fengqi and Zhang Guoyou published 怎样组建股份制企业 (*How to Establish a Shareholding Enterprise*) (Beijing: Peking University Press, 1993). He opined, 'the state shareholding system is a new form of state economy'. Wang Jue and Yu Jinfu supported his idea. Hu Jun held an opposing idea that the profit distribution among shareholders and employees was not equal, and accordingly, the socialist system was shaking. The debate was reviewed in a paper: Wang Kejing and Yin Chanjuan, 试论国有企业公司制股份制改革 (The Discussion on Corporate Form and Shareholding Reform of the SOEs), (2008) 6 中央财经大学学报 (*Journal of Central University of Finance and Economics*), p. 3.

[51] 'Three provinces Guangdong, Fujian, Hainan conducted an experiment of issuing shares to the public (not quoted in the stock exchanges) based on the authorities of comprehensive pilot areas. The measures and scale of issuing shares should be approved by the People's Bank of China (China's central bank) and National Committee for Economic System Reform (dissolution of NCESR was in 1997).' in 国务院批转国家体委关于一九九二年经济体制改革要点的通知 (Announcement of State Council Approving and Circulating Notice of Main Points in 1992 Reforming Economic System by NCESR) State Council [1992] No.12, available at http://www.reformdata.org/special/709/about.html (accessed 19/10/2019).
By the end of 1992, 3700 SOEs had become pilot enterprises of the shareholding system.

[52] 股份制企业试点办法 (Experimental Measures on Shareholding Enterprise); 股份有限公司规范意见 (Regulatory Opinions on Companies Limited by Shares); 有限责任公司规范意见 (Regulatory Opinions on Limited Liability Companies).

[53] See *infra* section 5.3.1 for more information pertaining to the CSRC functions.

[54] Ma Qiangquan (ed.), 中国证券史 1979-1998 (*China's Securities History 1979-1998*) 中信出版社 (Beijing: Citic Publishing House, 2003), p. 162.

government and SOEs. The enterprises began to act like commercial entities, pursuing profit and getting adapted to the market environment. Despite the positive impacts of the primitive reforms, many SOEs were still suffering from low efficiency and overhead burdens.

3.3.1.3 Corporatization and advancing corporate governance (1993-present)

In 1992, Deng Xiaoping, the former leader of the CPC, took a southern tour to the pilot provinces and gave a speech to confirm the reform attempts, which heralded a new phase of economic reforms towards a 'socialist market economy'.[55] This idiosyncratic term 'socialist market economy' literarily means a market economy with socialist characteristics, indicating the retained component of public ownership in a market environment. A perceptive comment is that 'establishing market institutions was less of an end itself, but a means to achieve economic growth and realize social stability'.[56] Others observed that this term reflected the pragmatic but cautious attitude of the central authority towards market economy.[57]

At the enterprise level, a major concern that remains is whether SOEs can survive and perform better in a market. In 1993, the 'modern enterprise system' (*xiandai qiye zhidu*) was proposed as the new trend of the SOEs reforms.[58] In the same year, the first Company Law was enacted and its primary goal was to facilitate the corporatization of the SOEs.

The modern corporate form endorsed by the central authority is to reach two ends. First, corporatized SOEs would realize the separation of the government and the enterprises. It is conceived that the government agency plays the role of a shareholder while the company's internal governance organs undertake the business operations. To separate regulatory functions and the shareholding role, the distinct agency—the State-owned Asset

[55] In 1992, Chairman Jiang Zemin delivered a message at the 14th National Congress of the CPC. This congress essentially summarized the 14 years of practical experiences after the commencement of economic reforms in 1978. More information is available at http://news.xinhuanet.com/ziliao/2003-01/20/content_697129.htm (accessed 19/10/2019).

[56] OECD (2000): Reforming China's Enterprises, p. 10.

[57] Barry Naughton, 'A Political Economy of China's Economic Transition', Loren Brandt and Thomas G. Rawski (eds.), *China's Great Economic Transformation* (Cambridge: Cambridge University Press, 2008), pp. 94-97.

[58] In 1993, the Third Plenum of the 14th Central Committee of the CPC was held. This meeting announced a series of decisions regarding the establishment of a socialist market economy. The full version of the CPC document 'Decisions on Several Issues Concerning the Establishment of a Socialist Market Economy' is available at http://cpc.people.com.cn/GB/64162/134902/8092314.html (accessed 21/10/2019). Among others, 建立现代企业制度 'establishing modern enterprises' was strongly highlighted and conceptualized with four components: 'explicitly stipulated property right, clearly defined rights and duties, separation of government and enterprise, and scientific management'.

Supervisory and Administrative Committee of the State Council (SASAC) was established in 2003. The branches of the SASAC have been set up at local levels in the provinces and large municipalities. In case of large company groups, the holding company plays the role of equity owner and becomes the parent company of the subsidiaries. This means that state shares are currently held by government agencies or the state-owned asset holding companies.

The second objective is to promote best management practices and eventually advance enterprise efficiency. In accordance with the Company Law, the corporatized SOEs must establish the mandatory governance structure—two-tier board under shareholders (general) meeting in place of the general managers' responsibility model in the previous reform stage. Moreover, in 2004, the SASAC launched an innovative pilot program among the central SOEs to standardize the executive boards and enhance board effectiveness. The pilot program extensively covers the diversity of board composition, the selection and nomination of professional managers, and the board function.[59] For some large SOE groups, the executive boards are required to have outside directors to provide independent and professional opinions as to business operation. In addition, specialized committees are instituted for performing key functions professionally, including the audit committees, strategy committees, ethics committees, and remuneration committees.[60]

To promote management expertise in the boards, the SASAC often holds management skills training for the SOEs' directors.[61] Regular communication between the government agents and the directors in the central SOEs is facilitated. Under the frequent informal inspection of the SASAC, the SOEs, especially the listed ones, and those at the central level, have moved rapidly to standardize their governance mechanism, at least in terms of formality and resolution procedure.

[59] In 2004, the SASAC issued 关于中央企业建立和完善国有独资公司董事会试点工作的通知(The Notice on Pilot Works of Establishing and Improving Board of Directors in Wholly State-owned Companies in Central Enterprise Group) , and the pilot program commenced pursuant to this regulation. By the end of 2015, 85 central SOEs have joined this pilot program. See a news report by official media: 85 家中央企业纳入建设规范董事会试点(85 Central SOEs Join Pilot Program of Establishing Standard Board of Directors), http://news.xinhuanet.com/fortune/2015-12/15/c_1117470345.htm (accessed 15/10/2019).

[60] *Ibid.*

[61] Relevant information and the reports of professional training are available at http://www.sasac.gov.cn/n1180/n6881559/n10281480/index.html (accessed 15/10/2019).

Apart from the efforts to enhance management efficiency, in 2013, a new round of mixed ownership reforms began strengthening the monitoring by non-state investors.[62] It is contemplated that the diversification of ownership would effectively lift insider control, since private and foreign investors may have stronger incentives to monitor insiders. Yet, non-state parties are concerned with the protection of their interests against the expropriation of state controlling shareholders. Some commentators argue that the success of mixed ownership reforms is essentially counting on whether the state virtually cedes control of the SOEs.[63]

Indeed, the concept of equity stakes jointly held by the state party and non-state party is not new. Since the late 1990s, private and foreign investors have already joined in some SOEs due to the implementation of other enterprise policies.[64] The line between the private sector and state sector is now blurred. The indirect influence of the government also extends as far as the large non-state enterprises. Thus, despite the privatization of central SOEs, government control may not diminish.[65] The progress of the new reform moves and their anticipated results remain to be observed in the years to come.

3.3.2 Rise and Fall of the Collective Enterprises

In China, collective ownership is rooted in rural areas. The villagers in a community jointly own the land and the villagers' committee is responsible for land use and the organization of agricultural production. In the central planning age, villagers were organized into communes or brigades, and they collectively owned product materials as well as the land,

[62] Chairman Xi Jinping endorsed the notion of mixed ownership reform at the Third Plenum of the 18th Chinese Communist Party in 2013. The State Council issued 国务院关于国有企业发展混合所有制经济的意见 (Opinions on the Development of Mixed Ownership among SOEs) in 2015 and this regulatory document enlightens local governments, ministries and commissions on advancing diversification of ownership structure in SOEs, available at http://www.gov.cn/zhengce/content/2015-09/24/content_10177.htm (accessed 15/10/2019).
[63] Marshall W. Meyer and Changqi Wu, 'Making Ownership Matter: Prospects for China's Mixed Ownership Economy', Paulson Policy Memorandum, September 2014, p. 2. http://www.paulsoninstitute.org/wp-content/uploads/2015/04/PPM_Making-Ownership-Matter_Meyer-and-Wu_English.pdf (accessed 16/11/2019);
Curtis J. Milhaupt and Wentong Zheng, 'Why Mixed Ownership Reforms Cannot Fix China's State Sector', Paulson Policy Memorandum, January 2016, p. 2. http://www.paulsoninstitute.org/wp-content/uploads/2016/01/PPM_SOE-Ownership_Milhaupt-and-Zheng_English.pdf (accessed 16/11/2019).
[64] For instance, the policy 'grasping the large; letting go of the small' (*zhuada fangxiao*) was implemented to adjust the overall structure of the state-owned assets. Those small, local, and financially distressed SOEs were sold to private businessmen. With regard to foreign investment, the primitive stage at the inception of the Opening-up Policy was to establish joint ventures with SOEs. Since 2002, foreign institutional investors obtain approval by China's regulatory authority to invest in the listed companies.
[65] Fayuan Liang, '新一轮国企改革中如何发展混合所有制经济' (How to Develop Mixed-ownership Economy in the New Wave of SOEs Reform), (2014) 2 企业研究 (*Business Research*), pp. 77-79.

undertook agricultural production altogether, and shared the output equally. To implement the policy of rural industrialization, some communes started to run small-sized enterprises, engaged in processing agricultural by-products and other related business. Because their products and services were able to fill in the supply gap left by the industrial SOEs, the annual growth rate of the commune and brigade enterprises was 25.7% in the period of 1970 to 1976.[66]

The economic reform has brought about a fundamental change in the rural areas since 1979. The commune production system was replaced by the household responsibility system, which retained collective ownership but allocated production to individual households. Consequently, this boosted the efficiency of agricultural production significantly, by increasing incentives of individual families generously. More labourers were released from farming and family savings became possible.[67] Under these hospitable conditions, the TVEs gained momentum to grow rapidly, and their proportion in the annual national industrial output increased from 9% in 1978 to 27% in 1993, and reached approximately 60% in 1999.[68]

Some scholars compared the SOEs and the TVEs and unravelled the reasons for the TVEs outperforming the SOEs during the late 1980s to 1990s.[69] Firstly, the TVEs enjoyed political endorsement but without too much government intervention. In such a favourable position, the TVEs were able to organize their production and formulate their development roadmap in a flexible manner. Some TVEs have become the suppliers of auxiliary products and services to what SOEs produced, or filled in market niches left by large SOEs.[70] Second, the TVEs had a better incentive structure. The entrepreneurs, usually the leaders of the villagers' committees, had one single goal, to maximize the welfare of all the residents in their villages.[71] When many of the villagers were participating in the production of the

[66] William A. Byrd and Qingsong Lin, 'China's Rural Industry: Structure, Development, and Reform' 1990 A World Bank Research Publication, The Oxford University Press, p. 10.
[67] Fan Gang and Chen Yu, ' "过渡性杂种"：中国乡镇企业的发展及制度转型' ('Transitional Hybrid': Development and Institutional Transformation of China's Township and Village Enterprise), 2005 4 (3) 经济学(季刊) (*China Economics Quarterly*), p. 948.
[68] Jinhua Che and Yingyi Qian, 'Institutional Environment, Community Government and Corporate Governance: Understanding China's Township-Village Enterprise' working paper no. 59 in April 1997, p. 25. The data is originally from the Statistical Yearbook of China, 1993, p. 15 and p. 395.
[69] Gary H. Jefferson and Thomas G. Rawski, 'Enterprise Reform in Chinese Industry', (1994) 8 *Journal of Economic Perspectives*, pp. 47-70.
[70] The success of TVEs in the southern part of Jiangsu Province was aptly termed as the 'Southern Su Model' (Su nan Model).
[71] Hongyi Chen and Scot Rozelle, 'Leaders, Managers, and the Organization of Township and Village Enterprises in China', (1999) 60 *Journal of Development Economics*, pp. 529-557.

TVE, the enterprise's profit became directly and positively related to the villagers' interests, and the goal of maximizing the TVE's profit was consistent with the aim of the villagers' committees. On the contrary, the leaders in the SOEs had stronger political incentives than economic ones. Third, privileges in terms of land use, bank loans, and market access, which the SOEs enjoyed, were somehow available to the TVEs. The villagers' committee played an important role during an era of underdeveloped market institutions.[72] The leaders of villagers' committees served as a bridge between the local government and the TVEs, and hence, the TVEs could gain specific support at the local policy level.[73] Moreover, the connection with local government also made obtaining loans from rural credit co-operatives or the local bank branches feasible.[74]

However, the number of TVEs and their share of annual national output were declining in the approach to the 21th century. The TVEs have gradually lost their comparative advantages.[75] First, when the market institutions took shape and private enterprises gained more development room, the semi-government background of the TVEs turned out to be not as meaningful as before. Second, the tax preferential policy adopted by the local government was revoked due to the fiscal reforms.[76] Bank loans began to flow into private enterprises that were more promising because they could provide solid collateral. In contrast, the community assets were not readily transferrable.[77] Third, the vaguely defined property right and obscure boundary between the TVEs and villagers' committee in the competitive market appeared less efficient and even obsolete.[78]

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[72] Qiucheng Tan, 转型时期乡村组织行为与乡镇企业发展 (Organizational Conduct of the Villagers' Committees and the Development of Township and Village Enterprises in Transitional Age), (2003) 3 中国社会科学 (*Social Science in China*), pp. 72-73.

[73] Anthony Ody, 'Rural Enterprise Development in China, 1986-1990', World Bank Discussion Paper, No. 162, World Bank, Washington, DC.

[74] Albert Part and Minggao Shen, 'Joint Liability Lending and the Rise and Fall of China's Township and Village Enterprise', (2003) 71 *Journal of Development Economics*, p. 500. This paper also uses data to show that bank loans financed a great majority of TVEs on p. 502.

[75] Ho, Samuel, Paul Bowles, and Xiaoyuan Dong, 2000, 'Letting Go of the Small: the Political Economy of Privatizing Rural Enterprise in Shandong and Jiangsu,' Hongbin Li, 'Property Right Transformation with a Tail: A Case Study of Successful Reform by a Screening Mechanism in China', Working paper, Stanford, 2000; Eduard Vermeer, 'Shareholding Cooperatives: A Property Rights Analysis' in Andrew Walder and Jean Oi (eds.), *Property Rights and Economic Reform in China* (Redwood city: Stanford University Press, 1999), pp. 123-144

[76] In 1994, China adopted fiscal reforms. The government revenues are classified into three parts: central, local, and shared. Before the reform, the distribution of revenues between the central and local government is at a negotiated percentage or amount, and accordingly, the local government used to have more discretion in implementing taxation policies than after the reforms. See Shouguang Wang, 'China's 1994 Fiscal Reform: An Initial Assessment', (1997) 37 *Asian Survey*, p. 801-817.

[77] See *supra* note 74 in this chapter. P. 501.

[78] See *supra* note 72 in this chapter.

To survive in the increasingly fierce market competition, many TVEs underwent restructuring into the corporate form, to eliminate the inefficient decision-making model. All the villagers, also the owners and employees of the TVEs, had voting rights to decide on business transactions and development strategies. However, villagers were inclined to approve distribution plans that generated more wages. This hindered the accumulation of enterprise funds and the enterprise's long-term development.[79] From 1998 to 2003, in the southern coastal areas, local governments advocated management buyout to privatize the TVEs.[80] The 'vaguely defined' property right, which used to achieve economic success in the transitional period, has been gradually replaced by private property right. The relative weight of the collective enterprises in China's economy is rather light.[81]

3.3.3 Boom of Private Enterprises

Similarly, a sea change has occurred in China's private sector in the last four decades. The central planning age eliminated the private economy. As above discussed, the state government tightly controlled any economic activities, which state-owned and collectively owned enterprises performed. Until the commencement of the economic reforms in 1978, individual self-employed business, in the legal form of individual proprietorship, was permitted. This policy breakthrough was intended to ease the unemployment pressure in the urban areas. Yet, the scale was limited to no more than eight persons in one firm. However, the number of individual proprietorships, from 1978 to 1986, was increasing at a rate of 74.6%. In 1986, there were 1.211 million individual proprietorships with 3.439 trillion CNY registered capital across the country.[82]

In 1987, the 13th Central Committee of the CPC officially recognized the 'private economic sector' as 'a necessary supplement' to the state sector. In the next year, the Constitution of the PRC, for the first time, declared in the amendment that the rights and interests of private economy are under legal protection. However, the lingering suspicion about the legitimacy of private economy in a socialist system was not immediately cast away. Private entrepreneurs took the 'red hats' on their enterprises to avoid the risk of unpredictable political risks.[83] The 'red hat' is a metaphor for the tag of state-owned and collective enterprise. Private business got 'affiliated' to the collective enterprises or SOEs

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79 Fan Gang and Chen Yu, see *supra* note 67 in this chapter, p. 948.
80 *Ibid*., p. 949.
81 See *supra* note 74 in this chapter.
82 The statistic is provided by the State Administration for Industry & Commerce of the PRC and used in the report http://cpc.people.com.cn/n/2012/0828/c64387-18850046.html (accessed 23/11/2019).
83 Victor Nee, see *supra* note 30 in this chapter.

by providing outsourced services. With this 'red hat', private enterprises could survive, expand, and develop in a stable policy environment.

In tandem with the general promotion of further transition to a 'socialist market economy' in 1992, the official document of the CPC and the national Constitution Law continued to upgrade the role of the private sector in the overall economic system in the following decade.[84] The legal framework and regulatory policies accordingly relaxed more room and provided more support for the development of private enterprises. Consequently, the private enterprises eventually embraced a burgeoning era and the private sector has become the most vibrant component of economic development, representing a majority of the GDP, employment, and government revenue.[85] Notably, private enterprises contribute around 70% of economic growth. In the areas of technology innovation and international trade, private enterprises also prevail over SOEs.[86]

In the meantime, private enterprises still face serious impediments to their development: policy bias, limited access to certain industries, heavy burden of tax and fees, inadequate access to finance, and low-level management. According to the official statistics, individual private enterprises, around 60% in all, go bankrupt within five years, and about 85% will do so in 10 years. The average business life span of the private enterprises is only 2.9 years.[87]

3.4 Corporate Governance and Board of Directors

3.4.1 Ownership and Control

3.4.1.1 Ownership structure

It is natural that closely held firms have a limited number of shareholders and are under the control of one or a few shareholders. In China, listed companies have concentrated ownership structure as well. In the early 1990s, when the stock market was new, almost all

[84] Tianli Feng and Guofeng Wang, 'How Private Enterprises Establish Organizational Legitimacy in China's Transitional Economy', (2010) 29 *Journal of Management Development*, pp. 377-393.
[85] For the relevant statistic, see 中国民营经济发展报告(China's Private Economy Development Report), 社会科学文献出版社(Beijing: Social Science Literature Publisher, 2013). For each year since 2006, an annual report is published as a single volume.
[86] The number of the private technology enterprises has increased to about 150,000. In 53 national high-tech development zones, private enterprises account for more 65% of patent applications, and 80% of new products are created by small and medium-sized enterprises, many of which are privately owned. The growing rate of international trade by private enterprises is 19.2 % higher than the average rate of all sectors.
[87] Shenzhen Stock Exchange, (2008) 'Empirical Studies into Development of China's Private Listed Companies'.

listed companies were converted from SOEs. The major goal of setting up a stock market back then was to provide a financing channel, specifically to the SOEs, as an alternative to banking loans.[88] In contrast, the non-state companies, especially private ones, did not gain sufficient opportunities for development, and accordingly, were almost unable to fulfill the listing requirements, such as profits in consecutive years. Even if the listing requirement was reached, non-state companies could barely be allocated with the quota to list shares on the stock market.[89]

To avoid the dilution of government control over the listed SOEs, only one-third of all shares of the listed SOEs were circulated on the stock exchanges, while two-thirds were held by the government entity as state shares, and by the wholly state-owned enterprises (WSOE) as legal person shares.[90] The division of tradable shares (TS) and non-tradable shares (NTS) is called the split share structure, a manifestation of partial privatization in China.[91]

The split share structure resulted in a conflict of interests between the TS holders and NTS holders. Namely, the shares of one listed company are priced differently; the assumption of risks varies among different groups of shareholders; and the dividend policies are completely at the disposal of NTS holders. These problems severely distorted the function of, and inhibited the development of, the stock market.[92] In addition, TS holders were mostly individual investors without sufficient power to curb insider control, and thus, their interests were positioned precariously.

In 2005, the central government launched the split-share structure reform to achieve the full circulation of all shares of listed companies.[93] The major strategy is to offer compensation for the TS holders by the NTS holders. Share trading is suspended during the period of formulating, announcing and approving the compensation plan. To offset the

[88] Weiye Li and Louis Putterman, 'Reforming China's SOEs: An Overview', (2008) 60 *Comparative Economic Studies*, p. 372.
[89] For more information about the quota system in 1990s, see Katharina Pistor and Chenggang Xu, 'Governing Stock Markets in Transition Economies: Lessons from China', (2005) 7-1 *American Law and Economic Review*, pp. 184-210.
[90] For more information about the split-share structure, see Qian Sun and Wilson H.S. Tong, 'China Share Issue Privatization: The Extent of its Success', (2003) 70 *Journal of Financial Economics*, pp. 183-222.
[91] Kai Li, Tan Wang, Yan-Leung Cheung, and Ping Jiang, 'Privatization and Risk Sharing: Evidence from the Split Share Structure Reform in China', (2011) 24-7 *The Review of Financial Studies*, pp. 2499-2525.
[92] Franklin Allen, Jun Qian, and Meijun Qian, 'Law, Finance, and Economic Growth in China', (2005) 77 *Journal of Financial Economics*, pp. 79-83.
[93] In 2005，关于上市公司股权分置改革试点有关问题的通知 (Announcement Regarding the Issues of the Split-share Structure Reforms in Pilot Listed Companies) was delivered by the CSRC, marking the beginning of the new wave of split-share structure reform.

impact on share prices due to the massive release of shares in the market, some other measures are adopted, like the 12-month lock-up period for NTS holders.[94]

The empirical evidence concerning market reaction to reforms of split share structure has also demonstrated many characteristics of the listed companies and the ownership structure of these companies.[95] In particular, 1301 companies, accounting for the 98% of all listed companies, had undergone the split-share restructure reform by the beginning of 2007.[96] This suggests that the overwhelming dominance of the listed SOEs on the stock exchanges continued until at least one decade ago.

Moreover, the extent of share concentration of these listed SOEs is strikingly high. On average, the largest shareholders hold 42.73% of all shares, while the second to tenth shareholders together hold 19.49%.[97] Furthermore, the split-share structure reforms did not bring immediate changes to the ownership structure but the removal of trade restrictions that would generate far-reaching impact on the liquidity and share price in the long term.[98]

More recently, a large increase in private companies listed on the stock exchanges occurred. Notably, by the end of 2013, there were already 1308 private companies in the stock market, accounting for 52.01% of all listed companies.[99] The initial public offerings (IPOs) have been suspended on two occasions to cope with market volatility, from October 2012 to January 2014, and from July to November in 2015. The expanding trend of private companies in the stock market is unchanged, not only in terms of total number but also of aggregate market value.[100] However, central SOEs still occupy 50.14% of the total share value of all listed companies (see Table 3.3).

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[94] Mikael Mattlin, 'The Chinese Government's New Approach to Ownership and Financial Control of Strategic State-owned Enterprises', BOFIT Discussion Paper No. 10/2007. The author opined that the 12-month lock-up period for non-tradable shares indicates that the central authority wants to remove trading restrictions but not lose state control.

[95] See, e.g., Andrea Beltratti, Bernardo Bortolotti, Marianna Caccavaio, 'The Stock Market Reaction to the 2005 Split Share Structure Reform in China', (2012) 20 *Pacific-Basin Financial Journal*, pp. 543-560.

[96] *Ibid.*, p. 546.

[97] *Ibid*.

[98] *Ibid*., p. 559.

[99] Yongjun Li, 我国上市公司股权结构分析 (An Analysis of Share Structure of the Listed Companies in China), (2014) 6 冶金管理 (*China Steel Focus*), p. 39.

[100] China Centre for Market Value Management, 2015 年 A 股市值年度报告 (The Annual Report of Market Value of A Shares of the PRC). According to this report, the market value for all private companies for the first time surpassed that of the central SOEs in the security market.

Table 3.3 Listed Companies and Fractions of Shares

Company Category	Number of Shares	Percentage to all of the A shares (%)
Central state-owned companies	20320.65	50.14
Local state-owned companies	7380.62	18.21
Private companies	5741.03	14.17
Joint ventures	6360.07	15.69
Foreign invested companies	724.26	1.17
Collectively owned companies	78.11	0.19
Others	173.95	0.43

According to the SSE report, the average number of shares per private company is much smaller than the number of shares per state-owned company in the stock market.[101] Moreover, the percentage of shares that the largest shareholders hold in private companies, on average, is 31.93%, much lower than the percentage in state-owned companies.[102] Furthermore, the second to the fifth largest shareholders together hold 10.25% less than the largest shareholders have on average in private companies. Such average differences in the state-owned companies are much larger.[103] In sum, concentrated ownership structure is prevalent among private companies, but the concentration degree is much less than that of state-owned companies in the stock market.

3.4.1.2 Government control

The legacies from the central planning era—government control and intervention took on a new form after continuing reforms, *i.e.*, the government agents become controlling shareholders or actual controllers. The chronic problems associated with government control, to some extent, still inhibit the enhancement of corporate governance in the SOEs.

First, there is no fixed or constrained source of funds for the SOEs, termed 'soft budget constraint' by economists.[104] The SOEs are given priority in obtaining government subsidiaries and bank loans. The budget and state subsidiaries are negotiable and can be

[101] Xiaonan Lu and Weidong Zhang, 中国民营上市公司发展研究 (The Research on Development of Private Companies Listed onto the Stock Market), 2012.
[102] *Ibid.*
[103] *Ibid.*
[104] Janos Kornai, 'The Soft Budget Constraint', (1986) 39 KYKLOS *International Review for Social Science*, pp. 3-30.

adjusted from time to time. In the event of financial distress, the government can bail out the SOEs. As a consequence, directors and senior managers in the SOEs may have moral hazard problems. That is, they have less pressure to maintain the business operation, since the SOEs would survive anyway, riding the government bailout.[105] However, the low efficiency of the SOEs, non-performing loans, and financial deficit may stifle the development of the overall economic system.[106]

Second, unlike private firms, the SOEs' goal is not purely to maximize the wealth of the firms but also to assume policy burdens including maintaining the employment rate, implementing industrial policies, and so on. These multiple goals cannot be fulfilled at the same time. Even worse, to pursue the policy goals not only distracts from efforts to maximize the firm's value but also encourages moral hazard problems among directors and senior managers, because it is difficult to measure the portion of losses due to mismanagement and the portion attributable to extra policy burdens.[107]

Third, the SOEs do not have real owners, or moreover, the principals who normally have the ultimate claim over the residual interest and to whom the agents are accountable. The central and local governments, on behalf of all the people, exercise the ownership of the SOEs, but the whole people of the PRC do not have substantive power to monitor the government agencies.[108] The central government has instituted the SASAC to play the role of shareholders of the SOEs; the SASAC sets up the WSOEs as holding companies; and the holding companies invest in the SOEs listed on the stock market. In this way, higher agency costs due to multiple agency relationships are inevitable, especially when no ultimate owners virtually exist. Therefore, concentrated ownership in China's SOEs does not necessarily mean a strong monitoring force. Even if the monitoring force works, the by-product of government interference, such as perverse incentives for directors, is not conducive to corporate efficiency.

[105] Yifu Lin and Guofu Tan, 'Policy Burden, Accountability, and the Soft Budget Constraint', (1999) 89 *The American Economic Review*, pp. 426-431.
[106] Ruiming Liu and Lei Shi, 国有企业的双重效率损失与经济增长 (Dual Efficiency Loss of the SOEs and Economic Growth), (2010) 1 经济研究 (*The Economic Review*), pp. 127-137.
[107] Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance', (1997) 52 *The Journal of Finance*, p. 755.
[108] Yingyi Qian, 'Enterprise Reform in China: Agency Problems and Political Control', (1996) 4 *Economics of Transition*, pp. 427-477.

In addition to these common problems among the SOEs, listed SOEs may face pervasive 'tunnelling' by the controlling shareholders, *i.e.*, the state holding companies.[109] Many listed companies have been 'carved out' or 'spun off' from the company groups. The company groups assign the profitable assets to the firms to be listed, and allocate inferior assets and debts to other unlisted firms. Once the profitable firms are approved for IPOs, they become 'cash cows' for their company groups. The profits and raised funds of the listed firms are 'tunnelled' to sustain those unlisted and unprofitable firms at the expense of the interests of minority shareholders in the listed companies. The major forms of 'tunnelling' encompass related party transactions, corporate loans, and earnings management.[110]

3.4.1.3 Family control

Private firms are usually started by one or several entrepreneurs and supported by family members in forms of fund contribution and other investment. It is a common practice that family members either take major positions in the firms or hold substantial company shares. Such a model remains unchanged when some of these private companies are listed on the stock markets.[111] The family relationship is likely to impair the corporate governance of listed companies in the following aspects.

Family control results in the involvement of business decision-making with family issues and personal relationships. Quite often, the patriarchal approach may prevail over the standard procedures and mechanisms of consultancy, discussion, and decision-making. Then, the quality of governance and decision-making is more contingent on one determinant—the competence of the actual controller. Whether the actual controller has great investment insights and operational techniques becomes decisive to the firm's performance. When the business is expanding in terms of scale and variety, it becomes more risky for listed companies with unstable corporate governance to count on personal capabilities.[112]

The dominance of family kinship in the firms not only keeps funds away but also makes it difficult to attract managerial talent. For one thing, to retain the family control of the firm,

[109] For a further explanation of tunnelling, see Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes Andrei Shleifer, 'Tunneling', (2000) 90 *American Economic Review*, pp. 22-27.
[110] Qiao Liu and Zhou (Joe) Lu, 'Corporate Governance and Earnings Management in the Chinese Listed Companies: A Tunneling Perspective', (2007) 13 *Journal of Corporate Finance*, pp. 881-906.
[111] Lei Wang and Leonel Prieto, 'Institutional and Individual Factors Impacting Domestic Private Companies in China', (2009) 17 *International Journal of Organizational Analysis*, p. 312.
[112] See *supra* note 100 in this chapter, p. 46.

issuing shares to the public has to be within a certain limit, or else the family control would be diluted when other strong investors come in. Therefore, fund-raising may be arbitrarily constrained and business expansion inhibited.[113] For another, even these private firms do need professional managers to have an edge in fierce competition. Controlling families are inclined to shut the door on strangers to maintain family control.[114]

There is a conflict of family interest and the firm's interest. When family firms are listed in the stock market, family members may cash out and transfer monies to their personal accounts. It is extremely difficulty to spot such tunneling actions under the cover of family relationships and through informal arrangements.[115] Thus, family kinship can provide the most supportive and consistent resources when the firms just start. As for long-term goals and continuous and stable development of listed companies, family control may present risky variables and impede efficient governance and rational decision-making.

3.4.2 Internal Governance

The internal governance of Chinese companies is basically set up in accordance with the Company Law.[116] The Company Law formulates comprehensive rules regarding organizational structure, internal bodies, and the dynamic mechanisms of internal governance. Individual companies may opt into or out of default rules and customize the specific rules in their articles of association (AOA) to their needs. Such alterations vary with the scale of the firm, stage of lifecycle, type of industry, and many other attributes that a firm possesses. Nevertheless, the generic pattern of governance strategies to control mismanagement and internal monitoring can be illustrated as follows.

3.4.2.1 Prototype of internal governance structure

The Company Law of PRC devises the mandatory internal governance structure: a two-tier board under shareholders (general) meeting (SGM).[117] The SGM is a forum, either regularly or provisionally held, where the shareholders of a company can attend, cast votes

[113] *Ibid.*
[114] *Ibid.*
[115] *Ibid.*
[116] The full text of the Company Law is available http://www.fdi.gov.cn/1800000121_39_4814_0_7.html (accessed 28/11/2019).
[117] In this thesis, 'shareholders meeting' and 'shareholders general meeting' are used interchangeably. The Company Law of the PRC uses 'shareholders meeting' (*gudonghui*) in the context of LLCs and 'shareholders general meeting' (*gudong dahui*) in the CLSs. However, an SGM is a meeting where all the shareholders of a company can participate to exercise their voting right on business proposals. The only difference, in the legal sense, is that on average, the number of shareholders in the CLS is large and the meeting procedure is more regulated to ensure shareholders' participation.

on crucial business matters and transactions, and elect or dismiss the members of two boards. In addition, the company's AOA, internal rules applicable to the company's constituent parties, is subject to the SGM's approval.

The two distinct boards are the executive board and supervisory board. The boards of directors (BODs) exercise the executive power and delegate a part of such power to senior managers. The supervisory boards are in charge of monitoring management and expected to check internal controls.[118] At the first glance, the two-tier board structure mirrors the German model. Yet, Chinese supervisory boards do not have the statutory power to nominate, elect, or dismiss directors or senior managers like their German counterparts do.[119]

3.4.2.2 Governance strategies constraining mismanagement

The first governance strategy directly affects the scope of executive power that a board of directors can exercise. The Company Law empowers the SGM to be the ultimate decision-maker rather than the board of directors, which differs from the 'director's primacy model' in the US.[120] This means that not only does the SGM grant the authority of the board of directors, but also particular matters are subject to the SGM's approval. In particular, the board of directors must propose to the SGM any actions and transactions that may cause fundamental and crucial changes to the company or to the relationship between the company's constituent parties. Notably, it is mandatory in the Company Law that amendment of the company's AOA, increase or decrease in registered capital, merger, division, dissolution, or conversion of the company should be approved by a two-thirds majority of all the shareholders in the LLCs or all the shareholders present at the meeting in the CLSs (Art. 44 and 104 respectively). In addition, the Company Law allows substantial room for specific stipulations regarding the purview of the SGM in the company's AOA. As such, the board of directors do not have sole decision-making power

[118] Jay Dahya, Yusuf Karbhari, Jason Zezong Xiao, and Mei Yang, 'The Usefulness of the Supervisory Board Report in China', (2003) 11 *Corporate Governance: An International Review*, pp. 308-321.
[119] For more information about the two-tier model in Germany, see Klaus J. Hopt and Patrick C. Leyens, 'Board Models in Europe—Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy', (2004) 1 *European Company and Financial Law Review*, pp. 139-142.
[120] For the legislation of this 'director primacy model', see, the Delaware General Corporation Law that sets forth: 'the business and affairs of every corporation shall be managed by or under the direction of a board of directors.' http://delcode.delaware.gov/title8/c001/sc04/index.shtml (accessed 18/11/2019).
For a scholarly discussion, see Stephen M. Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance', (2003) 97 *New York University of Law Review*, p. 547; and Stephen M. Bainbridge, 'Director Primacy and Shareholder Disempowerment', (2006) 119-6 *Harvard Law Review*, pp. 1735-1758.

over business matters of crucial importance. The SGM's approval may *ex ante* screen out those proposals and plans that may be potentially harmful to the shareholders' interests.

The other governance strategy is to retain power to determine who can be board members. The Company Law conferred the right to elect and remove directors (who are not employees' representatives) to the SGM (Art. 38) as well. Who has the right to nominate the candidates, the procedure of the election and removal, and the majority quorum are all in the realm of the company's AOA.

The term of office of a director is a maximum of three years; however, the term can be renewed upon successful re-election (Art. 46). Therefore, at least every three years, directors have to cope with the pressure of a potential turnover. Indeed, the frequency of exercising the removal right is not limited to the statutory term of office. Since there is no legal requirement for the cause of removal, the SGM may remove a director at any time for any reason, unless the company's AOA or the employment contract state otherwise.

In practice, majority shareholders control the SGM because the one-share-one-vote rule renders it so. Then the substantial decision-making power retained for the SGM in law is virtually more favourable to the interests of controlling shareholders, rather than that of the company. Through the SGM, controlling shareholders elect their ideal candidates to be board members. The directors would propose the plans that benefit the controlling shareholders for the sake of their careers. In this circle, the alliance of controlling shareholders and directors strengthens continually. But the independence of board of directors is severely undermined.

3.4.2.3 Specialized monitoring forces

In parallel to the executive board is the supervisory board, monitoring whether directors and senior managers properly exercise their decision-making powers. To ensure the independence of the supervisory board, the Company Law explicitly proscribes the dual role of a supervisory board member and a director or a senior manager at the same time (Art. 52). Supervisory board members may attend the meeting of the executive board. They are enabled to raise questions and put forth suggestions about the issues under the directors' consideration; however, they cannot vote. When discovering any irregularity in the operational conditions, the supervisory boards may conduct investigations and engage an accounting firm and other intermediaries to provide assistance and consultancy when necessary. The firm bears the expenses of such professional consultancy (Art. 55).

Furthermore, they may also call the attention of shareholders, present proposals to the SGM, and convene interim shareholders meetings to resolve crucial issues, such as the removal of directors (Art. 54). Finally, supervisory board members may require the directors to modify improper or unlawful conduct or even file civil actions against directors in egregious circumstances (Art 152).

However, in practice, there is significant variance in the exercising of these statutory powers and most empirical evidence shows that China's supervisory boards are not effective in monitoring the executive branch.[121] The supervisory boards usually lack the independent status, competence, incentives, and the relevant information to challenge and censor the executive branch. First, the supervisory boards in the SOEs are under government and party control. Their counterparts in the private firms have somehow obtained connections with the entrepreneurs or directors. Such affiliation to insiders can hardly deliver an effective monitoring service for the firm's interests.[122] Second, reviewing accounting books and noticing the irregularity of financial status requires professional skills that few supervisory board members possess. In many listed companies, the secretary of the BOD writes the supervisory board reports and other required documents for information disclosure.[123] Third, there is tension between access to information and relative independence. To understand the overall scenario and the 'behind-the-scenes' stories of business strategies and transactions, the supervisory board members need to get close to the decision makers even to the extent that the decision makers are willing to share inside information. However, at the same time, they become less independent and can hardly deliver any critical observations. Finally, it makes no difference to the supervisory board members if they do a good job, since neither legal liabilities nor incentive schemes are in place to motivate the supervisory function.[124]

3.4.3 Board of Directors

The BODs in China are mainly in charge of business decision-making, organization of production, and firm management. Even for crucial issues in the SGM, the BOD draft and

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

[122] Weiqiu Long and Qingchi Li, 公司内部治理机制的改进:"董事会-监事会"二元结构模式的调整 (The Internal Governance Improvement: The Adjustment of the Two-tier Board Model), (2005) 5 比较法研究 (*Journal of Comparative Law*), pp. 58-71.

[123] See *supra* note 99 in this chapter.

[124] *Ibid.*

propose the plans, and execute the final resolution of the SGM. Thus, how the BODs perform their functions is pivotal to the quality of corporate governance, and in turn, to the firms' performances and values.

Unlike their counterparts in private firms, directors in the SOEs also find themselves in a hierarchy of government officials. This fundamental difference is that the incentives, career track, and remuneration packages of directors in the SOEs are all idiosyncratic. Their primary goal is not to purely maximize the firm's value, since they are actually accountable to government superiors. The government superiors, as shareholders, tend to select those who can perfectly represent their interests and pursue policy agendas. To gain the trust of the government superior, the candidates must have a track record of experience in similar SOEs or government agencies, or have already developed connections with these government superiors. This ecology in the SOEs hinders lateral movement of professional managers. Besides, the independence of directors from government control and the Party's influence is not ensured.[125] As a result, it is likely that the SOEs do not have a competent and independent BOD, which *per se* is unfavourable to the SOEs' efficiency.

In addition, the remuneration packages for the directors in the SOEs are politically sensitive, and thus, under unified regulation.[126] For instance, the whole remuneration package for a director in a central SOE cannot be more than seven or eight times the average salary of the ordinary employees therein. Such inflexible regulation cannot efficiently incentivize the directors' best efforts. Moreover, the empirical evidence shows that seldom is equity ownership used to align the directors' personal interests with that of the firm.[127]

3.5 Market Mechanisms and Incentives

The Stock Market

China's stock market has been established since the opening of Shanghai and Shenzhen stock exchanges in 1991. With no more than three decades of development, this stock market became the second largest in the world by trading volume and market capitalization

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[125] Mi Zhou and Xiaoming Wang, 'Agency Cost and the Crisis of China's SOE', (2000) 11 *China Economic Review*, pp. 299-300.

[126] 中央管理企业负责人薪酬制度改革方案 (Reform Measures Concerning the Remuneration for the Leaders in Central Enterprise) was delivered by the CPC Central Political Bureau in 2014.

[127] Hongxia Liu and Michelle W.L. Fong, 'Board Characteristics of Medium and Large Chinese Companies', (2010) 10 *Corporate Governance*, pp. 168-169.

by the end of 2014.[128] Chart 3.4 illustrates the general trend of expansion by total market capitalization and the number of listed companies on the two stock exchanges from 2003 to 2012. However, relative to the robust figure of GDP, the performance of the stock market is rather disappointing, as indicated by the returns on investment.[129]

Figure 3.4 Total Market Capitalization and Number of Listed Companies on the SSE and SZSE, 2003-2012.

Source: China Capital Market Overview at the official website of Shanghai Stock Exchange[130]

Many practitioners and theorists, domestic and overseas, have studied this emerging stock market and made the following observations.[131] First, the stock market is merely a secondary source of funds while the financial system is dominated by the state-owned banking sector.[132] The great majority of China's companies rely on self-financing, including debts, foreign direct investment, and trade credits to sustain their business operations.[133]

[128] The 2014 CSRC Annual Report
[129] See Figure 1 in Franklin Allen, Jun Qian, Susan Chengyu Shan, and Julie Lei Zhu, 'The Best Performing Economy with the Worst Performing Market: Explaining the Poor Performance of the Chinese Stock Market', 2014 Working paper, Imperial College London.
[130] The official website of the Shanghai Stock Exchange is http://english.sse.com.cn/investors/introduction/chinacapital/ (accessed 29/10/2019).
[131] Since this part mainly focuses on the function of the stock market, it does not discuss the explanation for why China presents a counter-example to the theory of law, finance, and economic growth.
[132] See *supra* note 92 in this chapter, p. 61.
[133] *Ibid.*

Second, the stock market has been long lamented as being worse than a casino, due to the lack of game rules.[134] There are hundreds of millions of individual retail investors in China's stock market, who conduct more than 80% trading.[135] Individual retail investors do not have the expertise to analyse the disclosed information, nor do they have the resources to diversify their investment portfolios like institutional investors do. The share price is extremely volatile, and in turn, these individual investors undertake speculative trading rather than long-term investment. Moreover, the regulation and enforcement actions against insider trading, misrepresentation, and market manipulation are weak; thus, there is poor protection of the interests of these individual retail investors.

Third, it is doubtful that share price reflects the firm's value and future profitability and whether corporate governance matters in the market value of firms in China. Extensive empirical literature has revealed mixed findings. With regard to the function of the stock market, it is commonly believed that the stock market has not achieved fully-fledged development and cannot adequately fulfil efficient capital allocation, and discipline corporate managers.[136] However, recent studies do show that the informativeness of share prices has increased.[137]

Market for corporate control

The nascent market for corporate control in China has just come into existence. As previously examined, before 2006, almost all listed companies were state-owned and two-thirds of their shares were not tradable on the stock market. At that time, it was the government authority that initiated and led mergers and acquisitions (M&A), and restructuring to implement industrial strategies, or to bail out insolvent firms. The transfer of corporate control was mainly by means of agreement. Private parties could not buy state shares and legal person shares in the stock market.

As of 2006, with the launch of the split-share structure reform, the obstacle for NTS trading were removed. Furthermore, in 2006, the Administration Measures on the Takeover of Listed Companies was issued by the CSRC, which for the first time,

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[134] Forbes Report 10/01/2001, 'China's $ 600 Billion Casino: Can It Become a Stock Market?', quoting Jianglian Wu, a Chinese economist, who once commented that 'The stock markets in China are worse than casinos, because even casinos have rules'.
[135] Jennifer N. Carpenter, Fangzhou Lu, Robert F. Whitelaw, 'The Real Value of China's Stock Market' (2015) NEBER Working Paper No. 20957, p. 5.
[136] William T. Allen and Han Shen, 'Assessing China's Top-down Securities Markets', (2011) NBER Working Paper Series, p. 38.
[137] See *supra* note 135 in this chapter, p. 7.

established a regulatory framework for takeovers of listed companies in China.[138] However, the 2006 Administration Measures still imposed substantial control on takeover transactions, which was abolished in 2014.[139]

The concentrated ownership structure poses another challenge to the prospective acquirers, since an acquiring firm needs to buy out the majority of shares of the target firm in order to obtain control over the target firm. Nonetheless, an increasing number of private companies are getting listed on the stock exchanges and many have a relatively more dispersed ownership structure than the SOEs. Financing channels and tools for the takeovers of the listed companies become more diversified.[140] Thus, it becomes financially feasible to buy out a moderate fraction of the shares of a private company to obtain corporate control. However, for listed companies with a single or few large shareholder (s), the lack of funds alone suffices to keep bidders away.

At present, the disciplining function of the market for corporate control is constrained by the undeveloped stock market. As the share price may not be able to indicate the value of a firm accurately, both acquiring and target firms are reluctant to enter share transfer deals or have difficulty in consenting to the terms, due to the lack of an efficient pricing mechanism.

Besides, a takeover proposal may trigger volatility in the share price of the target firm. Without strong information disclosure systems and effective protection of individual investors, insiders may misuse the information advantage to seek unlawful earnings. Even worse, some decision-makers initiate a restructuring plan only to create the opportunity for insider trading, which also greatly disturbs the market for corporate control.[141] In sum, the directors and officers in the listed companies with a relatively dispersed ownership structure begin to pay attention to the threat of a takeover, while for the remaining majority the pressure from the market for corporate control is still trivial.

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[138] The full text of Administration Measures on the Takeover of Listed Companies is available at http://www.fdi.gov.cn/1800000121_39_4237_0_7.html (accessed 31/11/2019).
[139] Linklaters: China Reforms Rules on Takeovers and Material Asset Restructuring of Listed Companies, December 2014.
[140] For instance, the China Banking Regulatory Commission issued 商业银行并购贷款风险指引(The Guidelines Regarding the Risks of Commercial Banks' Loans for Merger and Acquisition) in 2008. These *Guidelines* mark a policy breakthrough of using bank loans for equity investment.
[141] Shanghai Stock Exchange: （2009）中国公司治理报告-- 控制权市场与公司治理(The Report on China's Corporate Governance—Market for Corporate Control and Corporate Governance), p. 35.

3.6 Conclusion

The enterprise sector has undergone tremendous changes, as the overall economic system has transitioned from central planning to market-oriented. Previously, the SOEs and collectively owned enterprises were the only legitimate forms of productive organizations. After decades of reforms, the major forces in the economy are private enterprises. The SOEs continue to dominate in key industries. In the meantime, modern corporate form and internal governance structure, as the SOE reforms initially promoted and national legislation formulated, have become widely adopted in business practices.

A common feature of Chinese companies is the concentrated ownership structure, no matter whether a company is privately owned or under state control or if it is listed on the stock exchange. Controlling shareholders or actual controllers have substantial influence within companies, but minority shareholders are positioned in disadvantageous situations or even exposed to the expropriation of controlling shareholders or directors and officers. In the lens of the agency theory, horizontal agency problems between controlling shareholders and minority shareholders can be prevalent among Chinese companies.

The SOEs suffered from low efficiency due to the soft budget constraints and excessive policy burdens. Meanwhile, the directors and officers in the SOEs have serious moral hazard problems, because the internal monitoring function remains weak, if not absent, and market mechanisms are unable to generate substantial pressures. To be specific, they are not monitored by the real owners of the SOEs but by some government agents whose aim is not to maximize the return on investment like normal investors. Managerial performances are not measured purely by profitability indicators. Directors and officers, in turn, are not incentivized to pursue commercial goals like their counterparts in private companies. Although the two-tier board structure is mandatory, the supervisory boards do not actually play a significant monitoring role due to the lack of information and incentives. In addition, directors and officers in the SOEs are not in a liquid managerial labour market, since the promotion of management personnel is determined by government authorities. As the SOEs are usually monopolies in their respective industries, their directors and officers do not face intense market competition. Last but not least, the stock market is still at a early stage, and the market for corporate control has barely taken shape. Directors in the SOEs that go publicly listed are virtually free from the threat of replacement after takeovers in the stock market.

Private companies, especially those begun by entrepreneurs, and of small and medium size, may operate under family control. The interest of a big family may prevail or personal relationships can disturb business operations. There is improper maintenance of internal governance mechanisms, as a close-knit group tends to make business decisions in a flexible manner. This might entail 'stealing' of the company's fund, opportunities or other resources or violations of laws and regulations. Nevertheless, the product and services market incentivize directors and officers to work efficiently and diligently to some extent, as private companies are exposed to intense market competition.

Chapter 4 Directors' Duties and Liabilities in China's Law

4.1 Introduction

This chapter mainly examines the status quo of the applicable laws that set forth directors' duties and liabilities in China. Before delving into the specific rules, it briefly introduces the sources and hierarchy of law in China, to impart a basic understanding of the Chinese legal system to readers.

The hierarchy of China's laws and regulations, in top-down order, consists of the Constitution, national laws, administrative regulations, ministry rules and local rules, and local regulations.[1] The state legislative organ—the National People's Congress (NPC) and its Standing Committee, enact and amend national laws.[2] The NPC Standing Committee also has the authority to interpret the Constitution and national laws. The State Council, the central government, issues administrative regulations in accordance with national laws.[3] The ministries, directly under the State Council, promulgate specific rules regarding the issues within their regulatory purview and designated authority, which are categorized as the ministry rules, or department rules. Besides, the commissions and other agencies, directly affiliated to the State Council, formulate regulatory documents. The regulatory documents usually provide for the methods and operational standards to fulfil the regulatory requirements. However, there is no official definition of the authority of the regulatory documents, which creates significant controversy over the application of these regulatory documents in legal practice.

The local people's congresses and local governments have the power to formulate only the rules and regulations applicable in their areas pursuant to national laws and administrative regulations.[4] The local rules promulgated by the local congresses have legal force equivalent to that of the ministry rules issued by the ministries.

[1] See 立法法 (Legislation law) ; the full text in English is available at https://www.cecc.gov/resources/legal-provisions/legislation-law-chinese-and-english-text (accessed 11/11/2019).
[2] *Ibid.*, Art. 7.
[3] *Ibid.*, Art. 56.
[4] *Ibid.*, Art. 63.

The Supreme People's Court (SPC), the highest judicial organ, plays a significant role in shaping and refining national laws.[5] The SPC issues judicial interpretations to guide the application of laws in the overall judicial system, which frequently goes beyond the literal meaning of legal provisions.[6] Some commentators highlighted a lack of justification for the expansive manner in which the SPC interprets laws.[7] Nevertheless, the judges at all levels refer to the judicial interpretations by the SPC in a similar way that they apply the national laws. Since 2010, the SPC has adopted the Guiding Case System to enhance national uniformity in the interpretation and application of the legal rules.[8] The judges are expected to invoke guiding cases that are similar to the disputes on hand.[9]

The remainder of this chapter is structured as follows. Section 4.2 briefly sketches the landscape and development trajectory of corporate and securities legislation in China. Given that the Company Law, the Securities Law, and the Enterprise Bankruptcy Law knit a web of legal duties and liabilities of directors, Sections 4.3, 4.4, and 4.5, respectively, analyse the relevant provisions in these national laws and examine the associated judicial interpretations.

4.2 Brief Overview of Corporate and Securities Legislation

4.2.1 Enterprise Legislation by Ownership Standard

The first legislation in the PRC that provided the LLC as a legal form for business entities was the Sino-foreign Equity Joint Venture Law (EJV Law). The EJV Law was enacted in 1979 to accommodate the inflow of foreign investment, immediately after the Opening-up and Economic Reform policy was launched in 1978. The EJV Law only contains 16 articles that broadly cover the issues related to capital contribution, registration approval, governance structure, labour protection, and the mechanism of foreign currency exchanges.

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[5] The official introduction of the SPC and the court system is available at the NPC's website http://www.npc.gov.cn/englishnpc/stateStructure/2007-12/06/content_1382076.htm (accessed 11/11/2019).
[6] 关于加强法律解释工作的决议 (The Resolutions on Strengthening the Interpretations of Laws) by the SCNPC in 1981 and 关于司法解释工作的规定 (The Provisions Regarding Judicial Interpretations) by the SPC in 2007 have clarified the binding force of the judicial interpretations by the SPC.
[7] For the debate over the scope and constitutionality of the judicial interpretations by the SPC, see, Chunlong Chen, 中国司法解释的地位与功能 (Function and Significance of the Judicial Interpretation in the PRC), (2003) 1 中国法学 *(China Legal Science)*, pp. 24-32.
[8] Before the establishment of the guiding case system, the SPC has selected and published the representative cases to guide the interpretative work in the SPC's Gazette since 1985. Some other case reference books by the SPC compiled the selected cases, not formally binding but representative of judicial practice, including 中国案例指导 (*Chinese Case Guidance Series*) and 人民法院案例选 (*People's Court Case Selection*).
[9] See Xingliang Chen (ed.), 中国案例指导制度研究 (*Chinese System of Directive Cases*) (Beijing: Peking University Press, 2014).

The rules were written in a clumsy and over-simplified manner. However, before this law, no business enterprises in the modern sense existed, nor did any enterprise legislation in the PRC.[10]

To facilitate diverse forms of foreign investment and business operation, China passed the Wholly Foreign-owned Enterprise Law (WFOE Law) and the Sino-foreign Contractual Joint Venture Law (CJV Law) in 1986 and 1988, respectively.[11] Similar to the EJV law, the policy goal focused on the regulation of foreign investment. However, the internal governance structure and the relationship between the constituent parties did not receive much attention. These laws, in tandem with the revisions, implementing rules and relevant administrative regulations constitute a separate legal system for foreign-invested enterprises. However, such a piece-meal law-making approach brought about severe overlaps, conflicts, redundancy, and even vacuum in these legal rules.[12]

In 2015, the Ministry of Commerce (MOFCOM) conducted a complete overhaul and began restructuring the foreign investment legislation. Amongst others, the Draft of Foreign Investment Law was circulated to solicit public opinion. The forthcoming law will replace 'the trio' of the EJV, CJV, and WFOE Laws. The fundamental idea of this law is to unify the regulatory framework of foreign investment, mainly including the rules for market entry, national treatment, national security review, information reporting system, and investment protection.[13] With regard to the legal forms for business, foreign-invested enterprises are subject to Company Law and the Partnership Enterprise Law.

Similarly, the SOEs, collective enterprises, and private enterprises have been regulated along distinct tracks, and the laws were separately enacted. A number of interim regulations were firstly issued by the State Council to implement the reform measures for managerial autonomy and independent enterprise status.[14] Based on these regulations, the

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[10] Jianwei Li, 中国企业立法体系的改革与重构 (The Reform and Restructure of China's Enterprise Legislation), (2013) 6 暨南学报 *(Ji'nan Journal, Philosophy and Social Science)*, p. 87.

[11] For the full text of the WFOE Law, see the official website of the Ministry of Commerce http://english.mofcom.gov.cn/aarticle/lawsdata/chineselaw/200301/20030100062858.html; and the CJV Law available at http://english.mofcom.gov.cn/article/lawsdata/chineselaw/200301/20030100065891.shtml (accessed 18/07/2018).

[12] See Peter Howard Corne, *Foreign Investment in China: The Administrative Legal System* (Hong Kong: Hong Kong University Press, 1997), pp. 147-186.

[13] English translation of the Draft of Foreign Investment Law by Jones Day, https://www.uschina.org/china-hub/english-translation-draft-foreign-investment-law (accessed 18/07/2018).

[14] (1979) 关于扩大国营工业企业经营管理自主权的若干规定 (Regulations on the Expansion of Autonomous Managerial and Operational Power of the State-Owned Industrial Enterprises); (1981) 国营工业企业职工代表大会暂行条例 (Interim Regulations on the Congress of Employees' Representatives in the

NPC Standing Committee enacted the Law on Industrial Enterprise Owned by the Whole People in 1988.[15]

As for the collective enterprises, the rural and urban ones had their respective regulations. The State Council passed the Provisions of Rural Collective Enterprises in 1990 and issued the Provisions of Urban Collective Enterprises in 1991. To promote the economic contribution of rural collectives, the NPC Standing Committee promulgated the Law of Township and Village Enterprises in 1996.[16]

As mentioned in Chapter 3, private enterprises used to be under tight constraints; however, the private economy has been gradually accepted, permitted, and confirmed through several revisions to the Constitution. In 1998, the State Council delivered the Interim Rules for Private Enterprises, which mainly set the limit to the business scope, scale, finance channel, and even the managers’ salaries.[17]

In sum, before the 1990s, the enterprise legislation intended to implement the reform measures and regulatory policies that treated the enterprises differently, according to their ownership. Owing to gradual reforms, the body of enterprise legislation was formed by various pieces of laws, regulations, and even interim rules. However, its contents were fragmented and inconsistent. The extensive state intervention and discrimination against the private economy became obsolete and counter-productive when continuing economic transition.[18]

4.2.2 The Company Law

The Company Law is the national legislation that provides for corporate forms, structures internal governance, and co-ordinates the relationship between major constituent parties. As early as 1987, when the shareholding system was introduced in some pilot SOEs, the State Council began to review the ‘Provisions of the Limited Liability Companies’ and ‘Provisions of the Companies Limited by Shares’, proposed by the National Economic and

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State-Owned Industrial Enterprises); (1982) 国营工厂厂长工作暂行条例 (Interim Regulations on the Work of Leaders in the State-Owned Enterprises); (1983) Interim Regulations on State-Owned Industrial Enterprise; (1984) 关于进一步扩大国营工业企业经营管理自主权的暂行规定 (Interim Regulations on Further Expansion of Autonomous Managerial and Operational Power of the State-Owned Industrial Enterprises).

[15] The full text of the Law on Industrial Enterprise Owned by the Whole People is available at http://english.mofcom.gov.cn/article/lawsdata/chineselaw/200303/20030300072563.shtml (accessed 22/03/2019).

[16] The full text is available at http://www.gov.cn/banshi/2005-06/01/content_3432.htm (accessed 22/03/2019).

[17] The full text is available at http://fgk.chinalaw.gov.cn/article/xzfg/198806/19880600410064.shtml (accessed 22/03/2019).

[18] Jianwei Li, see *supra* note 10 in this chapter.

Trade Commission.[19] However, further law-making procedure was suspended due to the intense debate over whether a 'capitalist' shareholding system would impair a socialist economy and whether economic reforms should continue.[20] Until 1992, Deng Xiaoping's Southern Tour re-asserted the reform agenda.[21] Accordingly, the first Company Law of the PRC was promulgated in 1993 and came into effect in 1994.[22]

The 1994 Company Law established a comprehensive legal framework for corporate form, based on the German law model. This Company Law provided two types of corporate forms: limited liability company (LLC) and company limited by shares (CLS). All companies must adopt the two-tier board structure under the authority organ—shareholders (general) meeting.[23] Namely, a board of directors is chiefly in charge of executive function; a supervisory board mainly monitors the exercise of executive power; and both boards are accountable to the shareholders. This dichotomy of corporate forms and the internal governance structure is still effective.

Meanwhile, the 1994 Company Law adopted the registered capital system. The registered amount of capital was paid-in contribution, *i.e.*, the actual contribution of shareholders by the date of registration. Moreover, the threshold of registered capital was set very high and the minimum amount varied according to the companies' main business.[24] It was very difficult for a private start-up to achieve the capital threshold. To maintain the company's assets and ensure transaction safety, the Criminal Laws and some administrative regulations imposed criminal penalties and administrative fines on the illegal withdrawal of capital, in addition to the civil liabilities.[25]

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[19] The National Economic and Trade Commission was the department of the State Council yet removed in the structural reform in 2003. The Ministry of Commerce took charge of governing domestic and overseas trade and economic cooperation that the National Economic and Trade Commission used to govern.
[20] A series of domestic and international events at that time invoked concerns of political risk and state safety arising from the economic reforms, such as the radical change in Eastern Europe and the collapse of the Soviet Union.
[21] Deng Xiaoping's Southern Tour was another landmark event in China's contemporary history. In 1992, Deng Xiaoping, in the capacity of the former leader of the CPC, visited the coastal areas, made a series of speeches, and obtained local support. After several months, the incumbent leader confirmed and endorsed his suggestion of further economic reforms. Since then, China has stepped onto the track of continuous reforms and economic growth.
[22] In 1993, the State Council initiated the proceedings for a unified Company Law based on the Regulatory Opinions of the LLCs and Regulatory Opinions of the CLSs by the State Council.
[23] The exception allowed that the LLCs with very few people and very small size might have one executive director to play the dual role of a director and a general manager.
[24] Art. 23 in the 1994 Company Law, the registered capital of limited liability company cannot be less than (1) RMB 500, 000 for production; (2) RMB 500, 000 for wholesale business; (3) RMB 300, 000 for sales; (4) RMB 100, 000 for technology development, consultancy and service.
[25] See Art.199 and 200 in the 1994 Company Law.

In 2005, a comprehensive revision of the Company Law was undertaken, almost amounting to a new law. The basic notion shifted to deference to private autonomy and this revision was greatly influenced by the US model. The extensive use of default rules encourages private parties to arrange for their own needs in the company's articles of association (AOA) and other internal rules.[26] Moreover, the capital contribution requirement was largely relaxed. An update is worth noting. In 2014, the minimum capital requirement was completely abolished, and simultaneously, an online credit system was established.[27] The public has access to the information and creditworthiness of any company in China.[28] Therefore, the legal environment for setting up and running a company became more hospitable than before.

The 2006 Company Law considerably strengthened shareholders' rights and investment protection.[29] In particular, the access to information, cumulative voting system, direct participation in the decision-making process, and an exit mechanism have provided all-round safeguard for investors' interests.[30] Furthermore, shareholders have a more powerful weapon—the right to sue when their rights cannot be properly exercised or when their economic interests are jeopardized. This also indicates that the regulatory approach is more

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Art. 159 in the Criminal Law provided for the crime of capital withdrawal and sanctioned the corresponding penalty.

[26] The phrases, '…according to the company's AOA', 'unless all the shareholders consent…' and '…if the company's AOA stipulates otherwise' have been interchangeably used in 119 places.

[27] The notion of registration system reform is 'relaxed entry requirement, strict supervision' (宽进严管). The minimum capital threshold is removed in the revision to the Company Law, effective since 1 March 2014.

[28] On 7 August 2014 the State Council published 企业信息公示暂行条例 (Interim Regulations on the Public Disclosure of Enterprise Information). The Regulations established a national enterprise information publicity system, and the centralized website is http://www.gsxt.gov.cn/index.html (accessed 23/03/2019).

[29] The comprehensive revision in 2005 came into effect in 2006, and thus, the Company Law in effect is also called the 2006 Company Law. The full text of the Company Law is available at http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384124.htm (accessed 14/09/2019).

[30] The following articles are quoted from the official translated version of the Company Law by the NPC.
'Shareholders of a CLS are entitled to inspect important corporate files and reports such as the company's AOA, memoranda of shareholders (general) meeting, resolutions passed through a board meeting, and accounting or financial reports. In addition to the information right, they can put forward proposals or raise questions as regards the business operation of the company' (Article 98).
'Shareholders of LLCs can make a request to inspect the accounting books of the company as well' (Article 34).
'Shareholders, holding shares above a certain threshold (10% of all shares), are entitled to convene or preside over the shareholders general meeting when the board of directors and board of supervisors do not do so' (Articles 41 and 102). 'One shareholder who holds, or several shareholders who jointly hold, three per cent or more of the shares of the company may submit an interim proposal in writing to the board of directors ten days before the general meeting is held. The board of directors shall, within two days upon receipt of the proposal, notify the other shareholders, and submit the interim proposal to the general meeting for deliberation' (Article 103).
Article 75 confers on dissident shareholders the right to request the company to acquire their shares at a reasonable price in any of the enumerated circumstances.

dependent on the judicial review *ex post* than previously on government intervention *ex ante*.[31]

4.2.3 The Securities Law

The Securities Law, also a ground-breaking statute in China, came into force in 1999 when the securities market was just beginning. The 1999 Securities Law laid down the fundamental regimes underpinning the securities market: (1) the scope and types of the securities; (2) the approval and issuing system for the securities; (3) transaction rules for shares; (4) takeover of listed companies; (5) information disclosure system; (6) the roles, function, authority and responsibilities of securities companies and other intermediary agencies; and (7) the function of the stock exchanges, and the CSRC.[32]

Similar to the 2005 amendment to the Company Law, the Securities Law was drastically revised in the same year, when the securities markets entered a new phase.[33] The scope of securities was expanded from merely corporate shares and bonds to government bonds and units of securities investment funds. It even included the derivative varieties of securities, and hence, was subject to the principles of the Securities Law.

For the issuing system, what is a public offer was re-defined; and a sponsor system and pre-disclosure for initial public offerings (IPO) was established to promote the quality of information and ensure investors' confidence.[34] A sponsor, usually a qualified institution, undertakes a comprehensive investigation into the operating status of an issuer and recommends the issuer for share issuance if there is no violation of laws and administrative regulations. The sponsorship system provides professional endorsement for the credibility of the issuers.

The legal status of the stock exchanges is clarified. The stock exchanges have the authority to examine and accept applications for issuing and trading securities (Art.48) In addition, the supervisory functions of the stock exchanges over the securities companies,

[31] Xinrong Guan, 我国司法介入公司治理的迷惑及对策 (Confusion of and Response on Judicial Review in Corporate Governance of the PRC), (2009) 4 政法论坛 (*Tribune of Political Science and Law*), pp. 124-129.
[32] Chunying Xin, 我国证券法的发展历程及修改完善 (The Evolution and Improvement of the Securities Law of the PRC), (2014) 10 证券法苑 (*Zhengquan Fayuan*), pp. 8-10. The author is the vice director of the Legislation Affairs Commission of the NPC Standing Committee.
[33] Baoshu Wang and Hui Huang, 'China's New Company Law and Securities Law: An Overview and Assessment', (2006) 19 *Australian Journal of Corporate Law*, pp. 229-242.
[34] See Art.11 in the Securities Law and Chapter III Sponsors' Responsibilities in 证券发行上市保荐业务管理办法 (Administrative Measures on Sponsorship for Securities Issuance and Listing) by the CSRC in 2009. Art. 21 in the Securities Law sets out a mandatory pre-disclosure system for IPO.

asset evaluation agents, and accounting firms are reinforced. With regard to the trading system of securities, the ban on trading in other venues than the stock exchanges has been lifted (Art.39). Meanwhile, the conditions of listing, suspension, and termination of shares are further specified.

With regard to takeovers of listed companies, a takeover can be initiated by bidding, by agreement or by other legitimate means (Art.85). The lock-up period of bidders is extended to 12 months after the completion of the takeover (Art. 98).[35] Finally, the information disclosure system is strengthened and the accountabilities for misrepresentation and insider trading are clearly set forth to improve investors' protection and maintain market order. Meanwhile, the state establishes a fund to pay off the damages to investors who are holding shares of the listed companies that end up in bankruptcy (Art. 134).

4.2.4 Enterprise Bankruptcy Law

The first national legislation governing enterprise bankruptcy in China was enacted in 1986, and it was only applicable to wholly state-owned enterprises (WSOE). For other enterprises, only eight provisions in the Civil Procedure Law were effective in 1991, and roughly addressed the issues in the liquidation procedure. The 1986 Enterprise Bankruptcy Law set forth the initiation and acceptance of a bankruptcy pleading, settlement of debts, debt priority, and liquidation procedures. The typical problems concerning the WSOEs, such as compensation for laid-off employees, were not addressed in this Bankruptcy Law. Nonetheless, bankruptcy and liquidation practice remained dormant for a long time because the SOEs were usually bailed out by the government, or transferred, or restructured.[36]

In 2006, the new Enterprise Bankruptcy Law was passed with 12 chapters and 136 articles, and is still in effect.[37] The application scope now covers all entities with legal person status in the vicinity of insolvency (Art.2). This statute is also one of the most significant pieces of legislation for the Chinese market economy, providing a legal

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[35] Refer to 上市公司收购管理办法 (Administrative Measures on the Takeover of Listed Companies) by the CSRC in 2006.

[36] Yujia Jiang, 'The Curious Case of Inactive Bankruptcy Practice in China: A Comparative Study of US and Chinese Bankruptcy Law', (2014) 34 *Northwestern Journal of International Law & Business*, p. 572.

[37] The full text of the Enterprise Bankruptcy Law is available at http://www.npc.gov.cn/englishnpc/Law/2008-01/02/content_1388019.htm (accessed 23/03/2019).

framework for the enterprise entities to exit the market and to protect their creditors' rights and interests.[38]

This Bankruptcy Law replaces the government-oriented liquidation model by authorizing the courts to designate a bankruptcy administrator, following the rules specific to the qualifications and appointment of an administrator (Art. 24). An administrator must 'investigate the status of the debtor's assets, take charge of all the assets, seals, accounting books, and documents of the debtor, decide on internal management matters, daily expenditure, and dispose of the assets of the debtor' (Art.25). The administrator's performance is under the supervision of the creditors, which may request the court to appoint a new administrator under certain conditions (Art.22).

The creditors' committees are accorded a wider range of rights to extensively participate in bankruptcy procedures. The resumption or suspension of the debtor's business, restructuring plans, settlement agreements, management plans for the debtor's assets, and disposal and distribution plans for the bankruptcy assets should all be approved by the creditors' committees. The creditors' committees also have the authority to supervise the administrator's performance and replace the administrator (Art. 61).

More notably, the new law introduced the restructuring regime for the first time as an alternative to liquidation.[39] The restructuring mechanism allows the insolvent enterprises an opportunity to turn around the failure and get back to life. The creditors may in turn, be likely to benefit from the restructuring, obtaining full payment of their debts. However, it is also possible that the restructuring plan fails and further reduces the bankruptcy assets, while creating more losses for creditors. The challenge is balancing the risks and interests among the different types of creditors and the shareholders of an insolvent company, and controlling the risks in the restructuring mechanism. These potential tensions require a more sophisticated design of substantive and procedural rules that the Bankruptcy Law does not achieve for the present.[40]

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[38] Henry R. Zheng, 'Bankruptcy Law of People's Republic of China: Principles, Procedure and Practice' (1986) 19 *Vanderbilt Law of Transnational Law*, pp. 683-738.

[39] Then drafting, voting, application and judicial approval of a restructuring plan are all regulated in Chapter VIII Restructuring. Art.75 suspends the execution of a secured debt. Art. 82 specifies different categories of creditors' votes on the restructuring plans in different groups.

[40] To name a few, when a reorganization plan is approved, the bankrupt assets would not be executed for the debts through the restructure period. Art. 75 provides a remedy for secured creditors in case of possibility of damages to or obvious reduction in the value of collaterals. The secured creditor(s) can apply to the People's Court for a resumption of the security interest. However, in practice, the secured creditors may not be able to discern the damages or reduction timely. Even if possible, the burden of proof makes the remedy very costly.

4.2.5 Summary

Overall, the company, securities, and bankruptcy laws are nascent in China. The currently effective laws and regulations took shape in the early 1990s and have been modernized and refined through a series of revisions in the ensuing decade. Thus, the implementation and enforcement practice of these laws accordingly has only a very short history.

The basic concepts and general structure of the corporate and securities legislation were firstly designed by emulating the model of civil law countries. With regard to the regulatory approach, there was a gradual relaxation of state control over corporate activities. In the furtherance of efficiency and economic growth, these major revisions imported some US legal strategies. It remains to be seen if these rules with a mixed western style have considered local circumstances and can effectively address the unique local issues.

4.3 General Duties and Liabilities of Directors

The Company Law devotes one complete chapter to regulating the qualifications and obligations of directors, supervisory board members, and senior management personnel via mandatory rules. These mandatory rules are broadly applicable to any directors in corporate entities. With regard to the election, function, and authority, term of office, and meeting procedures of a board of directors, the Company Law employs default rules, and hence, companies may have their own stipulations.

4.3.1 The Capacity of Directors

According to the Company Law, a company must have a board of directors and the board must have a chairman (Art. 45). The number of directors on a board ranges from three to thirteen for an LLC, five to nineteen for a CLS (Arts. 45 and 100). Nonetheless, small LLCs are allowed to simply have one executive director instead of holding a directorial board and the executive director can take a dual position as a general manager (Art. 45).

Similarly, creditors who disapprove of the reorganization plan do not receive compensation for losses, if the court sustains the re-organization plan but the bankrupt asset shrinks eventually.

Art. 79 and 80 articulate that the administrator and the debtor draft the organization plan. There is no room for shareholders of the debtor to participate and voice their interests.

See Steven J. Arsenault, 'The Westernization of Chinese Bankruptcy: An Examination of China's New Corporate Bankruptcy Law through the Lens of the UNCITRAL Legislative Guide to Insolvency Law', (2008) 27 *Penn State International Law Review*, pp. 45-87.

The basic personal information of directors is part of the required materials for the incorporation registration.[41]

Having employee representatives as board members is mandatory for state-owned companies but optional for non-state companies. The employee representatives are elected through the employees' general meeting; and the directors that are not employee representatives are elected and appointed by shareholders (general) meeting.

Listed companies are required to institute independent directors (Art. 123). Independent directors are those 'who do not hold any position in the listed company other than directorship and who have no relationship with the listed company engaging them or with its principal shareholder'.[42] They are expected to provide professional consultancy, objective opinions, and independent judgment in the furtherance of the company's interest.

In sum, directors are elected and appointed through due procedures by the authoritative body to take their seats on the executive board and perform the functions in accordance with the Company Law and the Company's AOA. Besides, their background information is recorded and disclosed in a range of documents, including registration, prospectus, annual reports and so on.

Some jurisdictions around the world deploy the terms '*de facto* director' and 'shadow director' to expansively regulate how board power is actually exercised.[43] A *de facto* director is one who virtually performs a director's function despite the flaws in the appointment procedure or in records.[44] Shadow directors make instructions for and exercise influence on the nominal board of directors, and the directors defer to their instructions.[45] Chinese legal scholars have proposed the introduction of these concepts at the legislation level or in the judicial interpretation by the SPC, considering that the governance practice is complex and not always consistent with legal provisions.[46] In so

[41] See Art. 20 in 中华人民共和国公司登记管理条例 (Regulations of the PRC on the Administration of Company Registration).
[42] In 2001, the CSRC issued 上市公司建立独立董事的指导意见 (Guiding Opinions on Independent Directorship among Listed Companies). The 2006 Company Law formally confirms independent directorship in listed companies with reference to such Guiding Opinions.
[43] London School of Economics and Political Science: Study on Directors' Duties and Liabilities in the EU (2013), pp. 45-54. The full text is available at http://ec.europa.eu/internal_market/company/docs/board/2013-study-analysis_en.pdf (accessed 12/12/2019).
[44] *Ibid.*
[45] *Ibid.*
[46] Guo Feng, 禁止篡夺公司机会规则探究 (Studies into the Prohibitive Rule on Usurping the Company's Opportunities), (2010) 1 中国法学 (*China Legal Science*), p. 105. The author proposed to expand the application scope of corporate opportunity doctrine and introduce the concept of '*de factor'* directors.

doing, those who actually make major decisions or control decision-making are included within the purview of directors' duties.

4.3.2 General Duties

The Company Law explicitly specifies directors' duties in the combination of a general clause and a prohibitive list. The general clause consists of three prongs of legal duties and the prohibitive list fleshes out one prong of general duties.

4.3.2.1 Abide by laws, administrative regulations, and the company's AOA

First and foremost, managerial conduct must be lawful. Namely, directors are required to abide by laws, administrative regulations, and the company's articles of association (Art. 147). This legality requirement is barely discussed by legal scholars, although the violation of this requirement is the only legal ground to bring civil actions against directors (Arts. 149 and 152). Given that a myriad of laws and regulations delineate the boundary of corporate activities and concomitantly impose the compliance requirement on directors and officers, this branch of legal duties, in effect, strengthens external regulatory control by empowering the shareholders and the company to hold directors accountable for the losses arising from illegal corporate activities.

The company's AOA, in essence, is an agreement that shareholders consent to. It is binding on the company, shareholders, directors, and senior officers (Art. 11). The company's AOA is permitted to specifically distribute decision-making power, define how directors and officers perform their functions, and streamline the workflow. Shareholders may revise the terms and conditions occasionally by voting at the general meeting. Thus, compliance with the company's AOA virtually means that directors must behave within the expectation of shareholders.

4.3.2.2 Duty of loyalty

It is generally set forth that directors owe duties of loyalty and care to the company they serve. However, this law does not address the precise meaning of 'duty of loyalty' and the review standard. Only a list of classic breaches of duty of loyalty obliquely fleshes out its content.

There have been law-making attempts to conceptualize the duty of loyalty. The 1994 Company Law required that directors should perform their functions with loyalty and for the benefit of the company that they serve.[47] The 2013 Guidelines on Appointment and Conduct of Directors of Listed Companies, issued by the Shanghai Stock Exchange, fills in the conception gap.[48] It clearly defines that the core of this duty is to take the company's interest as the highest priority. Directors must not harm the company's interest for the interests of the actual controlling party, shareholders, employees, any other third party, or self-interest.[49] Even though these provisions are either invalid or not formally binding, the articulation may still be of use as a reference for interpreting or revising the general term 'duty of loyalty' in the Company Law.

(a) Asset misappropriation

Notably, encroaching on company's assets is flatly banned in tandem with taking bribes and other illegal gains in the same provision of directors' general duties (Art. 148). This suggests that the primary regulatory concern is to prevent and attack asset stripping and corruption, which haunts companies, especially the SOEs. The first type in the list of classic breaches of duty of loyalty is fund misappropriation, followed by depositing the company's fund into personal bank account(s) (Art. 149).

One company, as a legal person, owns assets, funds and other intangible properties. Such property rights deserve legal protection, as accorded to any natural persons. Nonetheless, unlike natural persons, the directors and officers manage the company's fund, sometimes with the assistance of personnel especially in charge of financial matters. They are then prone to take advantage of their positions to possess or use the company's property for personal ends, which not only infringes upon the company's property rights but also betrays the trust vested in their role.

Such wrong-doing is often accompanied by fraud, concealment and conversion. Direct theft of company's equipment, raw materials, and funds, making the company pay more by inflating the billing, expense reimbursement, or payroll schemes, and skimming the profit and receivables are all commonly seen in management practice, especially in companies with weak internal control systems.

(b) Making loans and providing guarantees without due approval

[47] Art. 49 in the 1994 Company Law.
[48] The Guidelines of the Shanghai Stock Exchange on the Appointment and Conduct of Directors of Listed Companies issued in 2009 and revised in 2013. The Guidelines has a separate chapter on the duty of loyalty.
[49] *Ibid.*, Articles 19 to 25.

The prohibitive list also includes using a company's fund to make loans or to provide guarantees to other parties without the consent of the SGM or the board of directors (Art. 149). Such abuse of the company's funds may adversely affect the fund's turnover and even cause cash-flow problems, even if the liability risk is properly assessed in advance and a backup plan arranged. Even worse, individual directors or officers, especially the legal representatives,[50] may covertly enter a loan agreement or a collateral contract with a third party using the company's fund but for some personal benefits. The execution of such contracts does not require the participation of multiple parties in the company and even the conclusion of the contracts may go unnoticed until serious outcomes occur.

According to the prohibitive clause, no matter to whom and on whose behalf or in whose name, making loans and offering guarantees on the basis of the company's funds cannot be decided by individual directors or officers. The chapter on General Provisions of Company Law specifies that offering guarantees for the debt of any party other than the company itself, should in accordance with the company's AOA, be subject to the approval of the board of directors or the SGM (Art. 16). This means that due approval is a statutory pre-requisite for a contract of providing a guarantee by a company. The company's AOA can designate the approval authority to the board of directors or to the SGM.[51] Moreover, these provisions also affect the creditors to such guarantee contracts. The creditors cannot claim themselves as a bona fide third party, and hence, the validity of contract would be sustained, when they have no reason to believe that due approval has been obtained.[52]

(c) Self-dealing transactions

As the term suggests, a self-dealing transaction is akin to making a deal with oneself.[53] When a director represents his or her company and enters into a contract with himself/herself, it is doubtful whether he or she can still negotiate over terms on the standing of the company, as he or she usually does with a third party. One way to eliminate the possibility that the company would be defrauded or the company's interest would be

[50] According to the Company Law, every company has its legal representative, usually a director or a senior manager. The legal representative represents the company in the contracts and participates in litigation.

[51] Jianwei Li, 公司非关联商事担保的规范使用分析 (An Analysis into the Application of the Rules Regarding Corporate Non-Related-Party Commercial Securities), (2013) 3 当代法学 (*Contemporary Law Review*), p. 78.

[52] *Ibid.*

[53] Self-dealing, in a broad sense, refers to any form of diverting a company's wealth by insiders to themselves. See, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, 'The Law and Economics of Self-dealing', (2008) 88 *Journal of Financial Economics*, p. 430. The term in this sub-section only carries a narrow sense as intended in the Art.149 (4) in the Company Law.

prejudiced is to strictly forbid self-dealing transactions. The 1994 Company Law did so.[54] However, the win-win possibility was excluded as well.

The currently effective Company Law prohibits directors from 'entering into a contract with the company or carrying out transactions with the company in violation of the company's AOA or without the consent of the SGM' (Art. 149). In other words, directors are permitted to conduct self-dealings only if the SGM approves the transaction, and the approval and the approved transactions are compliant with the relevant provisions in the company's AOA. In essence, the SGM would make the decision for the company in place of the interested directors, which can help avert potential unfairness to the company arising from the conflict of interests. Yet, these relevant rules contain the following loopholes and inconsistencies.

First, the meaning of self-dealing in law is too narrow to encompass the transactions between the company and another party with whom directors have a close relationship.[55] Consequently, it would be not difficult to circumvent this prohibition. A directors' relatives or close friends might play the opposing party of a self-dealing transaction; however, the director will continue to represent the company. Such camouflaged self-dealing transactions are not subject to the requirement of due approval since the formality does not accord with the narrow-sense of 'self-dealing' in this prohibitive clause.

Second, there is no detailed requirement for information disclosure. There is no specification for information disclosure and the extent that such disclosure is deemed sufficient, not to say the legal consequence of insufficient or falsified information disclosure. Some scholars emphasize that the existence, nature, and extent of the conflict of interests and its potential influence on the proposed transactions should all be disclosed to the authoritative body.[56]

Nevertheless, the liability rule for related-party transactions broadly governs any transactions tainted with personal or other economic interest. Article 21 provides that the controlling shareholders, actual controllers, directors, supervisors, and senior managers of a company should not make use of their relationship or affiliation to damage the

[54] Art. 61 in 1994 Company Law
[55] Xiaojing Hu, 论董事自我交易的规制 (Legal Strategies Regulating Directors' Self-dealing Transactions), (2010) 6 现代法学 (*Contemporary Law Review)*, pp. 14-17.
[56] Ciyun Zhu and Lingjuan Zhu, 规制董事利益冲突交易的披露原则 (Disclosure Principle of Regulating Self-dealing Transactions by Directors), (2002) 2 现代法学 *(Modern Law Science)*, pp. 59-64.

company’s interests, or they assume compensatory liabilities for the resultant losses to the company. The ‘relationship’ or ‘affiliation’ (*guanlian guanxi*) is explicitly defined in a single provision, by the standard of direct or indirect control that the parties mentioned above hold in other enterprises or entities (Art. 217). Moreover, a catch-all phrase ‘any other relationship may result in the transfer of company’s interest’ is added. Therefore, directors engaging in any form of self-dealing transactions or related-party transactions cannot be free from the liability for the losses to the company.

However, the liability rule for related-party transactions is not identical to the liability for unapproved self-dealing transactions. In addition to compensatory liability, any illegal gains from the breach of the duty of loyalty would be confiscated, and an unapproved self-dealing transaction is listed as one of the classic breaches of the duty of loyalty. This means that the magnitude of liabilities from a self-dealing transaction may vary according to their inclusion in the prohibitive list or is left out of the provision regarding the related-party transactions.

In essence, the self-dealing transactions and related-party transactions should not be differentiated in law, because they can all be beneficial to the company as long as the personal interest or the other party’s interest does not cast a shadow on the fairness of transactions. Furthermore, the concomitant liability should not differ between self-dealing transactions and related-party transactions.

Third, it is not flexible that the Company Law only authorizes the SGM to approve self-dealing transactions. For the large companies, especially listed companies, it would be costly and time-consuming to convene a provisional SGM, as individual shareholders may be reluctant to devote time to examining the merit of decisions. Conversely, it is more feasible to render the transaction to disinterested directors, when the board is not small, or leave the choice of the SGM and board of directors to private arrangements. Besides, it is reasonable to exclude the interested shareholders from voting; however, the legal provision does not signify so.

Fourth, the Company Law does not particularly specify the validity of a self-dealing transaction. The only legal rule that can be used to determine the validity is the general provision in the Contract Law.[57] Under the Contract Law, any contract that involves a violation of the mandatory rules in national laws and administrative regulations is null and void.[58] Since the prohibitive list in the Company Law is mandatory, self-dealing transactions without due approval, or violating the company's AOA, should be regarded as null and void as the Contract Law applies. However, this can be unfair to a bona fide director, when the approval may be revoked due to such factors as a defect of the internal approval procedure.[59]

Finally, it is not sensible to arbitrarily consider self-dealing transactions that are in violation of the company's AOA or without the approval of the SGM, to be a breach of the duty of loyalty, and therefore, to prohibit such conduct. The core issue with self-dealing transactions is how directors deal with the conflict of personal interest and the company's interest. The approval procedure or internal rules intend to ensure that the directors refrain from conflicts of interest; however, they do not ensure or deny that the interested directors take the company's interest as priority and fulfil the duty of loyalty, when the self-dealing transactions conclude anyway.[60] Thus, cases of interested directors who commit self-dealing should be reviewed and decided by the courts, considering such a substantive standard as the entire fairness test, rather than determined merely by an *ex ante* procedure.

(d) Usurping corporate opportunities

Although business opportunities are not something like property or assets that owners take possession of and exercise exclusive rights over, indisputably, in the business world, opportunities can also be meaningful. A great opportunity may bring enormous economic benefit or a crucial turning point for the firm. Yet, the potential returns and risks are not always calculable in advance. In some instances, the opportunities may turn out to be nothing material. Nevertheless, this does not justify companies being deprived of the right to take and use the business opportunities that belong to them.

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[57] Ansheng Dong and Baohua Zhang, 缺失的合同效力规则—论关联交易对传统民法的挑战 (The Absence of Validity Rules—the Challenge Posed by Related-Party Transactions to the Traditional Civil Law), (2007) 3 法学家 *(The Jurist)*, pp. 59-66.

[58] Article 52, 54 in The Contract Law (1999), the translated version is available at http://www.china.org.cn/china/LegislationsForm2001-2010/2011-02/12/content_21908031.htm (accessed 08/12/2019).

[59] Unlike other third parties outside the firm, the directors are well aware of the relevant stipulations in the company's AOA. Thus, there is no need to tilt the balance towards the interested directors and sustain the validity of the self-dealing transactions that violate the company's AOA, such as those without due approval.

[60] Ying Sun, 论董事自我交易的法律规制—以《公司法》第 149 条的适用与完善为核心展开 (The Comments on the Regulation of Directors' Self-dealings—with a Focus on the Application and Improvement of Article 149 in the Company Law), (2010) 6 法学 (*Legal Science*), pp. 113-121.

Since 2006, China's Company Law has imported the term 'usurping corporate opportunities' in the prohibitive list of classic breaches of the duty of loyalty. Namely, directors and senior managers are prohibited from making use of their position to take opportunities that rightfully belong to the company for themselves or any other party without the consent of the SGM (Art. 149). The tests for identifying the opportunities that rightfully belong to the companies and what can be construed as 'usurping' are unspecified.

Chinese legal scholars attempted to fill in the legislative gap with reference to the US case law and mainly discussed the following factors: (1) the source of opportunities; (2) the relevance to the firm's business; and (3) the duty of information disclosure.[61] The first two factors determine whether the company should have owned the opportunities. The third factor justifies using corporate opportunities, in other words, ensuring that the company is informed of them.

The first factor represents the inquiry into how directors obtained the opportunity. The perception and attitude of the third party who offers or hints about an opportunity is critical. Explicit expressions of making a deal with the firm would leave no doubt that the opportunity belongs to the firm. Without an explicit or constructive intention about who the third party would like to trade or co-operate with, it is necessary to consider when and where directors learn of the opportunity, and if they obtained relevant information in their directorial capacity and using corporate resources.[62]

The second factor concerns the nature and substance of the opportunity by analysing the 'line of business' test and the 'interest or expectancy' test from the common law tradition.[63] The former test is objective, *i.e.*, whether the opportunity is within the major industry and the business scope of the firm at the time. Yet, this test may fail to capture the opportunities in the industries that the firm has never stepped into but just conceived of an attempt to. The latter test is subjective but equally convincing, since the 'expectation and interest' that the firm has in an opportunity *per se* is what corporate opportunity doctrine aims to protect.

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[61] See *supra* note 46 in this chapter and Shunming Cao and Hua Gao, 公司机会规则研究 (Research on Corporate Opportunity Doctrine), (2004) 2 政法论坛 (*Tribune of Political Science and Law*), pp. 16-23.

[62] Huaixia Hou, 我国禁止篡夺公司机会原则司法适用研究 (A Study into the Judicial Application of Prohibitive Rule of Usurping Corporate Opportunities), (2012) 4 法商研究 (*fashang yanjiu*), pp. 149-155.

[63] See, Yu Long, 浅析英美法中的篡夺公司机会规则及对我国《公司法》的启示 (An Analysis of the Corporate Opportunity Doctrine in the Common Law Systems and the Insights to the Chinese Company Law), (2009) 12 法制与社会 (*Legal System and Society*), p. 76.

As for the third factor, the prohibitive rule makes the consent of the SGM the only condition to justify the use of the corporate opportunity for other ends, but does not particularly set forth the duty of disclosure. Assuming that directors selectively disclose the information that misleads the SGM to agree to the proposals, which are harmful to the firm's interests, such a scenario is not governed by the prohibitive rule nor the liability rules for the breach of duty of loyalty. Then the question of remedying the losses from '*de facto*' usurping corporate opportunities remains undetermined in law.

(e) Engaging in the same business

Directors are great assets to the corporation. Any other business could distract directors from full devotion to the company. However, individuals do enjoy the freedom of conducting business activities willingly. The key policy concern underlying the rules for engaging in the same business as the company, is striking a balance between promoting economic freedom and protecting the company's interest.[64]

In the same clause, with appropriating corporate opportunities, directors and officers are also forbidden to engage—for himself, for herself, or for other parties—in the same type of business that the company runs, unless the SGM consents to it (Art.149). Setting restrictions on doing the same type of business is a prophylactic measure. In so doing, associated misconduct—usurping corporate opportunities and divulging corporate secrets can be forcefully alleviated. However, the SGM's consent would be more difficult, if not entirely impossible, to obtain, unless any substantial benefits outweighed the potential competitive pressure for the company. In effect, directors can hardly make use of their own capacities and professional experiences in any other entities or for any other parties than the company they serve.

The provision leaves some issues unregulated but intensely discussed in scholarly writings. First, what business can be acknowledged as 'similar to' or 'the kind of' company's business is not self-evident. The preliminary step is to discern the company's business. Some scholars noted that the registered business scope may be inconsistent with the actual operations of the company. Following this opinion, some scholars held that if the enterprise involves business information (not limited to corporate secrets) that directors

[64] Warner Fuller, 'Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors', (1941) 26 *Washington University Law Quarterly*, p. 189.

know of and the transfer or use of such information may generate competitive pressure on such firms, then the enterprise should be considered as 'a similar business'.[65]

Second, as regards the meaning of 'for themselves or for other parties', the prevailing opinion is to identify whether a director makes any earning from another enterprise. What role the director plays is not decisive.[66] Such an interpretation includes the regulatory focus on the protection of the company's interests, attempting to block any channel of diverting the company's assets and to prevent information leakage.

Third, many scholars argue that supervisory board members enjoy a wide range of statutory powers to perform the monitoring function, and therefore, may readily obtain the information related to financial status, business strategies, and even the development of the core technology. Thus, it is of great necessity to include supervisory board members also to protect the company's interests better, or they may exploit the loophole to give inside information to the company's competitors for their own interests.[67]

Fourth, whether directors and officers are still obliged to refrain from engaging in a similar business after retirement or resignation is an issue that involves the overlap of relevant provisions in the Company Law and the Labour Contract Law.[68] The Company Law neither holds the prohibition period to be longer than the term of office nor leaves this issue to the company's AOA. On the contrary, the Labour Contract Law sets forth that one employee and the employer may agree on confidentiality duty and non-competition restriction in the labour contract upon the rescission or termination of the labour contract. The employer may grant the employee monthly compensation in the non-competition restrictive period.[69]

[65] See, e.g., Yehu Zhai, 论我国竟业禁止立法不足与完善 (Observations on the Deficiency of Rules Regarding Prohibiting Engaging in Competitive Business), (2011) 1 湖北社会科学 (*hubei shehui kexue*), pp. 6-14.
[66] Jianfeng Jin, 公司管理层法定义务和立法完善 (Statutory Duties and Civil Liabilities Imposed on Corporate Management Personnel), (2008) 2 法律适用 (*falv shiyong*), pp. 12-18.
[67] Bo Jiang, 竟业禁止的相关问题 (Relevant Issues to Prohibition of Engaging in Competitive Business), (2006) 10 人民司法 (*renmin sifa*), pp. 71-74.
[68] Linqing Wang, 公司法下与劳动法语境下竟业禁止之比较 (Comparisons of Prohibition of Engaging in Competitive Business under the Company Law and Labour Contract law), (2013) 31 政法论坛 (*Tribune of Political Science and Law*), pp. 91-98.
[69] Art. 23 in the Labour Contract Law (effective in 2008 and revised in 2012) and the official translated version are available at http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content_1471106.htm (accessed 10/12/2019).

In essence, the non-competition restriction under the Company Law is a statutory duty imposed on directors and officers because they occupy crucial positions and are entrusted with managerial power. The non-competition restriction covenant pursuant to the Labour Contract Law is subject to the freedom of contract. Directors, like other employees, may negotiate on the relevant terms and conditions when signing the labour contract, which can generate a more flexible and pragmatic arrangement regarding the non-competition restriction after retirement or resignation.

4.3.2.3 Duty of care

The notion that directors ought to diligently perform their functions in the first place emerged in the 2002 Guidelines of Corporate Governance of Listed Companies. [70] Afterwards, the 2006 Company Law has explicitly extended this ethical requirement into the duty of care universally applicable to directors and officers in all types of companies, imparting it with a stronger binding force. However, there remains a vacuum in the meaning and standard of due diligence.

Duty of care, also called duty of diligence, is generally viewed as the transplantation of fiduciary duty of care from common law tradition.[71] Thus, many scholars turn to the case laws of Delaware and other states in the US, aiming to refine the general principle of due care in China's Company Law.[72] Meanwhile, it is necessary to remember the difficulties of codifying the fiduciary doctrines that originally embody the sophisticated case laws into transitional civil law systems.[73] Doubts are also raised about whether Chinese judges can

[70] The Code of Corporate Governance of Listed Companies (上市公司治理准则) was the first guidelines of corporate governance in China, collectively issued by the China Securities Regulatory Commission and State Economic and Trade Commission. In the *Guidelines*, Section 2 focuses on directors' duties and Art. 33 sets out that directors should play their roles with loyalty, due diligence, good faith to pursue the best interests of the company and all shareholders. The full text of this *Guidelines* is available at http://www.ecgi.org/codes/documents/code_en.pdf (accessed 29/11/2019).

[71] See Nicholas C. 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', Hideki Kanda, Kon-Sik Kim, and Cutis Milhaupt (eds.), *Transforming Corporate Governance in East Asia* (Oxford : Routledge, 2008), pp. 193-254.

[72] See, e.g., Guangdong Xu, Tianshu Zhou, Bin Zeng, and Jin Shi, 'Directors' Duties in China', (2013) 14 *European Business Organization Law Review*, pp. 57-95.
Zili Ren, 公司董事的勤勉义务标准研究 (Research into the Standard of Directors' Duty of Care), (2008) 6 中国法学 (*China Legal Science*), pp. 83-92;
Jianwen Wang and Feijian Xu, 公司高管勤勉义务判断标准的构造：外国经验与中国方案 (The Constitution of the Review Standard of Directors' and Officers' Duty of Care: Experience Abroad and Solutions Domestic), (2012) 9 南京社会科学 (*Nanjing Social Science*), pp. 110-115.

[73] See Rebecca Lee, 'Fiduciary Duty without Equity: "Fiduciary Duty" of Directors under the Revised Company Law of the PRC', (2007) 47 *Virginia Journal of International Law*, p. 897;

play a pro-active role in the interpretation and application of this general term.[74] Leaving the observations on the application of the duty of care to the next chapter, this section mainly addresses the following technicalities that require further clarification.

(a) Standard

Setting the standard of due care is quite challenging. The subjective competence, skills, and experience of a director may hardly be identical to that of another. Involvement in business issues and the circumstances of the companies may also substantially differ. Even assuming one director in the same company addresses business matters in one industry, the proper manner of exerting power in one case may mean something quite different in another case. Besides, it is very difficult for other parties than the directors themselves, to measure the energy and efforts are actually devoted and whether there is any sloppiness, not to say measured *ex post* by judges.

Regulatory documents and self-regulatory rules have provided comprehensive conduct standards to improve the corporate governance of listed companies.[75] The directors should pursue the best interests of the company and all shareholders.[76] Considering that business decisions are collectively made, active participation at board meetings, awareness of the due decision-making procedures and the scope of decision authority, prudential deliberation on the proposals before the meetings, and certain causes for abstention from voting are all emphasized as elements under the umbrella of the duty of care.[77]

Besides, directors must actively ask relevant personnel to provide precise information and take the initiative to investigate the operations of the company. In the decision-making process, directors are expected to carefully calculate the risks and benefits of the proposed actions.[78] Primarily, they must consider a wide range of factors, including potential benefits and losses, the method and basis of asset pricing, feasibility and lawfulness, the credit of the opposing party in the transaction and of the interested parties that the

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Katharina Pistor and Chenggang Xu, 'Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law', in C. J. Milhaupt, (ed.), *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era Cross-Border Deals* (New York: Columbia University Press 2003), p. 78.

[74] *Ibid.* Pistor and Xu (2003).

[75] Considering that the enormous number of regulatory documents and self-regulatory rules in China, to avoid the major omissions, one can input directors' duty of diligence in the database of Chinese laws and regulations (wkinfor or chinalawinfo) to obtain an exhaustive list.

[76] Art. 33 in Code of Corporate Governance of Listed Companies.

[77] *Ibid.*, Art. 35.

Art.28 and 32 in the Guidelines of Shanghai Stock Exchange on Appointment and Conduct of Directors of Listed Companies http://www.sse.com.cn/lawandrules/sserules/listing/stock/c/c_20150912_3985863.shtml (accessed 12/12/2019).

[78] *Ibid.*

opposing party has a relationship with, and the long-term impact. Overall, the 'soft' substantive rules use the 'duty of care' as a penetrating principle to delineate the desirable manner in which directors play their roles.

At first glance, the conduct standards mentioned above are quite inclusive. However, the expressions 'actively', 'carefully', and 'prudential deliberation' are still a matter of degree. Then the most challenging part of the due diligence doctrine emerges: what is the standard of care? Furthermore, failing to fulfil that standard may possibly incur a liability.

Many Chinese legal scholars have conducted comparative studies and discussed how to define the standard of care. The statement most frequently referred to and advocated, regarding directors' duties in the Model Business Corporation Act of the US[79], is as follows: 'A director shall perform his duties as a director, ……in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances'.[80] A large number of states have similar provisions in their corporate statutes. It is also called the 'reasonable care standard'. Fletcher defines the liability standard as follows: 'directors and officers of a corporation must use due care and are liable for their negligence in conducting the affairs of the corporation'.[81] This means that directors' liabilities are not for any losses arising from their business decisions. It is acceptable that someone with competence and capability constraint makes mistakes as long as he or she exercises due care.

There is a complete set of statutory rules for the duty of care and the negligence standard in the US, with variance among different states. In addition, relatively dynamic corporate litigation practice and abundant case laws contribute to the prevailing influence of the US fiduciary duty principle around the world. This does not necessarily mean that the reasonable care standard is sufficiently clear and precise. To apply this standard, the courts first need to examine factual situations in which the decision was made, and then identify

[79] See Jianwen Wang, Feijian Xu, 公司高管勤勉义务判断标准的构造：外国经验与中国方案 (The Device of Review Standard of Senior Managers' Duty of Diligence: Foreign Experience and Chinese Plan), (2012) 9 南京社会科学 (*Nanjing Social Science*), pp. 110-115.
Huihong Zhu, 董事勤勉义务比较分析 (A Comparative Analysis into Director's Duty of Care), (2011) 2 法商研究 (*fashang yanjiu*), pp. 67-68.
Jingwei Liu, 董事勤勉义务判断标准比较研究 (A Comparative Study on the Criteria of Director's Duty of Diligence), (2007) 21 当代法学 (*Contemporary Law Review*), pp. 5-9.

[80] Corporate Laws Committee in American Bar Association: Modern Business Corporation Act (2010). This exemplary act is followed by 24 states in the US.

[81] William Meade Fletcher: Fletcher Cyclopedia of the Law of Private Corporations §1029.

the subjective factors, including motivation, goal, qualification, and actual efforts. Finally, they must determine if there is a lapse of care.

(b) Business judgment rules (BJR)

China's Company Law does not adopt the BJR, which is the adjunct to the fiduciary duty of care in US corporate laws. The BJR is a presumption that shields directors from judicial scrutiny when they make business decisions in good faith, to the best interests of shareholders and the company, without any conflict of interest, and on an informed basis.[82] In other words, if plaintiffs cannot rebut the presumption, judges would defer to the directors rather than conduct any merit reviews to assess the degree of care taken. Some legal scholars opposed this 'judicial retreat into the presumptive arena of the business judgment rule' and doubted 'whether there still exists a sanction for lack of care'.[83] Law and economics scholars argue that the judicial review of the reasonableness of a business decision is not efficient because of expertise limitation and hindsight bias. Moreover, excessive personal liability would make directors avoid risky decisions that might be desirable to shareholders.[84] Nonetheless, a common view is that the core issue as to duty of care is how to maintain a balance between discretion and liability.[85]

The adoption of the BJR is still under scholarly debate in China. Some commentators asserted that the BJR should be imported to keep the Chinese version of fiduciary duty doctrines complete.[86] It was suggested that judicial interpretation by the SPC is more suitable than legal rules to embrace the dynamic interaction between the BJR and business practice.[87] Also, some studies focused on the case law of the BJR in the takeover scenario,[88] revealing the complexity of the BJR, and emphasized the utility and

[82] Consolo v. Federal Maritime Comm'n, 383 U.S. 607, 620 (1966), p. 144.
[83] Stuart R. Cohn, 'Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule', (1983) 62-4 *Texas Law Review*, p. 594.
[84] See *supra* note 45 in Chapter 2 (Easterbrook and Fischel 1991).
[85] See *infra* note 90 for Stephen M. Bainbidge 2002.
[86] See, e.g., Zhongli Li, 董事违反注意义务之责任追究—以美国的经营判断法则为例 (Liabilities against Breaches of Duty of Care by Directors—Taking the US Business Judgment Rule for Example), (2010) 3 湖北社会科学 (*Hubei Social Science*), pp. 162-165.
Jingwei Liu, 董事勤勉义务判断标准比较研究 (A Comparative Study into the Standard of Directors' Duty of Care), (2007) 21-5 当代法学 (*Contemporary Law Review*), pp. 148-153.
[87] Qiong Fu and Li Cao, 独立董事勤勉义务边界与免责路径 (On the Boundary of Independent Directors' Duty of Care and Liability Relief Approach), (2011) 12 社会科学 (*Journal of Social Science*), pp. 111-117.
[88] See the landmark cases: Unocal Corp v. Mesa Petroleum Co. 493 A.2d 846 (Del. 1985), Revlon, Inc. v. MacAndrews & Forbes Holding, Inc. 506 A.2d 173 (Del. 1986),

applicability of the BJR in China.[89] However, scholarly discourse has not yet received the attention of policymakers.

4.3.3 Civil Liabilities

Legal duties only count when liabilities are stipulated as the consequences of deviation from legal duties. One distinguishing feature of the 2006 Company Law is the clarification of monetary liabilities for breaches of legal duties in comparison with its predecessor laws. Directors' liabilities are just a case in point.

The elements of a liability claim

Pursuant to the Company Law, three elements are necessary and sufficient to establish a claim of directors' liability: (1) a violation of laws, administrative regulations, or the company's AOA; (2) damages to the company or to the shareholders; (3) causal link between the violation and damages (Art. 149 and 152).

A perplexing issue surfaces: why is only the first part of directors' duties set as the legal ground for holding directors liable. No official document can provide any clue about the legislative intention of the liability rules. However, most legal studies have focused on the standards of due care and loyalty. The slight mismatch between the contents of directors' duties and the liability standard is simply ignored.

Perhaps, one may see this question as meaningless from a pragmatic perspective. Duties of loyalty and care are explicitly prescribed in the Company Law; breaches of these duties *per se* constitute violations of national law, and the liability rules are applicable anyway. Thus, breaches of duties of loyalty and care are actually absorbed into the violation of laws as a count of directors' liability.

However, duties of loyalty and care have their independent merit and attributes. These duties arise from the legal relationship, which is of private law nature. In the paradigm of private law, breaches of duties probably result in liabilities to the other party in this legal relationship. Yet, the Company Law holds murky water. Despite recognizing the directors' duties of loyalty and care to the companies that they serve, liabilities are sanctioned on account of legal violations. Such a design reflects the orientation of government regulation,

[89] Charlie Xiao-chuan Weng, 'Assessing the Applicability of the Business Judgment Rule and the Defensive Business Judgment Rule in the Chinese Judiciary: A Perspective on Takeover Dispute Adjudication', (2010) 34 *Fordham International Law Journal*, pp. 124-147.

which to some extent, buries the core requirement of devotion, loyalty, professionalism, and prudence on the part of directors.

4.3.4 Legal Standing to Sue Directors

The Company Law explicitly acknowledges the litigation rights and legal standings to enforce directors' liabilities. One way is to proceed as ordinary tort lawsuits. The one who suffers the losses is the one who sues. Shareholders have the litigation right to sue the directors and senior managers who violate their duties and cause them losses (Art.153), and so do companies to claim their losses. The other method is shareholders derivative action, a concept from the US, to overcome internal obstruction in the execution of a company's rights.

Shareholders derivative actions

Shareholders initiate derivative action to recover the losses caused to the company. Its essence is that shareholders can execute the company's right of litigation. On the one hand, a company is a legally artificial person and its board of directors or other insiders make decisions. In the event of a lawsuit against the directors themselves or their peers, it is highly possible that they will abstain from or obstruct the action. Therefore, shareholders are granted the legal standing to seek remedies for their company. On the other hand, someone might just buy the shares of a company and misuse this derivative action to attack the directors and the company. The news of a lawsuit concerning management conduct harms the reputation and reduces the market value of a company. Thus, the legal design of shareholders derivative actions is to screen frivolous actions and to incentivize shareholders to take appropriate action.[90]

(a) Proper shareholder plaintiffs

Plaintiff qualification requirements for shareholders in LLCs and CLSs are differentiated. LLCs usually have a close-knit group of shareholders. The shareholders' trust in each other is the basis of co-operation, similar to a partnership. The shareholders' interest is closely related to the LLC's. In addition, there is a statutory limitation to the free transferability of LLC shares to maintain stable co-operation.[91] A stranger cannot become an LLC's shareholder unexpectedly, and file a lawsuit without merit. Thus, the shareholders of an

[90] Stephen M. Bainbridge, *Corporation Law and Economics* (foundation press, 2002), pp. 370-386.

[91] According to Article 72 of the Company Law, one shareholder, planning to transfer their shares to a third party should obtain the approval of more than half of the other shareholders in the LLC. If the other shareholders disagree with the external transfer, they have the obligation to buy the shares. In another word, shareholders in the LLC have a pre-emptive right to acquire the shares of other shareholders.

LLC, irrespective of the duration or magnitude of their contribution to the LLC's capital, are all plaintiffs qualified to initiate a derivative action (Art.152).

Unlike an LLC, a CLS has a large group of shareholders, and these shareholders are readily voting with their feet through the operation of the CLS. Assuming a CLS is listed on the stock exchange, numerous public investors are trading its shares, the majority of whom are concerned about the fluctuation of share price. It is possible that a shareholder will misuse derivative action to make speculative deals if no qualification requirement is in place.[92] The Company Law stipulates that one shareholder holding, or several shareholders jointly holding, at least 1% of the total shares for at least 180 consecutive days may file a derivative action (Art. 152). Indeed, 1% of the total shares of a listed company represent a large sum of investment. Institutional investors just fulfil the ownership requirement and are qualified to use derivative actions to monitor management conduct.[93]

(b) Demand requirement

Before instigating legal proceedings, qualified plaintiff shareholders ought to make written demands on the supervisory board or the supervisor of the LLC to pursue the claim regarding directors' liabilities (Art. 152). This is a compulsory requirement that embodies the principle of exhaustion of intra-corporate remedies.[94] If the supervisory board or the supervisor of the LLC rejects the demand or fails to initiate a lawsuit within 30 days after receiving the demand, the qualified plaintiff shareholders may file a derivative lawsuit in the people's court. This demand requirement can be waived when there is an emergency and the failure to pursue a claim immediately will cause irreparable harm to the company (Art. 152).

[92] Hui Huang, 'The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform', (2007) 4 *Berkeley Business Law Journal*, p. 237. The author also argues that minority shareholders in LLCs have 'graver plight' than do their counterparts in CLSs, and thus, deserve more access to derivative actions. This observation is partially true due to the statutory limitation for share transfer and the lack of regulatory monitoring of LLCs. However, minority shareholders in LLCs have a wide range of information rights and can participate in decision-making and governance issues, such as the nomination of directors. A general comparison of the situation of minority shareholders may not stand solid.

[93] *Ibid.*

[94] Daniel R. Fischel, comment: 'The Demand and Standing Requirements in Stockholder Derivative Actions', (1976) 44 University of Chicago Law Review, p.168.
Donald C. Clarke and Nicholas C. Howson, 'Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China', in Dan W. Puchniak, Harold Baum, and Michael Ewing-Chow (eds.) *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge: Cambridge University Press, 2012), pp. 243-278.

4.4 Information Disclosure Duty of Directors in Listed Companies

In securities market, investors usually have serious information problems. Unlike grocery shopping, where buyers can readily perceive the quality of the goods and compare the prices of different sellers, public investors are not able to obtain full knowledge of the current status and development potential of one listed company. Although listed companies are willing to disclose information to attract investors,[95] the quality and completeness of the information are not quite reliable, at least in the perception of investors.[96]

To alleviate the information asymmetry, government regulation comes into play and a mandatory information disclosure system is adopted worldwide. Credible information disclosure facilitates the flow of capital resources to the companies that are likely to create more value. Thus, the information disclosure system is the cornerstone of a well-functioning stock market.[97] Besides, an information disclosure system helps in reducing agency problems and increases the public exposure of listed companies.

4.4.1 Directors' Duty of Information Disclosure

Pursuant to general legal rules in the Company Law, directors in listed companies also owe duties of loyalty and diligence to the company and are expected to further shareholders' interests as a whole. Shareholders are entitled to the operational information of the company. Directors' information disclosure duty according to the Securities Law makes a difference only because the scope of beneficiaries of such duties is expanding to any investors in the securities market. The disclosed information amounts to public goods, and accordingly, is subject to government regulations. In this regard, the nature of information disclosure duty is hybrid.

In China, the Securities Law and regulatory documents issued by the CSRC combine to establish the information disclosure system. The Securities Law employs one chapter to set forth general principals, contents, formality, manner, and accountability with regard to information disclosure. Since the securities market and the supporting institutions remain in the initial stage, the CSRC issued regulatory documents—Administrative Measures on

[95] Sanford J. Grossman and Joseph E. Stiglitz, 'On the Impossibility of Informationally Efficient Market', (1980) 70 *The American Economic Review*, pp. 393-804.
[96] With regard to the quality and uncertainty of the information disclosed in the capital market, refer to Gorge A. Akerlof, 'The Market for Lemons: Quality Uncertainty and the Market Mechanism', (1970) 84 *The Quarterly Journal of Economics*, pp. 488-500.
[97] For the role of information disclosure in securities market, see, Paul M. Healy and Krishna G. Palepu, 'Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature', (2001) 31 *Journal of Accounting and Economics*, pp. 405-440.

Information Disclosure by the Listed Companies to streamline the procedures of information disclosure, clarify the accountability of the obligators, and ultimately to strengthen the compliance with legal rules.[98]

In principle, information disclosed by an issuer or a listed company must be 'truthful, accurate and complete' and should not consist of any false or misleading statements or major omissions (Art. 63). To better implement the requirements of information quality, directors, supervisory board members, and senior management personnel in the listed companies also have the duty of 'ensuring the veracity, accuracy, and completeness' of disclosed information (Art. 68).

A series of documents that a listed company must release include the prospectus, listing memorandum, listing announcement, regular reports, and interim reports (Arts. 65, 66 and 67). All of these documents must be submitted to the CSRC and the stock exchange in a timely manner.

The major contents of these documents are as follows: (1) general situation of the company; (2) financial statement and business of the company; (3) brief introduction of the directors, supervisors, and senior management personnel of the company and their respective holdings of the company's shares; (4) the names of the top 10 shareholders of the company and their respective shareholdings; (5) actual controller; (6) major lawsuits in which the company is involved; (7) any major event that could have substantial impact on the share price; (8) other matters as may be prescribed by the CSRC (Art. 65, 66, and 67).

Directors and/or senior managers of a listed company are required to sign their written opinions to confirm the regular reports of the company. The board of supervisors of a listed company reviews these regular reports prepared by the boards of directors and provides its written opinions after a review (Art. 68). The regular reports include annual, half-year, and quarterly reports, which contain financial status, accounting report, on-going business projects and any other information that may significantly influence investment decisions.[99]

The regulatory document (Administrative Measures) stresses that directors and officers should perform the information disclosure duty faithfully and diligently. Timeliness and

[98] Full version is available on the CSRC's official website: http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgz/ssl/201012/t20101231_189729.html (accessed 08/12/2019).
[99] *Ibid*., Art. 19.

impartiality are added as the information quality requirement.[100] Specifically, directors are expected to continuously monitor and be informed of the operational and financial status of the company, the occurrence of major events, and their potential influence on the company. Directors are also expected to take the initiative to investigate and acquire the necessary information for decision-making.[101] Such recommended practice, in essence, addresses the possibility that some directors may attempt to exempt themselves from the duty of information disclosure by claiming they do not know what is going on.

This regulatory document pushes forward the management system for information disclosure matters to standardize the procedure of transmission, review, and disclosure of information. In this system, directors also need to monitor the preparation of information disclosure documents and ensure that the disclosure is timely and within the stipulated period. Meanwhile, the performance of information disclosure duty will be kept as a record.

4.4.2 Liabilities for Misrepresentation

Civil liabilities, administrative penalties, and criminal punishment are all waiting for any liabilities for misrepresentation. Civil liabilities are more about providing dispersed investors in the stock market with a channel to seek the remedies. However, civil litigation on this issue has been restricted for long in China, and only relaxed very recently. The primary method to address misrepresentation problems is public enforcement, especially the CSRC sanctioning administrative penalties.

4.4.2.1 Administrative penalties

Under the Securities Law, directors may be sanctioned with a fine ranging from 30,000 to 300,000 CNY, when the listed company (or issuer) they serve failed to disclose information according to the relevant regulations, or the disclosed information has any false entry or misleading information. For the same reason, the listed company would also be ordered to rectify, or given a warning, and be fined in the range of 300,000 to 600,000 CNY (Art. 193).

The CSRC has the authority to investigate the recent movement of any parties in the securities market, including listed companies and issuers. When the CSRC notices irregularities, it may directly launch a formal case, determine the nature of activities, and announce administrative penalties. Literally, the legal ground for the administrative

[100] *Ibid.*, Art. 3.
[101] *Ibid.*, Art. 42.

penalties would be very inclusive, not only including the typical "cooking" of accounts but also for non-compliance with the regulations such as 'Administrative Measures'.

4.4.2.2 Civil liabilities

When any fraudulent, misleading statements, or major omissions in a disclosed document cause losses to the investors, the directors, supervisors, senior managers and other directly accountable personnel of the listed company or the issuer are jointly and severally liable for investors' losses, unless they can prove that they have no fault.[102]

In the Administrative Measures, the exemption of liability has its basis in that directors can prove diligence in the performance of their functions. This is a very high standard. Misrepresentation is a tort to investors. The legal rules to the effect presume that directors and other obligators are at fault in misrepresentation. If they wish to evade administrative sanctions, directors must prove their diligence in all activities. This standard is much higher than that of 'no fault'. In practice, it would be very difficult to establish exemption conditions.

Moreover, this regulatory document addresses a situation in which directors, senior managers, and the supervisory board are not able to ensure the quality of disclosed information, or hold different opinions. They are required to state and disclose such reasons and opinions (Art. 24). Besides, the regulatory document further specifies that the written opinion of the supervisory board must set out whether document preparation and review procedures are lawful and whether the contents of the report are a true, accurate, and complete reflection of the status of the listed company (Art 24).

4.5 Directors' Liabilities to the Company's Creditors

Normally, a board of directors, a collegial and internal organ, does not have a direct legal relationship with the company's creditors. Even in cases where individual directors infringe upon the rights and interests of a third party while holding office, the company is responsible for their behaviour, according to the *Respondeat Superior* principle. However, the party that actually exerts an impact on the creditors' economic interest is not the company but the decision-makers therein. Such an impact becomes immediate and direct when the company is in the vicinity of insolvency. Any value reduction in the company's assets means less the likelihood of debt recovery to the creditors. In light of this, the

[102] Under the Securities Law, intermediary agencies and other goalkeepers also assume joint and several liabilities as directors do, which this thesis leaves out to remain focused on the research subject.

Enterprise Bankruptcy Law addresses the potential threat to creditors' interest by imposing liabilities on the people chiefly in charge. Quite often, these people chiefly in charge are no one but directors and senior managers of the company.

Specifically, directors would be liable for creditors' losses when their insolvent companies have: (1) transferred their asset for free; (2) made deals at unreasonable prices; (3) provided guarantees to creditors previously unsecured; (4) paid off the debt to some creditor(s) before the due date; (5) waived their creditor's right; (6) concealed or transferred their asset to evade debt; and (7) fabricated debt or assumed unrealistic debt (Arts. 31, 32, and 33). Here, insolvent companies are those whose bankruptcy petitions have been accepted by the courts.

Besides, the Enterprise Bankruptcy Law also generally sets forth that 'directors are liable when their breaches of the duties of loyalty and care cause the company's bankruptcy' (Art. 125). However, to whom and for what losses directors are liable is barely comprehensible. If applying this provision anyway, it is not practically feasible to identify the causal link between breaches of the duties of loyalty and care, and the company's collapse, except for egregious violations.

In addition, when the company's assets do not suffice to pay off its debt, its creditors are granted legal rights to go after the shareholders who have withdrawn capital already contributed to the company or defaulted on the payment of capital.[103] These shareholders are liable for the company's debt to the extent of their subscribed capital and the interest accruing from the subscribed capital.[104] Meanwhile, directors who have aided such withdrawal and evasion are jointly and severally liable with such shareholders.[105]

In fact, other shareholders who have fulfilled their duties of capital contribution are entitled to require full payment of the capital and the interest accruing from the unpaid capital after the due date.[106] It is argued that promoters and shareholders have consented to a contract or some provisions regarding capital contribution, and thus, the duty thereof, is of a contractual nature.[107] Shareholders that fail in performing their duties of capital contribution are liable for breach of the contract. Directors who assist in such breaches of

[103] Art. 36 and 200 in the Company Law
[104] Art.14 in 关于公司法若干问题的规定（三） (The Provisions of Several Issues Concerning the Company Law of the PRC III) issued by the Supreme People's Court in 2014. This *Provisions* is the judicial interpretation.
[105] *Ibid.*
[106] *Ibid.*, Art. 15
[107] Lei Hao, 协助抽逃出资情形下董事对债权人的责任 (Directors' Liability to the Company's Creditors in the Event of Aiding in Capital Withdrawal and Capital Evasion), (2012) 5 人民司法 (*renmin sifa*), pp. 85-90.

contractual duties are jointly and severally liable for the return or completion of capital contribution.[108]

To sum up, China's lawmakers hold conservative and cautious attitudes towards directors' liabilities to the creditors. Only when a company is under the bankruptcy procedure and the directors intentionally adopt schemes to reduce the company's asset, directors would be held liable for the creditors' losses. Such liabilities are commonly deemed as tortious liabilities, falling in the category of infringement on creditors' rights in the China's Tort Law.[109]

However, Chinese law does not particularly regulate directors' behaviour when their companies are financially distressed. Shareholders might prefer a high-risk project because of the prospect of profit without suffering losses beyond their capital contribution, while creditors prefer stable projects to maintain the company's assets so that they can ultimately claim their loans and interests.[110] Intensive discussion is necessary to understand the position of directors in such circumstances and if they should have specific duties, such as filing a bankruptcy request on time and prioritising creditors' interests. At present, the discussions are mainly focused on the technicalities and the applicability of the liability rules to creditors. However, fundamental issues such as the policy goal and benchmark remain unexplored.

4.6 Conclusion

China has set up a multi-layered system of substantive rules regulating directors' performance in companies. The Company Law designs the most fundamental doctrines: directors must abide by laws, administrative regulations, and the company's AOA; they owe the duties of loyalty and care to the company they serve. The classic breaches of loyalty duty are conditionally prohibited, including but not limited to asset misappropriation, self-dealing transactions, engaging in the same business as the company, usurping corporate opportunities, divulging corporate secrets, and accepting illegal gains and bribes.

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[108] See Art. 14 (1) in Provisions of Several Issues Concerning the Company Law of the PRC III) issued by the Supreme People's Court in 2014 (*supra* note 10).

[109] Guo Feng and Ruijuan Chai, 论董事对公司债权人的责任 (Debate on Directors' Liabilities to the Company's Creditors), (2007) 1 国家检察官学院学报 (*Journal of National Prosecutors College*), pp. 115-121.

[110] Laura Lin, 'Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors', (1993) 46 *Vanderbilt Law Review*, pp. 1486-1524.

Directors’ liabilities can arise from damages caused by violations of laws, administrative regulations and the company’s AOAs. Whether merely a breach of duty of loyalty or of care suffices to make the cause of actions against directors, is not explicitly stated in the Company Law. Under the Enterprise Bankruptcy Law, directors would be liable for corporate bankruptcy caused by breaches of duties of loyalty and care. However, bankruptcy law does not specify the scope and magnitude of personal liabilities in the event of corporate bankruptcy.

Directors in listed companies must ensure the veracity, accuracy, and completeness of the disclosed information to the public. When the prospectus, regular and interim reports, and other disclosed documents contain any fraudulent information, misleading representation, or major omission, directors are jointly and severally liable for the losses suffered by the investors due to the inaccurate, incomplete, or fabricated information. Meanwhile, the CSRC may impose administrative penalties on the listed companies and parties who are chiefly in charge, regardless of actual losses to the investors.

Both shareholders and the company have the legal standings to file a lawsuit to claim directors’ liabilities for their respective losses. Besides, derivative actions are also legitimately confirmed to reinforce the implementation of liability rules.

Admittedly, the underlying theory of the legal strategy is not yet well developed; the technicalities of directors’ duties and liabilities need to be revised and refined. Regulatory documents and self-regulatory rules have continued to put flesh on the general duties. As the incomplete law theory argues, the dilemma of flexibility and precision confronting the duty and liability rules cannot be completely resolved at the law-making stage. Then how the adjudicators interpret and apply the legal rules is absolutely crucial to achieving the ultimate policy goals.

Chapter 5 Enforcement of Directors' Duties and Liabilities in China

5.1 Introduction

Law enforcement is decisive in the deterrent effect of liability rules and influential in compliance practice. This chapter examines the enforcement of legal rules regarding directors' duties and liabilities in current practice and the general level of liability risk confronting directors. Since adjudicators, through formal procedures, sanction or award legal liabilities, the magnitude of liability risk depends on the frequency of invoking formal procedures to challenge management, and the adjudicators' interpretation and application of liability rules, especially the degree of strictness of the liability standard. The remainder of this chapter is divided into two parts to examine how private litigation and administrative sanctions, respectively, operate in China. Each section not only addresses the enforcement intensity and magnitude of liability but also reveals the factors responsible for the current practice. The major methodology employed in this chapter is the analysis of judicial decisions and administrative sanction decisions.

5.2 Private Litigation

As stated in the previous chapter, it was not until the revised Company Law came into force in 2006 that private parties became empowered to sue directors and officers for their wrong-doing. In the ensuing decade, this new type of lawsuits has aroused some scholars' attention. This section first reviews previous empirical studies and compares their findings and analysis. Subsequently, it examines an updated set of cases to understand the current pattern of directors' liability lawsuits. To identify the reasons for the efficacy of directors' liabilities, it examines such factors as the incentives of prospective plaintiffs to sue, the inclination, capacity and role of Chinese judges, and other deeply ingrained factors, in detail.

5.2.1 Previous Empirical Research

There are three sets of empirical research into cases pertaining to directors' liabilities for losses suffered by the company or/and shareholders. The earliest set of empirical studies was conducted soon after official confirmation of private actions to enforce directors' liabilities, which is one part of the research project on new types of corporate litigation.[1] This project was approved and financially supported by the Beijing Municipal Commission of Education. The research team consisted of the legal scholars at Peking University and the judges in Beijing people's courts at the basic, intermediary, and higher levels.[2] They selected 352 cases handled by Beijing people's courts at all levels in the years 2006 and 2007, classified these cases into 17 types,[3] and analysed them from both academic and practical perspectives.[4]

Amongst others, only 16 cases concerned directors' liabilities for company's losses, and only one case touched upon the breach of the duty of care. In these 16 cases, the courts tended to review whether the procedure and formality in which directors made decisions were consistent with the company's AOA, rather than examining the merits of the decisions and action challenged.[5]

They portrayed a series of features that all the new types of corporate litigation possessed, including the cases of directors' liabilities. First, a great majority of the cases were arising from LLCs, whilst few were related to CLSs. The authors presented two reasons for this phenomenon: first, the number of LLCs is much larger than that of CLSs, as the capital requirement for setting up an LLC is much lower.[6] Second, there are statutory constraints on the transferability of an LLC's shares to a third party. This means that shareholders in LLCs cannot simply vote with their feet by selling their shares, but

[1] See Gan Peizhong, Liu Lanfang, and Lei Chi, 新类型公司诉讼疑难问题研究 *(Studies on Complicated and Difficult Issues with New Types of Company Law Litigation)* (Beijing: Peking University Press, 2009).
[2] *Ibid.*, p. 51.
[3] *Ibid.* This book deals with the cases regarding (1) controlling shareholders misusing controlling power to the prejudice of the interest and rights of the company and other shareholders;(2) shareholders using corporate form to escape debt, causing losses to creditors; (3) related party transactions; (4) the validity of resolutions by shareholders meeting or directors' meeting; (5) shareholders' access to information; (6) dividends and distribution of asset returns; (7) transfer of the LLCs' shares; (8) share transfer without due procedure or due authority; (9) request for share re-purchase; (10) fiduciary duties of directors, supervisory board members, and senior managers; (11) shareholders derivative actions; (12) corporate dissolution; (13) debt liquidation after business licence revoked; (14) liabilities of professional intermediaries; (15) overlap between the Company Law and foreign investment legislation.
[4] *Ibid.*, p. 52.
[5] *Ibid.*, p. 54. The research work, particularly on directors' liabilities cases, was later published in the academic journal: Lou Jianbo, Yan Hui, and Zhao Yang, 公司法中董事、监事、高管人员信义义务的法律适用研究—以北京市法院 2005~2007 年间的相关案例为样本的实证研究 (The Application of Fiduciary Duties of Directors, Supervisory Board Members, and Senior Officers in the Company Law—An Empirical Study of Relevant Cases Decided in the Beijing People's Court System in 2005-2007), (2012) 1 商事法论集 (*Commercial Law Review*), pp. 530-564.
[6] Before 2014, the threshold requirements of registered and subscribed capital and the number of shareholders for forming a company were still valid in the Company Law. All the threshold requirements for setting up an LLC were easier than for a CLS.

have to resort to litigation, when the opinions on investment and the operational plan diverge, or any conflicts of interest occur.

Second, the claims in one case were often multiple and involved more than one party of the firm. Third, 70.74% of the cases were concluded in the form of judicial decisions, and 29.26% did not receive a substantive review but were determined on account of procedural issues such as court's jurisdiction. In China, the courts may mediate between the plaintiffs and defendants, and these parties may reach an agreement before the courts to resolve their disputes. Yet, there was no record of company-related cases settled before the courts. The authors inferred that private parties would not file a lawsuit until the legal right and interests had been severely injured and the conflicts could not be resolved in some other manner.

The other set of empirical research focused on the enforcement of directors' duties and liabilities through private litigation. Wang Jun, a legal scholar, collected 137 judicial decisions that had been delivered by the basic, intermediate, and higher courts in 14 provinces and municipalities from May 2001 to June 2010.[7] During 2007 to 2010, there were 100 cases, accounting for 73% of the whole sample.[8] Wang Jun's findings were as follows: (1) 136 cases occurred in closely held companies,[9] including LLCs, Sino-foreign joint ventures, wholly-foreign owned companies, and joint-stock cooperative enterprises; (2) almost all cases in the sample were related to the breach of the loyalty duty; (3) in many cases, the behaviour at issue did not fall into the statutory prohibition list; (4) the courts tended to examine the formality and procedure of the challenged actions or decisions and interpreted the provisions within the reach of literal meaning. Based on these findings, Wang Jun also discussed how the courts ought to apply the provisions in the Company Law to determine the assumption of liabilities.[10]

A third set of empirical research by a group of legal scholars examined 33 representative cases from 2006 to 2012.[11] Xu Guangdong *et al.* analysed these cases and obtained consistent findings as Wang Jun. Besides, on some occasions, the judges actively

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[7] Wang Jun, 公司经营者忠实和勤勉义务诉讼研究—14 省，直辖市的 137 件判决书为样本 (Analysis of Private Actions against Breach of Loyalty and Diligence Duties—Based on A Sample of 137 Judicial Decisions in 14 Provinces and Municipalities), (2011) 4 北方法学 (*Northern Legal Science*), pp. 24-39.

[8] *Ibid.*, p. 27.

[9] *Ibid.* The author used the term 'closely held companies' to encompass any types of enterprise and company that is not publicly listed on the stock markets.

[10] *Ibid.*, pp. 27-35.

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

interpreted the terms of the duties of loyalty and care and applied the rules with particular consideration of the factual circumstances. Nevertheless, most often, the judges preferred mechanically applying the legal rules. The authors pointed out that some Chinese judges believed that hindsight assessment of the business decisions might discourage risk-taking.[12] Another contribution of these authors was explaining the dearth of civil litigation against directors and officers in listed companies.[13] Last but not the least, they also investigated how the securities regulatory authority interpreted the duties of loyalty and care when addressing the violations of disclosure requirements.

5.2.2 Analysis of Judicial Decisions

Following previous studies of enforcement of directors' duties and liabilities, I collected and reviewed more recent judicial decisions from a different database—Wolters Kluwer China Law and Reference[14] to update and supplement the materials for the analysis of enforcement practices. From the factual information in these judicial decisions, data were obtained to show: (1) which disputes are more likely to give rise to private actions and reach judicial decisions; (2) who files the lawsuits and on what account; (3) how the courts address the claims; and (4) other dimensions that indicate a pattern of directors' liability cases.

However, such data analysis cannot lead to a conclusive and definite result, because not all judicial decisions are accessible to the public in China, and any database might have systematic bias in the selection and record of cases. Besides, the cases that the plaintiffs withdrew, those which the courts did not accept, settled before or out of the court, or similarly ended in other forms than judicial decisions, are not published. Therefore, only the disputes that were ultimately resolved in the form of judicial decisions and published online are under examination, which provides a general picture of private litigation in enforcing directors' liabilities.

5.2.2.1 Source and data

In 2013, the Supreme People's Court (SPC) has established the internet platform 'China Judgement Online' and required the courts to publish effective decisions and opinions

[12] *Ibid.*, p. 72.
[13] *Ibid.*, p. 65.
[14] Wolters Kluwer China Law and Reference (威科先行): http://www.wkinfo.com.cn (accessed 22/11/2019).

online to promote judicial transparency.[15] All levels of courts across the country are responding to this initiative but at different paces, and the number of effective opinions is still far larger than that of published ones.[16] Before this initiative, only the higher people's courts in some pilot provinces and municipalities separately and selectively released cases on their official websites.[17]

To overcome the inconsistency, overlap, or omission of the search results from different official sources, I have chosen the Wolters Kluwer China Law and Reference.[18] This platform was established in 2011 and comprehensively collects and compiles laws and regulations, cases, news, and other information of legal practice in China. With the experience and advantage of a global provider of professional information, the Wolter Kluwer platform has become increasingly popular among practitioners in China.

The key words for searching the cases of directors' liabilities are determined with reference to the official list of cause of actions issued by the SPC.[19] China's courts only accept and hear a civil case when claims are made to establish any cause of actions in the SPC list. This list consists of all the causes of actions and corresponding legal standings that substantive rules, explicitly or implicitly, grant private parties. The courts also follow this list to archive the judicial opinions, as do many case databases.

Company-related litigation is listed in the twenty-first category. However, no items under this category directly indicate directors' breach of duties; only items 255 and 256 are relevant, *i.e.*, 'causing losses to shareholders' and 'causing losses to companies', regardless of the identity of the perpetrators.

As such, 'directors causing losses to the company' and 'directors causing losses to the shareholders' were entered in the search bar on the case database webpage with a time period of 1 January 2013 to 31 December 2017 in June 2018. In total, the search results

[15] On 2 July 2013, the SPC circulated 最高人民法院裁判文书上网公布暂行办法 (Measures for the People's Courts to Publish Judicial Opinions on the Internet) and until 2014, the basic level courts in 13 provinces, for the first time, began publishing their judicial opinions on the unified website. Judicial Opinions of China website: http://wenshu.court.gov.cn (accessed 22/11/2019).
[16] Liu Xing, 判决文书网络公开情况调查 (Investigation of Judicial Opinions Publishing Online), (2014) March 19 中国青年报 (*China Youth News*).
[17] For instance, the Beijing Higher People's Court releases judicial decisions on the following website: http://bjgy.chinacourt.org/paper.shtml; the Shanghai Higher People's Court provides a platform for judicial documents on http://www.hshfy.sh.cn/shfy/gweb/index_flws.html (both accessed 22/11/2019).
[18] The website for KW China Law and Reference is www.wkinfo.com.cn.
[19] 民事案件案由规定 (Causes of Actions of Civil Cases) issued by the SPC in 2007 and revised in 2011 and 2013.

showed 697 judicial decisions. When counting the judicial decisions of second instance and the opinions of procedural issues, if any, regarding the same dispute as one case, it was possible to obtain 675 cases of monetary liabilities of directors and officers.

As Table 5.1 illustrates, 432 cases were filed against senior managers, supervisory board members, financial officers, or other key employees, such as marketing or project managers; 243 cases were against directors. This result shows that private actions are not entirely dormant in terms of misconduct of directors and officers in China, which differs from the impression in previous literature. Further analysis is focused on the 243 cases of directors' wrong-doing.

Table 5.1 Number of Cases of Liabilities of Directors and Officers (2013-2017)

Year	Number of cases of directors' liabilities	Number of cases of liabilities of senior managers and other officers	Number of all cases of managerial misconduct
2013	27	20	47
2014	50	58	108
2015	47	72	119
2016	40	133	173
2017	79	149	228
In total	243	432	675

Comparing this sample size to that of previous literature: Wang Jun collected 137 cases in a ten-year period of 2001 to 2010 and Xu Guangdong *et al.* obtained 33 cases from 2006 to 2012. Hence, this sample of 243 cases for five years is much larger. Whether this considerable increase is the result of more cases being handled, or of more cases being published, or just the variation in different sources, is not clear. After all, private actions to enforce directors' liabilities are relatively inactive but not completely dormant, when viewed in comparison to the enormous number of companies nationwide and 14,515 cases of shareholding status and 5827 cases of capital contribution dispute in the same time period.[20]

[20] Clicking on 'Causes of Action' column will unfold the umbrella category 'disputes related to the companies' on the website http://law.wkinfo.com.cn/judgment-documents/list?tip= (accessed10/11/2019). The aggregate number of cases for each item of cause of action can be obtained thereon.

Since the courts usually conduct a thorough examination of the companies involved, the contents of judicial opinions are quite informative. Such information as the number of shareholders, type of companies, type of claims and so on is collected and processed into descriptive statistics to identify how private litigation is being used to hold directors accountable.

5.2.2.2 Major features of the sample cases

Previous literature consistently found that almost all cases concerning directors' liabilities were arising from companies not publicly listed on stock exchanges.[21] This study looks further into the judicial opinions and attempts to depict the involved companies by the dimensions of legal form, ownership, and the number of shareholders.[22] Almost all the companies in the sample cases are limited liability companies (LLC), and two are group companies, namely, the holding companies or parent companies in company groups. As Table 5.2 reveals, only eight companies are companies limited by shares (CLS), and none of the companies in the sample are listed companies. This means that most of the companies are without numerous or dispersed shareholders, since the Company Law explicitly sets the upper limit of the number of shareholders for the LLCs.

With regard to the ownership of the companies, the great majority of them are privately owned. Only two companies are state-owned and six companies were formerly SOEs. One case was filed to hold directors responsible for retaining unreasonable welfare packages for employees even after the SOE Reform.[23] The court, however, deemed this claim as a 'historical issue' and dismissed it. Equally noteworthy, eight cases were brought against directors in foreign-invested companies, representing 11.52% of all sample cases.

Usually, there is no close relationship between the number of shareholders and the claims against directors, and hence, that number is not recorded in most of the judicial decisions. Nevertheless, 57 cases clearly specify the number of shareholders, accounting for almost 25% of all cases. Amongst others, 33 cases are with only one or two shareholders, and the one-shareholder companies are all wholly foreign-owned companies. Meanwhile, 20 cases have companies with no more than 5 shareholders; another 4 cases

[21] Wang Jun, see *supra* note 7, p. 27.
[22] Equity capital is also a useful indicator of the company's scale. However, many judicial decisions did not mention the capital contribution status as they usually do in resolving shareholding, share transfer, and debt liquidity disputes.
[23] Fengshun Yifeng transportation company v. Tian Sheng by Guangdong Province Meizhou City Intermediary People's Court (广东省梅州市中级人民法院) in 2017.

have six to eight shareholders (see Table 5.2). This indicates that a significant portion of cases involve companies with a highly concentrated ownership structure.

Table 5.2 Companies Involved

Types of Companies	Number of the Cases	Proportion
	1. Legal form	
Limited liability companies (LLC)	235	96.70%
Companies limited by shares (CLS)	8	3.30%
Listed companies	0	0
	2. Ownership	
Private companies	204	83.95%
Foreign-invested companies	28	11.52%
With state shares or previously being SOEs	8	3.29%
NA	3	1.23%
In total	243	100 %
	3. Number of Shareholders	
1-2 shareholders	33	13.58%
3-5 shareholders	20	8.23%
6-8 shareholders	4	1.65%
NA	186	76.54%
In total	243	100%

Besides, the involved companies occupy a wide variety of industries. To name a few, mining, banking, real property development, apparel, catering, online sales, consultancy, and high-tech industries are all present in the sample. In some cases, industry-specific knowledge is necessary to deal with the issues. For instance, a director in a mining company was sued for mistakenly changing the location of the pit and causing losses to the company. The court had to, at least, understand the meaning of evidence about open-pit mining technology to determine whether the decision was utterly unreasonable.[24]

As for the scale of the involved companies, only the amount of registered capital, as part of the basic registration information of the companies, was examined by some courts, ranging from ten thousand to tens of millions of CNY. Even though registered capital may not be equal to paid-up capital, it is tenable to contend that small and medium sized companies and their shareholders therein are more likely to resort to judicial review.

As for the plaintiffs, the companies have filed 131 cases and shareholders have filed 105 for the companies' losses (see Table 5.3). Another 7 cases were brought by shareholders for the sake of their own losses; however, none of these cases were upheld by the courts. The courts uniformly held that the shareholder plaintiffs failed to establish a direct causal link between management misconduct and shareholders' losses, and suggested that the plaintiffs should otherwise file a lawsuit on account of the company's interest being harmed.

As shareholders sometimes take the positions of directors or supervisory board members as well, it does not become immediately clear whether the private actions are taken on behalf of the companies or derivatively as shareholders. In several cases, the plaintiffs themselves were confused about their capacity and standing in the litigation proceedings.[25] In derivative actions, defendants often alleged that the plaintiffs did not have the legal standing to sue derivatively or claimed that the pre-requisite requesting procedure was not properly carried out. The courts, in response, addressed such allegations and clarified that the pre-requisite requesting procedure was designed to exhaust internal remedies for disputes regarding business operations, and thus, should be followed.

Table 5.3 Identity of the Plaintiffs

The Identity of Plaintiffs	Number of Cases	Proportion
	for company's losses	
Companies	131	53.91%
Shareholders	105	43.21%

[24] Zhejiang Sanshi group company v. Fang Hao by Anhui Province Suzhou City Intermediary People's Court (安徽省宿州市中级人民法院) in 2013.
[25] Xu, Wang, Zhao, Yang v. Sun Huazhong decided by Hunan Province Zhuzhou City Lusong Basic People's Court (湖南省株洲市芦淞区人民法院) in 2014.

for shareholders' losses		
Shareholders	7	2.88%
In total	243	100%

Besides the third parties that were sued as co-defendants in the cases of usurpation of corporate opportunities and so on, the accused directors usually held a dual role or multiple roles in the companies. As Table 5.4 shows, in 138 cases, the accused directors also acted as senior managers and/or legal representatives. Meanwhile, in 96 cases, the defendants were directors who were also holding shares in the companies they served. This implies that defendants usually hold substantial control in the companies, and there is less separation of ownership and control in these companies. Combined with the findings of the involved companies and plaintiffs, this thesis suggests that the tension between the opposing parties over corporate control underlies these lawsuits.

Table 5.4 Identity of the Defendants

Identity of Defendants		**Number of cases**	**Proportion**
Directors	are shareholders	96	39.51%
	not shareholders or not mentioned	147	60.49%
Directors	with a dual role as a manager or/and a legal representative	138	56.79%
	without a dual role	105	43.21%

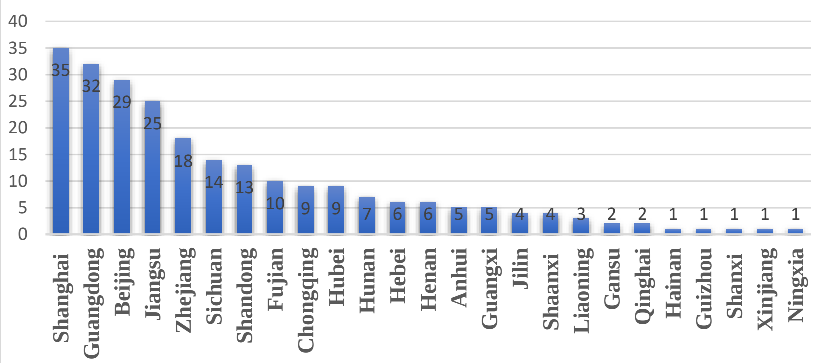
One high profile lawsuit that went to the Hong Kong High Court is another classic example for the control contest. Gome (国美), an electrical appliance retailer based in Beijing and listed on the Hong Kong stock exchange, sued its former directors and the founder, Huang Guangyu, for breach of fiduciary duties relating to the repurchase of Gome's shares in 2008.[26] Besides, Huang and his family, as the largest shareholders in this company, were holding 35.55% of the shares. The incumbent CEO, Chen Xiao, with his

[26] For relevant news reports, see, e.g., on the New York Times website, 'Gome Sues Huang over Shares Repurchase', available at https://dealbook.nytimes.com/2010/08/06/gome-sues-huang-over-share-repurchases/?_r=0 (accessed 06/12/2019).

alliance—institutional investor Bain Capital, intended to suppress the control and influence of Huang Guangyu over the company group and weaken the support of other shareholders for Huang. Gome, under the direction of Chen, filed lawsuits against Huang with multiple claims, and the Hong Kong High Court froze Huang's personal assets to the tune of Hong Kong dollars 1.6 billion.[27] This lawsuit was widely reported and heatedly discussed, because Gome was one of the largest electronics retailers in China and such a fierce contest for corporate control between the incumbent CEO and the founder had rarely been observed.

In the meantime, Huang was suspected of stock market manipulation and detained on this account. In August 2010, he was found guilty of insider trading, illegal business operations, and bribery, and was sentenced to 14 years in prison by the appellate court—the Beijing Municipality Higher Court. His economic crimes were entangled with many senior government officials, which embodied a serious problem in China's market environment, *i.e.*, the illicit connection between government officials and businessmen.[28] Nevertheless, Chen Xiao continued to adopt a series of schemes to gain control over the company, including incentive schemes for directors and senior officers, inviting foreign capital, and issuing new shares to dilute the shares of existing shareholders, especially Huang and his family.

Figure 5.5 Number of the Cases in Provincial and Municipality Jurisdictions



[27] Guo Xingyan, 香港高院致黄光裕传票曝光, 共七项索赔 (The Exposure of Writ of Summons by Hong Kong High Court to Huang Guangyu, Totalling Seven Claims), (2010) Aug. 10 第一财经日报 (*First Finance Daily*).
[28] Hongming Cheng, *Financial Crimes in China: Developments, Sanctions, and the Systematic Spread of Corruption* (Houndmill: Palgrave Macmillan, 2016), pp. 112-114.

Besides, unsurprisingly, more cases have been addressed in the jurisdictions where economic development is relatively advanced and corporate practice is more dynamic. Yet the regional variation is significant (see Figure 5.5). Shanghai had 35 cases, with the largest number of cases in one provincial or municipality jurisdiction; Guangdong province had 32 cases; Beijing handled 29 cases; and Jiangsu province delivered 18 cases. Taken together, these 5 provincial and municipal jurisdictions in the eastern coastal areas had 139 cases, accounting for 57.20 % of all cases in the sample. In sharp contrast, the vast majority of other jurisdictions addressed much fewer or no cases of directors’ liabilities.

Table 5.6 depicts the types of claims that plaintiffs made before the courts and the number of cases determined in favour of the plaintiffs for each type of claims. It is necessary to clarify three points in examining the causes of actions. First, the classification of claims is not strictly in accordance with the prohibitive list in the Company Law. As many of the claims do not fit any type in the prohibitive list, the classification of such claims is mainly based on the similarity of the management conduct and the company’s rights being affected. Second, cases with multiple claims are repeatedly recorded and counted under different types of claims, as this part focuses on the causes of actions and the merits of the disputes. Third, for claims handled multiple times, the decisions rendered by the appellate court are regarded as the final outcome of the claims. Further, as long as the court confirmed that the defendants breached the duties of loyalty and care, the claims are deemed to be upheld by the court, regardless of monetary awards.

Table 5.6 Causes of Actions

Types of Causes of Actions		**Number of Cases**	**Number of the Cases that Plaintiffs Won**
Breach of the duty of loyalty			
Infringing upon the company’s property right	corporate fund	79	56
	facilities, equipment and inventories	6	6
	real property asset	3	1
	intellectual property	3	2
Self-dealing transactions or related party transactions		16	9

Engaging in the same business as the company runs		47	24
Usurpation of corporate opportunities or/and divulging corporate securities		22	8
Without due approval or ultra vires	providing loans	4	3
	providing guarantee	5	4
Holding back the company's business licence, seals, accounting books and ledger		11	10
Violations of laws and regulations			
Causing the company to be sanctioned by the regulatory authority (tax frauds or other violations)		11	7
Breach of the duty of care			
Disposal of the company's assets on unreasonable terms		16	6
Failure to perform functions		5	0
Mistakenly or improperly dealing with issues		56	16
Others			
Cause losses to shareholders		5	0
		289	152

As Table 5.6 reveals, the most frequent cause of actions is misappropriation of corporate funds, with 79 cases, occupying 32.51% of all the 243 cases, and more than 70% of these cases succeeded. Examining these cases, the defendants employed various methods to take possession of, obtain, use, or spend the company's funds for their own benefits. In a number of cases, the project payment, bank loans, payment for products, or other receivables, intended to be made to the companies by a third party, were actually received by the defendants in their personal accounts, and the defendants did not transfer such funds to their company. On the other hand, some defendants inflated the company's expenditure, such as the employees' wages, and withheld a part of it in their own pockets. These types of cases reflect that the accounting system and internal control of small and medium sized companies are not well established or maintained, and thus, vulnerable to 'theft' of corporate funds.

Similar to misappropriation of corporate funds, there are three other types of lawsuits in which defendants allegedly infringed upon the property right of the company, *i.e.*, six cases regarding the equipment, facilities, and inventory, 3 cases concerning the real property rights, and 3 cases of IP rights. In these cases, the courts directly applied the principles and rules in the Property Law rather than the duty of loyalty rules. They simply determined whether the company’s property right was damaged and any losses caused.

The second largest type of claim concerned engaging in the same business as the company. In these cases, the defendants participated in the operation of or contributed capital to a third entity that engaged in the same business. Quite often, these third entities are sued as co-defendants to assume joint and several liabilities. In tandem with this type of claim in some cases, plaintiffs also alleged that the defendants usurped corporate opportunities or other resources, such as client information, and even specialized qualifications for certain industries.

In addition to a series of elements that constitute this type of misconduct, plaintiffs have to provide evidence of actual losses due to the operation of the third party in the same business and the defendant’s earnings. Indeed, plaintiffs usually have no access to the profit information of another company, as most such companies are not listed and do not disclose such information to the public. The particular way that the defendant director invests, participates, and gains earnings in a third entity is even more secret. For these reasons, plaintiffs have fewer chances of receiving substantial monetary remedies.

The third largest number of claims concerned self-dealing transactions or related party transactions. The courts use market price as a benchmark to determine whether the company suffers any losses as a result of contested transactions. Whether defendants have fully disclosed relevant information to the company or whether the decision was made through due procedure are not within the scope of judicial review. As such, directors would be challenged for entering self-dealing transactions with the company under terms less favourable than the market price.

Holding back the company’s business licence, certificate, or accounting books after resignation or removal are not as frequently sued as previous studies show. However, the win rate is very high. Making loans or providing guarantees without due approval, especially in a large corporate fund or using the real property of a company, is also likely to incur private actions to hold directors accountable. Besides, in 11 cases, the company or their representatives sued the defendants because the company was imposed with a penalty by the regulatory authorities for tax frauds, violations of environmental law, or violations of other regulations.

Last but not least, 77 cases against directors challenged the reasonableness of their decisions or conduct, and the plaintiffs often did not explicitly claim that the defendants breached the duty of care. No more than one-third of these cases were upheld by the courts. These cases can be generally classified into three groups: (1) disposal of the company's assets or property under unreasonable terms; (2) failure to properly perform their functions; (3) and other decisions mistakenly or improperly made. Notably, the third group is merely a catch-all category but has the largest number of cases, and involves various aspects of business operations and internal governance. To name a few, how a director settles labour disputes, whether offering preferential terms to a supplier is inconsistent with the corporate strategy, and delay in project delivery are at issue before the courts. This suggests that there is a practical need to hold directors accountable not only for intentionally damaging the company's interests but also for less sensible or improper decisions. However, the vague and empty term 'duty of care' in the Company Law seems to be far from explicit for plaintiffs to establish their claims regarding diverse and complex issues in business practice.

5.2.2.3 Interpretation and application

As examined in Chapter 4, the legal rules of directors' duties and liabilities are very general and vague and the contents and meaning of the general terms are not specified, even though the fiduciary duty *per se* has a broad and encompassing nature.[29] This incomplete nature, and the defects in legislation, present a challenge to the Chinese judges for the following reasons.

First, Chinese judges do not have wide discretion and latitude to expound and develop the general legal terms like their counterparts in the common law jurisdictions, since the overall legal system follows the civil-law tradition and does not endorse judge-made law or the principle of *stare decisis*.[30] However, the application of general terms in a particular dispute will unavoidably require the courts to articulate the meaning of the terms under certain circumstances. As such, the courts are faced with a dilemma between over-stepping their authority and averting forceful application of general terms.

[29] Katharina Pistor and Chenggang Xu, 'Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory', in Curtis J. Milhaupt (ed.) *Corporate Law and Governance in a New Era of Cross-Border Deals* (New York: Columbia University Press, 2003), p. 78.
[30] Chenguang Wang, 'Law-making Functions of the Chinese Courts: Judicial Activism in a Country of Rapid Social Changes', (2006) 3 *Frontiers of Law in China*, p. 531.

Second, Chinese judges often lack the professional competence to handle disputes concerning complex transactions. Although there has been great improvement in the professional education and skill training of the judges, an aspect that was previously denounced by local and foreign scholars,[31] it remains uncommon for judges to have a sufficient understanding of business practices or significant insight into the inner working of companies.[32]

Nevertheless, the sample cases present a mixed picture. Some courts strictly followed the literal meaning of the legal rules and directly applied them without detailed argument about how the general terms are applicable to particular facts. Other courts innovatively made up for the incomplete rules, regardless of the above disadvantages. Besides, it seems that scholars' introduction and discussion of the fiduciary duty doctrine has been influential in judicial practice.

(a) Duty of loyalty

In one case, the Lishui Intermediary People's Court in Zhejiang province asserted that it was within its judicial purview to determine whether the actions breached the duty of loyalty pursuant to the general principle of public order and good customs (*gongxu liangsu*) and in consideration of the particular circumstances.[33] This suggests that the Lishui intermediary court was fully aware of the judicial discretion to apply the duty rule, but invoked general legal principles to support the determination of misconduct, instead of giving an explicit definition of the duty of loyalty. It is uncertain whether the Lishui intermediary court intended to take a circuitous path to avoid controversy over the legitimacy of making new rules in deciding the case. However, such an approach brings about an elusive issue of whether the general principle of public order and good customs serves as the boundary of the duty of loyalty or only as its moral and legal basis from the perspective of legal doctrines.

The Shanghai first intermediate court explained that the policy goal of the duty of loyalty is to guarantee the interests of the firm and all shareholders when the directors and

[31] For the discussions about the qualification and competence of Chinese judges, see *infra* note 51 (Randall Peerenboom, 2014).
[32] See *infra* Section 5.2.3 Explanations for the Enforcement Pattern: Judicial deficiency.
[33] Gansu Chengji Biomedicine Company v. Chen Shuo decided by the Zhejiang Province Lishui City Intermediary People's Court (浙江省丽水市中级人民法院) in 2014.

senior managers face conflicts of interest.[34] The Beijing first intermediate court clarified that the boards of directors owe a duty of loyalty to the firm, and they should not make use of their position to seek personal or a third party's interest and should always maintain the firm's interest, even in the event of a conflict of interests.[35] As such, the Chinese courts do not directly define the duty of loyalty but clearly emphasize prioritizing the firm's interest and undivided service as the rightful manner to exercise managerial power. In this sense, some courts have assigned a meaning to the duty of loyalty with reference to the standard of conflict of interests.

(b) Duty of care

The sample contains few cases with an explicit claim of the breach of duty of care. Accordingly, the judicial interpretation of the meaning and standard of due care is fragmented and even implicit. In one case, the plaintiffs made multiple claims that the defendants should be liable for the losses arising from a production accident and the corresponding decrease in the company's profit and employees' salaries. Unlike many other courts that only repeated the legal provisions, the court explained the legal duty provision and liability basis as follows.[36]

> In accordance with Article 148 and 150 in the Company Law, directors and senior managers should abide by laws, administrative regulations and the company's articles of association. Directors and senior managers owe the duties of loyalty and care to the company they serve. They must exercise their power in the best interests of the company, in good faith, and with due care that an ordinarily prudent person under similar circumstances would have exercised. Besides, they should not encroach on the company's assets.
>
> Directors and senior managers should be liable for the losses caused to the company, when they violate laws, administrative regulations, and company's articles of association. If the losses are not caused by the fault on the part of directors or senior managers but by external factors and commercial risks, they cannot be deemed as breaching the duty of care.

The court did not mechanically apply the liability rule, violation of laws, administrative regulations, and the company's articles of association, to determine whether the liability

[34] Shanji Computer Technology Company v. Jiang Zuwang by the Shanghai First Intermediary People's Court (上海市第一中级人民法院) in 2014.
[35] Wang Zhi v. Zhao Xiongjin by the Beijing First Intermediary People's Court (北京市第一中级人民法院) in 2014.
[36] Ningbo Zhonglv Company v. Hong Bin by the Shanghai First Intermediary People's Court (上海市第一中级人民法院) in 2015.

claim was established. Instead, the court innovatively filled in the lines of the liability rule with the objective standard of due care that 'an ordinarily prudent person under similar circumstances would exercise'. The terms 'good faith' and 'in the best interests of the company', which the court used, are not embraced in the legal provisions as well. In addition, the court added 'fault' as one element to establish the liability for breach of the duty of care and clarified the causal link between the losses and improper performance, by excluding external factors and commercial risks. In line with this logic, it does not suffice to conclude that a breach of duty of care occurs merely from the bad outcome of a business decision.

In the other case, the court held that it is very important to impose some constraints on management conduct; however, holding directors liable for any business errors will lead them to be overly cautious and too hesitant to seize great and risky opportunities. Moreover, the court emphasized that every business decision has an element of risk, and hence, it is necessary to carefully examine the causal link between the alleged wrong-doing and the losses sustained by the company.[37]

(c) Misappropriation

In cases where the defendants took possession of the company's equipment, seals, or other assets not to be used for the companies' business operations, the courts applied the general principle of the Property Law[38] together with the Company Law and decided that the defendants should return the company's assets and compensate the losses arising from such unlawful possession and use.[39]

Many cases also involve various forms of misappropriation, which is essentially transferring the company's funds to a personal account, either under the cover of payroll, bonus, reimbursement, and even fabricated transactions, or by receiving payment from the company in personal accounts. The courts usually investigated the internal rules regarding financial management and workflow to determine whether the defendants complied with these internal rules. If there is no violation of the internal rules or the company's articles of

[37] Sanming Hydraulic Gate Company v. Yan Qunli decided by the Fujian Province Sha County People's Court (福建省沙县人民法院) in 2014.
[38] See Article 34, 39, 68 in the Property Law of the PRC. The full text for the Property Law is available at http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content_1471118.htm (accessed 16/11/2019).
[39] See, e.g., Anhui Aobao Technology Company and Aihui Aobao Diary Company v. Peng Hanyu and Zhu Yonghong decided by the Anhui Province Anqing City Yixiu District People's Court (安徽省安庆市宜秀区人民法院) in 2013.

association, the courts did not deem reimbursement, bonus, especially the consumption for business development or customer maintenance, as illegal. For instance, the Qingpu District Court in Shanghai held the following opinion:

> As the evidence shows, the defendant followed the internal procedure to gain reimbursement, even though the key factor in this procedure is the signature by the defendant himself. The plaintiff company should set up a sound internal control system and employ standard financial workflow. The representatives of the plaintiff company also owe duties of loyalty and care and should take timely measures to stop irregular practices. Moreover, these representatives also collectively hold the majority shares of the company, and thus, are completely able to change the unreasonable procedural rules. After all, it is common practice that directors or general managers have accommodation expenses for business development. Thus, the key issue here is to strengthen the internal constraints. The plaintiff's claims were not upheld.[40]

The Qingpu District Court, in this case, adopted a conservative attitude. Given that directors should be liable for the losses caused by violation of laws, administrative regulations, and the company's articles of association under the Company Law, the court conducted a formality review rather than delving into the substance of the alleged expenditure or checking whether the reimbursement is consistent with the actual expenditure. Moreover, the court endorsed the proper scope of managerial autonomy in consideration of business custom and emphasized the significance of a well-designed internal control system.

(d) Engaging in the same business

Unlike directors and senior managers, supervisory board members are not prohibited from engaging in the same business as the company. In one sample case, the court of first instance only referred to the corporate register that recorded the defendant as a supervisory board member, even though the plaintiff provided evidence that the defendant was virtually playing a managerial role. This is an example where some courts tend to strictly follow the legal provisions, especially those with vague terms, and mechanically give formal documents more weight. Yet the court of appeal held that the incorrect information

[40] Shanghai Tainansi Clothing Company v. Yang Huilin decided by Shanghai Qingpu District People's Court (上海市青浦区人民法院) in 2013.
The legal representatives are the people that represent their companies when entering transactions and participating in lawsuits, according to the Company Law. In this case, the legal representatives are the directors and shareholders of the involved company.

on the register was not a cause for exempting the defendant from the duty concomitant with the executive power he actually wielded.[41]

The courts adhere to the legal text and do not extend the legal duty to the directors and senior managers who have just retired or resigned from the office. They pay attention to the time period when the individual remained in a directorial or managerial position and whether the individual was involved in another company at the same time. The damages and wrongful gains to be confiscated are calculated in this time period as well. However, the protection afforded to the company's interest comes with loopholes. Directors and managers may make use of the window period immediately after leaving their position, or suspension of the company's operation to seek personal gains in another company, unless the employment contract has non-competition clauses.

Another perplexing issue is determining that a business is the same as that of the company. From the sample cases, the courts conducted a combined review into 'business scope' in the corporate register and the products and services that the company provided on a regular basis. When the 'business scope' in the corporate register is too large and inclusive, the court would consider the actual production. This approach is consistent with what legal scholars commonly propose.[42]

Finally, it is not clear from the legal text, that a director or manager connected to another firm or business can be deemed to be in breach of the duty of loyalty. The court addressed this issue by identifying whether the defendant had an interest in another business, regardless of how such interest arises, from control or investment, or other cause.[43]

(e) Nature and elements of liabilities

As far as the sample cases suggest, the complaints against directors are uniformly deemed as tort claims rather than as contract claims, even though the Company Law does not specify so. In line with such interpretation of the nature of directors' liabilities, the courts break down the claims into three elements: (1) violation of laws, administrative regulations, or company's articles of association; (2) actual losses; (3) and the causal link between violation and losses, in accordance with the Company Law. Moreover, some courts add a

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[41] Sichuan Yinshan Technology Company v. Chengdu Jingshang Company and Shang Jing decided by the Sichuan Province Chengdu Longquanyi District People's Court (四川省成都市龙泉驿区人民法院) in 2014.
[42] See *supra* note 62 and note 63 in Chapter 4.
[43] Chengdeng Fangzhou Elevator Company v. Zhangbaocheng and Chongqing Yishidun Elevator Company decided by the Hebei Province Chende City Intermediary People's Court (河北省承德市中级人民法院) in 2014.

'fault' element too.[44] The 'fault' and 'causal link' elements are quite decisive to the magnitude of monetary liabilities, but there is no specific test to determine whether these two elements are established. The courts presented their reasoning and opinions on these two elements mainly based on the factual circumstances.

Further, the courts usually apply the general principle of the burden of proof for tort claims, since no specific evidence rule for directors breaching the duties of loyalty and care is prescribed in law. The plaintiffs, in turn, have the burden to provide evidence to establish all the above elements to hold the defendants liable, or they would lose the case. Obviously, such allocation of the burden of proof in a scenario where the defendants obviously have more information and evidence would greatly discourage the prospective plaintiffs from filing a lawsuit. Almost half of the claims in the sample cases are confirmed and upheld by the courts; however, a prevailing claim does not necessarily mean an award of monetary remedies. In several sample cases, the plaintiffs did not participate in the disputed transaction and were unable to prove the precise amount of economic losses, not to say the unlawful gains of the defendants from engaging in the same business as the company. Therefore, a low level of monetary liabilities in practice would not suffice to deter management misconduct.

5.2.3 Explanations for the Enforcement Pattern

The level of private enforcement actions is primarily dependent on the willingness and ability of private parties to file lawsuits. As the above studies show, the number of lawsuits concerning directors' liabilities is still small, relative to the aggregate number of companies and that of bankrupt enterprises, and in comparison with other types of company-involved cases in China. Furthermore, cases with regard to directors in listed companies are almost non-existent.

Receptiveness to the actions against directors

It is reasonable to argue that both directive and derivative actions to challenge directors' decisions and performance are not familiar to the business and investment community, since these legal devices have been in effect for around one decade. Some studies report that businesspersons who place high value on traditional culture are reluctant to confront their peers in the courtroom, as it would crush the cornerstones for business co-operation,

[44] See *supra* note 35 in this chapter.

trust and alliance.[45] Yet, for economically rational persons, there must be more material factors that hold them back from resorting to litigation.

Procedural hurdles

The civil procedural rules are not hospitable to private actions against directors. As previously demonstrated in Chapter 4, shareholders and companies may sue directors to remedy their own losses. In addition, a new type of action—derivative action, now allows shareholders to sue directors on behalf of their company. Directors who make litigation decisions for the company are unwilling to go against themselves or their peers. Shareholders may find it quite difficult to prove the causal link between wrongful decisions and their losses. It seems that only derivative action can be an effective tool to bypass the substantive obstacles to direct actions. However, shareholders are discouraged from taking action, since there are no rules to deal with the procedural issues of derivative actions, and only general civil procedural principles are applicable.

First, the financial cost that shareholder plaintiffs bear is disproportionate to the financial benefit they may gain. Before the Judicial Interpretations by the SPC in September 2017, there was no single rule dealing with the allocation of awards and costs. Shareholder plaintiffs need to pay the filing fees, court fees, attorney fees, and other expenses incurred throughout the litigation from their own pockets, if they fail.[46] Even if shareholder plaintiffs win, the loser(s) would only cover the filing and court fees under the general civil procedural rule, and the shareholder plaintiffs would still need to afford attorney fees and other service expenditures.[47] After all, shareholder plaintiffs may at best benefit *pro rata* from a derivative action, whereas they have to afford attorney fees and other expenditure, and devote their own time and energy, regardless of the litigation outcome.

The new Judicial Interpretation reiterates that the awards of a derivative action should be made to the company and states that the company should reimburse the plaintiffs for their reasonable expenditure on the condition that all or some of the claims are upheld in court. However, shareholders still need to bear all the costs of a derivative action when they lose

[45] See, e.g., Raymond Siu Yeung Chan, Daniel Ho, and Angus Young, 'Rethinking the Relevance or Irrelevance of Directors' Duties in China: The Intersection between Culture and Laws', (2014) 1 *Asian Journal of Law and Society*, pp. 183-203.
[46] See Art. 107 in the Civil Procedural Law; and 诉讼费用交纳办法 (Measures on the Payment of Litigation Costs) issued by the State Council.
[47] *Ibid.*

the case. As the sample cases demonstrate, derivative actions are mostly initiated by shareholders who have a large portion of equity interest in the company, and therefore, have strong motivations to challenge directors and officers or make use of litigation to force them out of the company.

Second, the burden of proof is not reasonably allocated in consideration of the information asymmetry between shareholders, especially the minority and dispersed ones, and directors with a good grip on business operations and internal affairs. Moreover, the meaning and standard of duties of loyalty and care are not set forth in law. This means that the plaintiffs have to try their best to prove all their claims and allegations but can hardly predict whether they can satisfy the standard of proof. This not only imposes a heavy burden on the plaintiffs but also diminishes the efficiency of fact-finding in the courtroom.

Third, contingency fee arrangements are excluded from being used in group litigation in China,[48] which discounts the possibility of minority shareholders filing a derivative action, especially in giant companies. A contingency fee is a kind of arrangement for the legal service fee, which allows plaintiffs to obtain legal representation at the beginning of the case without any upfront payment to lawyers. The lawyers would receive a percentage of the awards when they win the case; in China, this can be up to 30 per cent of the contract value.[49] This arrangement, in essence, finances the actions of plaintiffs who are not otherwise able to, or not willing to, pay legal service expenditure in advance. In addition, the dependence of their service fee on the court's decision incentivises lawyers to maximize the plaintiffs' interests. If they lose the case, their efforts would be futile, and not be rewarded by the plaintiffs.

With regard to the shareholders derivative actions, contingency fee arrangements can also help resolve collective action problems and incentive problems confronting multiple shareholder plaintiffs, since the lawyer has an even larger stake in the cases than the plaintiff, and thus, is willing to proactively drive the action to proceed. In the meantime, shareholder plaintiffs do not need to pay the lawyers themselves.

However, contingency fees cannot be used in derivative actions filed by a large number of shareholders, because lawyers are explicitly prohibited from accepting contingency fees for their services in group litigation. This prohibition may adversely affect the derivative

[48] See Art. 11 in 律师服务收费管理办法 (Measures on the Administration of Lawyers' Fees) issued by State Development and Reform Commission and the Ministry of Justice in 2006.
[49] *Ibid.*, Art. 13.

actions involving large CLSs and listed companies. As previously examined, the Company Law sets the threshold requirement for qualified plaintiffs in the CLSs to sue derivatively as 'shareholders individually or collectively holding at least 1% of all the company shares for 180 consecutive days'.[50] Accordingly, the number of shareholders that hold enough shares to sue directors in giant companies cannot be small, which results in the exclusion of contingency fee arrangements. The larger the number of shareholders filing a suit, the more the need for contingency fees and motivated lawyers.

Judiciary deficiencies

Another determinant for litigation decision-making is whether the courts are able to resolve disputes fairly and impartially. Yet, many commentators have expressed concerns that China's judiciary lacks independence and competence.[51] Indeed, it is explicitly stated that the people's courts, in accordance with the law, exercise judicial power independently, not subject to interference by any administrative organ, public organization, and individuals in Article 126 of the Constitution.[52] The Judges Law affirms that judges have the right to brook no interference from administrative organs, public organizations, and individuals.[53] Nonetheless, the overall political structure results in the courts being subject to various controls and interference. Judicial deficiencies greatly diminish the public confidence in resolving disputes and seeking remedies through litigation.

China has four levels of courts from national to provincial, city, and county level as follows: supreme, higher, intermediary, and basic.[54] There is a vertical supervision force within the court systems; courts at higher levels supervise the administration of justice at lower levels, and the Supreme People's Court, the highest judicial organ, supervises the administration of justice by the courts at various levels.[55] However, it is common practice for judges in lower courts to seek instructions and opinions from higher-level courts in

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[50] See Art. 152 in the Company Law

[51] See, e.g., Randall Peerenboom, *China's Long March toward Rule of Law* (New York: Cambridge University Press, 2002), p. 280; and Yuwen Li, *The Judicial System and Reform in Post-Mao China: Stumbling towards Justice* (New York: Routledge, 2014), pp. 39-87.

[52] Full text of the Constitution of the People's Republic of China is available on the official website of the NPC, available at http://www.npc.gov.cn/englishnpc/Constitution/2007-11/15/content_1372991.htm (accessed 27/11/2019).

[53] Art. 8 (2) in 法官法 (The Judges Law).

[54] In addition, China has specialized courts for the military, maritime, railway transportation, and forestry ones (Art. 2 in the Organic Law of the People's Courts). Directors' duties and liabilities are usually deemed as ordinary civil disputes and not within the purview of specialized courts, and thus these specialized courts are not discussed here.

[55] See *supra* note 50, Art.127.

individual cases. The higher court may reply only based on the report from the lower court and often tainted with local protectionism concerns.[56]

Within a court, the collegiate panels hear and decide most cases.[57] A collegiate panel usually consists of three or five judges, of whom the senior one chairs the panel. When a case is complex and controversial, the panel should transfer it to the adjudicative committee in that court for discussion, review, and approval before issuing the judgment.[58] The adjudicative committee members are the division head, the vice president, and the president of the court, and other high-ranking judiciary officers, while seasoned judges may not be included. After the panel reviews and discusses the reports, the committee delivers the judgment by voting behind closed doors. Members with an interest in the case would not necessarily withdraw as they usually do in public trials. Most committee members tend to defer to the opinions of the president or other high-ranking judiciary officers of the court in the absence of the president. Because the president and high-ranking judicial officers of the court are also the leaders of Party Committees, it is highly likely that a significant and sensitive case would be handled with undue political influence through the adjudicative committee.[59]

At the horizontal level, judicial power is relatively weak. As a matter of law, the courts are accountable to their corresponding level of people's congresses, the legislature organs.[60] People's congresses have the power to elect, appoint, and dismiss the presidents of the courts, review the work reports of the courts, and even supervise individual cases.[61] The supervision of individual cases by local people's congress intends to prevent wrong or unfair judgments due to the mistakes or corruption of judicial officers.[62] However, the judges are in a very difficult position when dealing with the different opinions from those without any professional training or experiences.[63]

[56] Wusheng Zhang and Zeyong Wu, 司法独立与法院组织机构的调整 (Judicial Independence and Restructuring of Organization of the Courts), (2000) 2 中国法学 (*China Legal Science*), p. 50.
[57] See Art. 10 in 人民法院组织法 (Organic Law of the People's Courts) issued by the NPC in 2006
[58] *Ibid.*, Art. 11.
[59] See *supra* note 51 Peerenboom 2002, p. 281.
[60] See Art. 8 and 28 in 地方各级人民代表大会和地方各级人民政府组织法 (Organic Law of People's Congresses and Governments at Local Levels).
[61] *Ibid*.
[62] See *supra* note 51 Yuwen Li 2014, pp. 40-45.
[63] Ruihua Liu, 论人大的个案监督 (On the Supervision Power of the People's Congress over Individual Cases), (2002) 4 现代法学 (*Modern Law Science*)，p. 32.

Influences that are more powerful come from the local governments and local communist party committees who decide on the budget and staffing level of the courts.[64] In the case of an action against directors in a company that makes a substantial economic contribution in the locality, such as maintaining the employment rate and providing public revenues, the local government is very likely to suppress the trial of a case that may have an adverse impact on the company, because local government officials have long been evaluated and singled out for promotion by the economic growth benchmark.[65]

The lower courts would also be in an awkward position in handling the disputes pertaining to the central SOEs or their subsidiaries. The central SOEs, directly owned by the central government agency, are quite powerful, both economically and politically. Their directors and officers have political ranking up to the ministry level.[66] Even the subsidiaries of the central SOEs do not operate in line with the local industrial or development policies. To avoid tension with superior authorities, the local courts may not accept cases involving the central SOEs and their subsidiaries.

Judicial competence is a technical concern that controls the outcome of each case before the court. A low level of judicial competence is considered as a more serious problem than a lack of independence. With continuous reform efforts and a series of regulations in place, the professional competence of Chinese judges has greatly improved in terms of educational background and legal training.[67] Meanwhile, economic growth and industrial development also pose enormous challenges to the judges. The disputes on managerial functions and responsibilities, amongst others, raise the requirement of basic business expertise in the judiciary.

Judges have to deal with accounting books, audit reports, asset appraisal reports, and other technical evidence. In one sample case, the court of first instance did not take account of equipment depreciation, and accordingly, made mistakes in the calculation of

[64] Donald C. Clark and Nicholas C. Howson, 'Pathway to Minority Shareholders Protection: Derivative Actions in the People's Republic of China' in D. Puchniak, H. Baum, and M. Ewing-Chow (eds.) *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge: Cambridge University), pp. 254-256.
[65] Justin Yifu Lin and Zhiqiang Liu, 'Fiscal Decentralization and Economic Growth in China', (2000) 49 *Economic Development and Cultural Change*, pp. 1-21.
[66] Udo C. Braendle, Tanja Gasser, and Juergen Noll, 'Corporate Governance in China—Is Economic Growth Potential Hindered by *Guanxi*?', (2005) 110 *Business and Society Review*, pp. 389-405.
[67] Nicholas C. Howson, 'China's Judicial System and Judicial Reform', (2011) 54 *Law Quadrangle*, pp. 62-65.

the company's losses, which was corrected by the court of appeal.[68] At present, few cases explicitly request judges to assess whether directors have exercised reasonable prudence. This perhaps indicates the public distrust of judicial review in complex business matters.

5.3 Administrative Sanctions for Breach of the Information Disclosure Duty

Information disclosure is a pre-requisite to share pricing, and thus, underpins the function of stock markets. The listed companies are exposed to continuous and all-round public supervision due to the regulatory requirements of information disclosure. Directors and officers, in turn, are also under substantial pressure, since the financial status and major transactions of the company they serve are usually referred to for the assessment of their performances. Moreover, unlawful transactions and decisions can be uncovered through investigations into the disclosures and statements. Thus, the intense enforcement of misrepresentation plays a crucial role in ameliorating the agency problems in the listed companies. As securities litigation in China is rather weak and contingent on public enforcement actions, this section only examines the administrative penalties for misrepresentation.[69]

5.3.1 Enforcement Agents

China has established a multi-layered system to regulate securities-related activities, maintain the order of the securities market, and protect investors. In response to the rapid development of the securities market, the regulatory notions and approach have been continuously adjusted and refined into the status today.[70]

The CSRC is the central authority of the regulatory system, similar to the SEC in the US. According to the Securities Law, it is the responsibility of the CSRC to: formulate regulatory rules to govern and standardize conduct and trading of securities in the markets; examine the application of share offering and grant approval to IPOs and other activities *ex ante*; oversee and inspect the disclosure of information in the course of offering and trading

[68] Ye Hejie, Xie Mingzhong, Liang Zhihai v. Qiu Jianhe and Jiang Zhiying decided by Guangdong Province Foshan City Chancheng District People's Court (广东省佛山市禅城区人民法院) in 2014.
[69] Jin Sheng, 'Private Securities Litigation in China: Passive People's Courts and Weak Investor Protection', (2014) 26 *Bond Law Review*, pp. 94-147.
[70] Jing Bian, *China's Securities Market: towards Efficient Regulation* (New York: Routledge, 2014).

securities; and investigate and punish violations of securities laws and regulations *ex post*.[71]

With particular regard to the enforcement function, the CSRC is empowered to conduct on-the-spot examination, investigate and collect evidence in the event of any irregularity, inspect and photocopy any records, documents and materials related to the case, inquire into the involved parties and require them to provide an explanation for the issues under investigation, examine the fund accounts and securities accounts of the parties involved.[72] In situations where relevant documents or materials are likely to be transferred, concealed, or destroyed, and that the involved parties are about to remove or conceal illegal funds and securities, the CSRC has the authority to seal up the documents and materials and freeze the fund and securities accounts.[73] The scope of regulatory authority and enforcement measures has been gradually expanding over the years to better attack complex violations of the securities laws and regulations.[74]

As of 2002, the CSRC has adopted a new principle—division of investigation and adjudication, which mandates two separate departments in the CSRC to conduct investigations and make sanction decisions, respectively (see Table 5.6).[75] This initiative intends to streamline the workflow of securities law enforcement, increase the expertise of staff, and ultimately improve enforcement efficiency.

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[71] The full text of official translation of the Securities Law is available on the NPC website http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm (accessed 09/12/2019).
The detailed function of the CSRC is provided in Article 179.
Article 179 The securities regulatory authority under the State Council shall perform the following functions in regulating the securities market: (1) to formulate, according to the laws, rules and regulations concerning regulation of the securities market and to lawfully exercise its power of examination and approval or verification; (2) to regulate, according to the laws, the offering, trading, registration, custody and clearing of securities; (3) to regulate, according to the laws, the securities business activities of the issuers of securities, listed companies, stock exchanges, securities companies, securities registration and clearing institutions, securities investment fund management institutions, securities investment fund consulting organizations, credit-rating institutions, and those law firms, public accounting firms and asset appraisal organizations that are engaged in securities business; (4) to formulate, according to the laws, the qualification criteria and codes of conduct for persons engaged in securities business, and to see that these are observed; (5) to supervise and inspect, according to the laws, the disclosure of information in connection with securities offering and trading; (6) to guide and supervise the activities of the Securities Industry Association according to the laws; (7) to investigate and deal with the violations of laws and administrative regulations concerning the regulation of the securities market; and (8) other functions prescribed in the laws and administrative regulations.
The CSRC also holds primary regulatory responsibilities for the futures market, which is beyond the scope of this study.

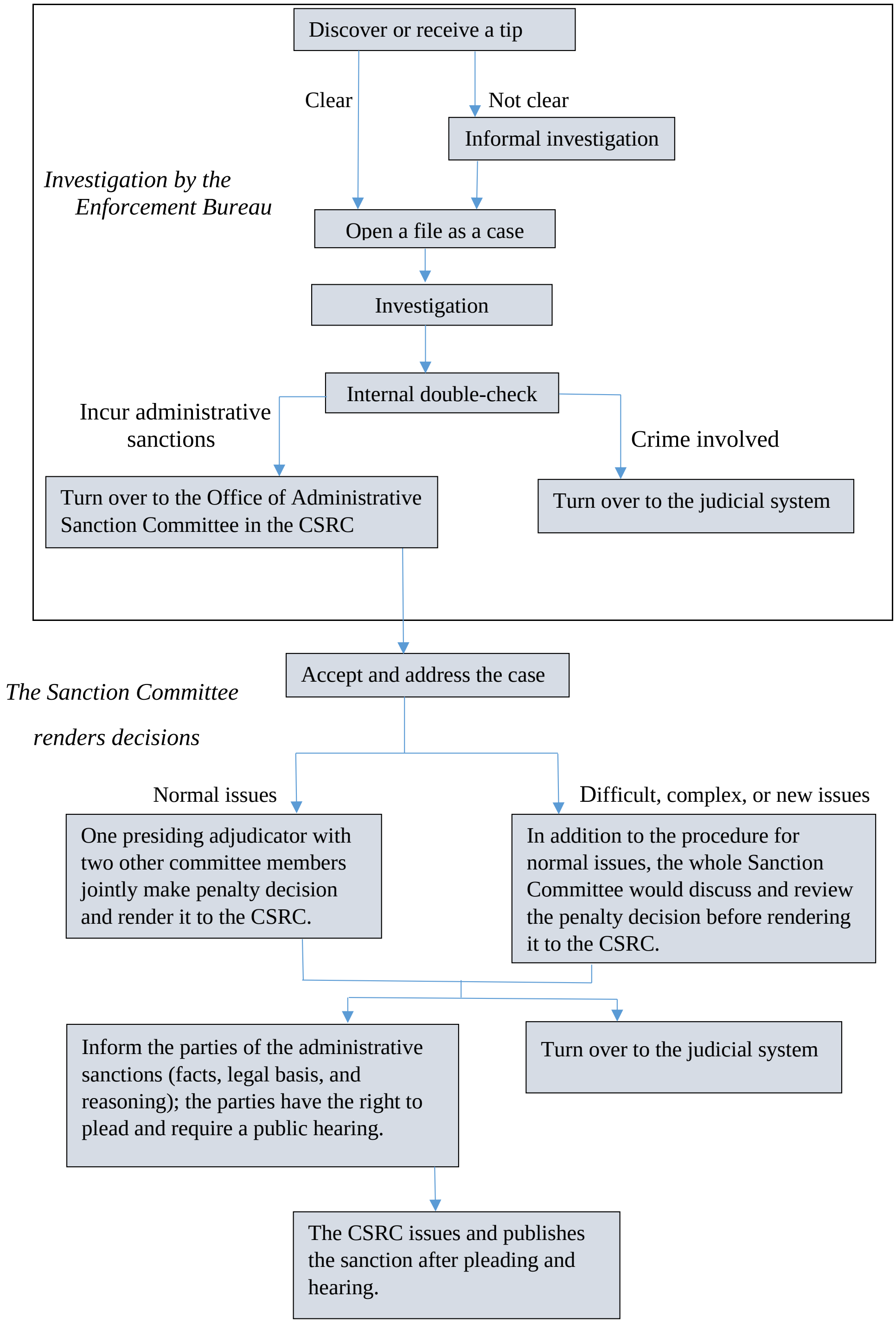
[72] Art. 180 in the Securities Law

[73] *Ibid*.

[74] Jing Bian, *China's Securities Market: towards Efficient Regulation* (New York: Routledge, 2014), pp. 132-135.

[75] The CSRC issued '关于进一步完善中国证券监督管理委员会行政处罚体制的通知' (Announcement Regarding Further Improvement of the Administrative Sanction System of the CSRC) on 25 April 2002.

Table 5.7 Workflow of the CSRC's Enforcement Actions



In particular, the Enforcement Bureau, which is a department of the CSRC, mainly executes investigative functions. The Bureau accepts and addresses all the tips or complaints of irregularity. First, the Bureau commences an informal screening investigation of the tips and decides whether to file a case considering the substance of the irregularity. When a case is filed, the Bureau organizes the inquiry and probe, co-ordinates the enforcement forces, seals up documents or materials, and freezes accounts and assets in the above-mentioned circumstances. On completion of investigative work, the Enforcement Bureau prepares an investigation report and double-checks it.[76] To strengthen enforcement, an examination division was established in November 2007 and is continuously expanding to address major, urgent, and cross-region cases that the Enforcement Bureau assigns to them.

The Administrative Sanction Committee specifically adjudicates these cases and exercises the sanction powers following the legal procedure.[77] The Enforcement Bureau transfers the case materials and investigation report to the Office of the Administrative Sanction Committee. For each case, a collegial panel is set up with three committee members, with one of them taking the presiding role. When the case involves complex, difficult, or new issues, the whole Committee will hold discussions and conduct a thorough examination. Besides, any committee member should withdraw from the case in case of a conflict of interest.[78]

The Committee needs to send out prior notice of administrative sanctions to the parties, which contains facts, issues, legal basis, and reasoning for the sanction decision and informs the parties of the right to a public hearing. When the parties have sufficiently defended themselves through a hearing procedure or in writing, the Committee makes the administrative sanction decision and publishes it on the official platform. To enhance the professional expertise of adjudication, the Committee also engages outside experts in the accounting, investment, and legal professions to provide consultancy.

Under the direct leadership of the CSRC, 38 regional offices are instituted in the provinces and major municipalities to play a daily and timely regulatory role in their

[76] The official website provides the information of the function that the Enforcement Bureau performs. http://www.csrc.gov.cn/pub/newsite/jcj/ (accessed 22/11/2019).
[77] A series of laws and regulatory rules govern the power and procedure of imposing administrative sanctions, including the Administrative Sanction Law, the Securities Law, and the Rules of Public Hearing in the Procedure of Administrative Sanction by the CSRC.
[78] Withdrawal from the case where the agents may have potential conflict of interests is commonly required in sanctioning and hearing procedure for public enforcement in securities law.

jurisdictions. The regional offices undertake regular supervision over the listed companies and intermediary entities, monitor market trends and alert the listed companies about any risks, investigate and sanction minor infractions, facilitate investors' education, and deal with other matters with the delegation of authority by the CSRC.[79] To extend the regulatory reach of the CSRC and intensify the enforcement actions, the regional offices have been encouraged to play a pro-active role in imposing sanctions since 2011.[80]

Besides, the Shanghai and Shenzhen Stock Exchanges not only provide venues for centralized trading of shares but are also self-regulatory organizations that serve a real-time monitoring function according to the Securities Law and under the direct supervision of the CSRC.[81] In particular, the Stock Exchanges oversee the disclosure of information and press the relevant persons in charge to ensure that their companies disclose information promptly and accurately, since the Securities Law provides that the listed companies should submit the disclosure reports and documents to the Stock Exchanges.[82] Moreover, the stock exchanges may deliver a technical suspension of trading when a sudden event that disturbs the trading order occurs and has the authority to suspend or terminate trading of the shares of a listed company in certain conditions.[83] Public criticism by the stock exchanges has a deterrent impact on the listed companies and individual directors and executives.[84]

5.3.2 Enforcement Intensity

From the CSRC's annual reports, the number of cases that the CSRC has handled in each year was obtained, and the numbers for each type of cases were compiled in Table 5.7.[85] As the aggregate figures indicate, the CSRC has made efforts to increase enforcement actions. Notably, the number of cases addressed by the CSRC in 2014 totalled 163, doubling that of 2011 or of 2012. After this steep growth, the total number was still on the rise, by 20.24% from 2014 to 2015. Nevertheless, the number of misrepresentation cases is not increasing at a similar rate.

[79] See Article 1 of 中国证监会派出机构监管职责规定的通知 (Notice on the Regulatory Responsibilities of CSRC's Regional Offices).
[80] In 2011, the CSRC initiated a pilot project in its Shanghai, Shenzhen and Guangdong offices. These three regional offices now exercise the administrative punishment power for minor infractions.
[81] See Article 113, 114 and 115 in Chapter 5 of the Securities Law.
[82] *Ibid.*
[83] Art. 55 and 56 in the Securities Law.
[84] Benjamin L. Liebman and Curtis J. Milhaupt, 'Reputational Sanctions in China's Securities Market', (2008) 108 *Columbia Law Review*, pp. 947-951.
[85] The CSRC's annual reports are available on http://www.csrc.gov.cn/pub/newsite/zjhjs/zjhnb/ (accessed 23/11/2019).

Table 5.8 Number of Administrative Sanction Decisions by the CSRC per Year

Year	Misrepresentations	Insider Trading	Market Manipulation	Others	In total
2011	21	10	5	45	81
2012	34	33	10	5	82
2013	23	51	8	4	86
2014	36	69	15	43	163
2015	47	64	18	67	196

The very recent literature presents a statistic of the administrative sanctions imposed on listed companies from 2003 to 2015.[86] It is revealed that before 2011 the enforcement actions of the CSRC were at a considerably low level. However, increasing enforcement actions by its regional offices have reversed that trend. In general, listed companies are not the parties that may commit insider trading and market manipulations. The only one type of violation of the Securities Law by listed companies is misrepresentation. Thus, the figures below also illustrate the intensity of enforcement actions against misrepresentation by the CSRC and its regional offices (Table 5.8).[87]

Table 5.9 Sanctions against Listed Companies by the CSRC and its Regional Offices

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
CSRC	22	26	15	21	22	15	14	17	18	15	17	18	29
Regional Offices	5	6	0	0	6	11	53	54	118	232	226	134	129

Source: W. Xu et al. Table 3[88]

However, the deterrent impact of increasing enforcement actions would be undermined by the negligible penalties stipulated in the Securities Law.[89] In addition, private securities litigation is still a rare occurrence in China, primarily because the courts are reluctant to

[86] Wenming Xu, Jianwei Chen, and Guangdong Xu, 'An Empirical Analysis of the Public Enforcement of Securities Law in China: Finding the Missing Piece to the Puzzle', (2017) *European Business Organization Law Review*, pp. 11-12.
[87] The number of sanction decisions imposed by the CSRC on the listed companies in Table 5.8 is different from the number of misrepresentation cases addressed by the CSRC in Table 5.7. The misrepresentation of the intermediary agencies punished by the CSRC is not counted in Table 5.8 but included in Table 5.7.
[88] See *supra* note 86 in this chapter.
[89] See Art. 193 in the Securities Law

accept and hear securities lawsuits and even intentionally delay the formal proceedings, as shown in a 10-year empirical study.[90] This means that monetary liabilities, including administrative sanctions and civil liabilities, are far from sufficient to deter directors and officers who violate information disclosure requirements.

Finally, it has long been recognized that the CSRC has selectively taken enforcement actions.[91] Namely, private enterprises are punished more frequently and more severely than SOEs. Such enforcement bias against private enterprises is not surprising when viewed holistically. The central authority in China has developed economic policies based on the socialist ideology, which espouses state ownership and the state sector. For instance, the SOEs are more likely to obtain bank loans and their IPO applications are more readily approved. In contrast, private enterprises are often forced to tap an alternative source of finance such as personal savings and personal connections.[92] Yet, there has been a gradual mitigation in such bias and today, only the central SOEs still enjoy preferential treatment in many aspects, including fewer enforcement risks.[93]

5.3.3 Typical Administrative Sanction Decisions

In addition to the quantitative assessment of the enforcement actions against misrepresentation, it is important to explore how the regulatory authorities deal with a series of legal issues, especially those left unaddressed in law. The CSRC is the central authority that formulates general regulatory policies and specific rules, and launches the enforcement campaigns targeted specific types of violations.[94] Moreover, those severe and repeated violations of disclosure rules may eventually go to the CSRC, as its regional offices primarily handle minor infractions.[95] In light of this, this section primarily examines the administrative sanction decisions issued by the CSRC in 2015 and 2016 to

[90] Robin Hui Huang, 'Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment', (2013) 61 *The American Journal of Comparative Law*, pp. 768-770. The author finds that the small number of securities lawsuits is not attributable to the pre-requisite requirement of criminal judgement or administrative sanctions and many entrepreneurial attorneys play a relatively active role in seeking remedies for investors.
[91] Donghua Chen, Dequan Jiang, Shangkun Liang, and Fangping Wang, 'Selective Enforcement of Regulation', (2011) 4 *China Journal of Accounting Research*, pp. 9-27.
[92] See *supra* note 92 in Chapter 3. (Allen *et al*. 2005)
[93] See *supra* note 86, Section 4.2 Selectively enforcement of securities laws?
[94] For instance, in 2015, the CSRC undertook several rounds of enforcement campaigns to maintain pressure on violators of the securities laws and regulations. Each round of enforcement campaign targets one type of violations.
[95] See, CSRC [2015] No. 91 Shenzhen Lingqi Co. and nine responsible individuals. In this case, Shenzhen Lingqi Co., had been investigated and sanctioned since 2011 by the Shenzhen municipality regional offices for inaccurate and incomplete information disclosure. After several warning and reprimands, the CSRC took over this case and decided on punishment.

identify the emerging characteristics of administrative investigations of and sanctions against misrepresentations.

Accounting and financial frauds

A wide variety of improper disclosures come within range of the CSRC's radar. First, unsurprisingly, a number of listed companies falsify their accounting books to inflate net profits by under-stating or delaying liabilities and expenses, accelerating revenue recognition, and even fabricating contracts, invoices, and bank notes without business substance. Financial statement is the basic component in almost all disclosure documents, regular or interim, and hence, any disclosure documents containing problematic and fraudulent accounting entries are virtually violations of information disclosure requirements.

As shown by the 2015 and 2016 decisions, the CSRC may review the regular reports and other disclosure documents for several consecutive fiscal years as a whole. Any inconsistencies or abrupt increase or decrease in profit in these fiscal years may trigger further investigation. Moreover, the CSRC is well aware of the market trends and industry dynamics. For instance, one wind energy company disclosed profit growth in the half-yearly report, but the overall industry was plummeting during that period. The CSRC noticed this irregularity and discovered an inflation of profit by improper remuneration recognition.[96]

Moreover, the CSRC looked into technical issues that the accountants' estimates and judgments are central to, such as the calculation and entry of asset value depreciation over the years, long-term deferred expense, bad debt provision for receivables, *et cetera*. To assess the accounting methods and determine if there was any misreporting, the CSRC referred to the Accounting Standards for Business Enterprises and reviewed previous accounting methods that one listed company had routinely followed.[97]

In one case, the subsidiary of a listed company, in 2012, put down the product liabilities to another company under non-operating expenses. However, the actual amount of product liabilities could not be reasonably ascertained then, and after negotiation, the subsidiary did not need to pay the product liabilities. The subsidiary offset the amount of product

[96] CSRC [2015] No. 66 Huarui wind energy company and 15 responsible individuals.
[97] The Accounting Standards for Business Enterprises, issued by the Ministry of Finance in 2006, is applicable to all business enterprises established in China. The Standards provides the basis for recognition, measurement, and reporting business activities for accounting purposes.

liabilities in 2012 by decreasing the operating expense and increasing undistributed profit in 2013, which, in turn, influenced the equity interest of the listed company.

The CSRC determined that the accounting method for product liabilities was neither proper nor consistent with routine treatment.[98] Furthermore, the manner in which the subsidiary responded to the incorrect evaluation for the product liabilities in 2013 did not comply with the Accounting Standards for Business Enterprises No. 28—Changes of Accounting Policies and Accounting Estimates and Error Correction. This incompliance was deemed as the cause for the deflation of its profit in 2012 and the inflation of profit in 2013.

To sum up, listed companies have employed more deceptive and complex tactics to gloss over operational and financial performance. In response, the CSRC has probed deeply into the substance and essence of corporate activities, carefully checked the accounting books against the facts, and assessed the accounting estimates, judgments, and revisions over the passage of time. As for the legal basis, the CSRC not only applies the general requirement of information disclosure—accuracy, authenticity, and completeness, but also actively administers more specific rules in the Accounting Standards for Business Enterprises.

Related party transactions

The administrative sanctions are frequently imposed on the listed companies for non-disclosure or incomplete disclosure of related party transactions and the existence and status of the related parties. The form of related party transactions in the 2015 and 2016 decisions ranges from provision of guarantees or collateral to concealed transactions via a third party. The CSRC does not examine whether the undisclosed transactions tunnelled the interests of listed companies to their related parties or whether such transactions are approved by authoritative bodies in due procedure. The CSRC only checks whether there is disclosure of related party transactions and whether the disclosure complies with legal requirements. When the related party transactions show profit inflation or reveal an attempt to inflate profit, the CSRC would alert the potential investment risk arising from the related party transactions.[99]

Misleading statement

[98] CSRC [2016] No. 12 Hainan Yatai business company and 24 responsible individuals.
[99] See, CSRC [2015] No. 7 Peking Qingniao Huaguang technology company and 15 responsible individuals.

The background information of listed companies is also subject to rigorous examination by the CSRC. One listed company, for example, disclosed that it was planning to run an internet finance business and was setting up a subsidiary for this purpose.[100] Based on the evidence from the investigation, the CSRC determined this to be a misleading statement and held that 'the listed company selectively disclosed favourable information, confusingly used the internet finance industry as the new line of business, and greatly exaggerated the expanding progress of the new business'.[101] More notably, the CSRC ruled that the listed company only had some data and credit of personal loans and was only able to provide services related to internet finance but not any financial products via the internet.[102]

Similarly, a listed company in the agricultural product industry bought well-processed pine nuts and pumpkin seeds from suppliers directly, but disclosed that its major business involved removing the shells of nuts and processing nuts and seeds.[103] The CSRC noted that the statement on the processing technique, types of raw materials, and the manufacturing model, all contained inaccurate information.[104] As indicated by these administrative decisions, the CSRC conducts overall investigations into the disclosure documents and it is likely to detect any statement deviating from the factual situation and construe it as misrepresentation.

Administrative liabilities and sanctions

The Securities Law specifies the requirements of information disclosure, and sets the upper limit for administrative sanctions against the violation of such requirements. However, there are no legal rules related to the exemption of the liabilities or any legal standards pertaining to the degree of the monetary sanctions.

As shown in the administrative decisions, individual respondents presented various arguments for why they should not be liable for the misrepresentation of the companies they serve. Some claimed that they have fulfilled duties of loyalty and care but were not experts, or in charge of accounting and financial issues. Some asserted that they reasonably entrusted the preparation of disclosure documents to accountants and auditors. In addition, some independent directors explained that they were not informed of relevant transactions.

[100] CSRC [2016] No. 138 Shanghai Anshuo information technology company, Gao Ming, and Cao Feng.
[101] *Ibid.*
[102] *Ibid.*
[103] CSRC [2016] No. 107 Liaoning Zhenlong specialty company and 19 responsible individuals.
[104] *Ibid.*

However, there is no single case where the defending claims are supported by the CSRC. For one thing, the CSRC usually decides that the individual respondents did not have sufficient evidence to prove that they fulfilled the duties of loyalty and care and that they adopted necessary monitoring measures. In quite a few cases, the CSRC stressed that directors should effectively perform a monitoring function and have the responsibility to set up and maintain an internal control system and information reporting system. This will incentivise directors to perform their functions more actively.

For another, the CSRC explicitly holds that the lack of professional competence, personal health issues, non-participation in particular transactions, lack of knowledge of misrepresentation, and so on, are not legal grounds to exempt the responsible individuals from the administrative liability for the violations of information disclosure laws and regulations. Even the new directors are responsible for the accuracy, authenticity, and completeness of the disclosure reports, which may contain transactions and financial data, from before they took office.[105]

Nevertheless, the CSRC considers relevant factors to determine the proper magnitude of fines for individuals with different responsibilities, such as signatures in the disclosure documents, transaction agreements, meeting resolutions, *et cetera*. Individuals who assumed information disclosure duties but did not sign the relevant documents receive smaller fines. Conversely, those who sign the disclosure and transaction documents cannot defend themselves by arguing that they rely on the information and advice provided by their subordinates or contending that they are not competent to deal with the technical issues. Finally, independent and external directors are usually punished with a fine ranging from 20,000 to 50,000 CNY, which is lower than the range of fine imposed on executive directors.

5.4 Conclusion

Based on the quantitative and qualitative analysis of 243 cases, the major features of private enforcement of directors' duties and liabilities are revealed as follows. First, private actions are mostly initiated to challenge management in the LLCs and the number of the cases against directors and officers is not as small as previous studies show. However, such private actions are almost non-existent in listed companies or in SOEs. Minority shareholders in listed companies usually lack the incentive to file a lawsuit against

[105] CSRC [2016] No. 102 Heilongjiang Beidahuang agriculture company and 16 responsible individuals.

directors of their companies, because they would face a series of procedural obstacles and disproportionate costs. With regard to management misconduct in the SOEs, private investors rarely seek remedies before the courts, since the courts are perceived to be under government-party interference, and accordingly, may not exercise impartiality in handling such cases.

Second, the causes of actions are increasingly diverse. The claims of breach of duty of loyalty are not limited to the types enumerated in the statutory prohibition list. The sample cases show abuse and theft of corporate resources, extensively encompassing funds, equipment, real property, business opportunities, connections, and even specialist qualifications for certain industries. Moreover, plaintiffs may not explicitly allege a breach of the duty of care. Instead, they stress that a specific conduct or decision, improper or unreasonable, has caused losses to the company and they request the courts to hold defendants liable for such losses. It is then up to the courts to determine whether the defendants were at fault in consideration of their decision-making process, their scope of authority, and other factual circumstances.

Third, a number of companies involved have a small group of shareholders who exercise executive power or monitoring power on their own. In this scenario, the underlying reason for filing a lawsuit is usually the internal conflict with business operations or a contest for corporate control.

Fourth, a large portion of claims is not sustained due to lack of evidence. Owing to the lack of evidence rules, especially for the cases of directors’ liabilities, it is only possible to refer to the general principle in the Civil Procedure Law. Consequently, plaintiffs bear the burden of proving their claims, despite defendants often possessing informational advantages. Further, it is difficult to prove or precisely measure the amount of losses to the company. The courts have to award damages to the company at their own discretion, which increases the uncertainty of a lawsuit.

In addition, it is rather unpredictable in which manner judges examine the merit of a disputed transaction and how they interpret and apply general rules. In the sample cases, some judges actively bridge the gaps in the legal rules and construe the general terms into specific requirements in context. However, some judges stick to the literal meaning and apply the rules mechanically. Therefore, the general and vague term of legal duties in law, unpredictable outcome of judicial review, and the cost and difficulty of proving claims make private actions less useful in addressing management problems.

Administrative investigation and sanctions play a major role in disciplining the listed companies and their directors and officers. The enforcement against misrepresentation largely increases the transparency of internal governance in listed companies. However, the level of enforcement actions is not high. In recent years, the CSRC has streamlined the workflow of enforcement agents to enhance the quality of administrative decisions. According to previous empirical studies, the regional offices of the CSRC have vigorously performed enforcement actions. Although the number of administrative sanction decisions is steadily increasing, the penalty is too small to deter individuals. Another issue with the enforcement pattern is that private companies are more often investigated and punished than state-owned companies.

The administrative sanction decisions reveal that the CSRC not only targets outright frauds but also focuses on misleading statements, and even minor inconsistencies in the disclosure documents. Further, the CSRC repeatedly underscores that directors should fulfil the duties of loyalty and care to ensure that the disclosed information complies with the laws and regulations. Meanwhile, the CSRC never accepts the defence of the directors that the duties of loyalty and care were fully performed.

Thus, enforcement by the CSRC against misrepresentation plays an indispensable role in deterring management misconduct in the listed companies; furthermore, the CSRC has been attempting to reinforce their enforcement actions and professionalize the enforcement forces. However, the intensity of deterrence is insufficient, which is largely attributable to the light administrative penalty and difficulties in enforcing individual monetary liabilities.

Chapter 6 Functional Observations, Conclusions and Recommendations

6.1 Introduction

This chapter aims to answer the central research question: how, and to what extent, does the legal strategy[1], directors' duties and liabilities, ameliorate the agency problems in China? At the core of this research question is an inquiry into the function of this legal strategy. Previous chapters examined the positive status of directors' duties and liabilities, and revealed the uniqueness of the corporate and market context in China. It is now possible to take the perspective of law and economics to analyse major findings of previous chapters, and then to draw observations on the function that this legal strategy is now serving and expected to serve. For this purpose, the rest of this chapter is organized as follows. Section 6.2 answers the sub-questions raised in Chapter 1 by presenting a summary and analysis of previous studies and discussions. Section 6.3 draws conclusions by providing an overall view of the usefulness of directors' duties and liabilities and demonstrating the operational difficulties of directors' duties and liabilities in China. Section 6.4 recommends efforts and measures to boost the utility of directors' duties and liabilities. Section 6.5 lists several related issues that future studies might examine. Section 6.6 makes the final remarks.

6.2 Observations on the Function of Directors' Duties and Liabilities in China

This thesis first revisited the economic theories about the nature of the firm. These theories attempted to explain why firms exist or why some production takes place in firms rather than in markets from different perspectives. Amongst others, the agency theory, formulated with reference to the contractual view of the firm and the transaction cost approach, identifies the conflict of interests between major constituent parties in a firm, including shareholders and managers, controlling shareholders and minority shareholders, and shareholders and other stakeholders, such as creditors. These conflicts of interests may create a series of agency problems and incur organizational costs, also termed as 'agency cost'. Amongst others, directors and officers may misuse their managerial power to further personal interests rather than those of the company or shareholders. Shareholders' interests,

[1] See *supra* Section 1.2 Research Questions for the definition and usage of 'legal strategy' throughout this thesis.

in turn, are endangered. Shareholders need to be ensured that their investment would not be mismanaged and managers need to raise funds to exercise their management talents.

The legal liability strategy addresses agency problems by bringing monetary liabilities as a deterrent to undesirable behaviour. To assess and examine the function of directors' duties and liabilities in China, this thesis examined the characteristic features of China's companies and the models of ownership and control, analysed how the legal rules are carved out to regulate managerial behaviour, and investigated the enforcement of legal liabilities and the intensity of liability deterrent. This section combines major findings from previous chapters and answers the research question, and sub-questions.

6.2.1 Typical Agency Problems in China

Chapter 3 categorized the enterprises by ownership standard, reviewed the evolution of each type of enterprises against a transitional backdrop, and noticed that the modern corporate form came to China no more than four decades ago. It revealed that the SOEs have sustained a politically and economically important status, and thus, have been the regulatory focus while undergoing a series of reforms in China. Corporate form was officially introduced as a major means to transform traditional SOEs, the production units affiliated to the government then, to independent market players. In particular, the operational mechanism of SOEs is no longer determined by government fiat. Private enterprises used to be subject to intense regulatory restrictions; however, they have gained development momentum, and achieved an explosive growth recently. Private enterprises commonly adopt corporate form mainly to restrict investment risks via the attribute of limited liabilities of shareholders in law.

Moreover, Chapter 3 examined the ownership structure, control model, and internal governance of China's companies. According to these studies, most companies have a concentrated ownership structure. It is quite common around the world that small-and-medium-sized companies have a small number of shareholders. In China, even companies listed on the stock exchanges do not have a dispersed ownership structure, even though numerous public investors are trading shares on a daily basis. In addition, as shown in Chapter 3, the extent of share concentration in listed companies is generally high, and the largest shareholders usually hold around one-third of all shares in their companies.[2]

[2] See *supra* notes 95 and 101 in Chapter 3 for the percentage of the shares that the largest shareholders on average hold in the listed SOEs and private companies, respectively.

As mandated in the Company Law, the shareholders (general) meeting holds substantial controlling power, including electing and removing directors, and approving major business plans and transactions.[3] Under the one-share-one-vote rule, the resolutions rendered to the shareholders (general) meetings are largely determined by the controlling shareholders, but minority shareholders only have a small number of votes. This means that one or a few controlling shareholders have the final say over personnel and operational matters, whereas minority shareholders' interests are almost at the discretionary disposal of the controlling shareholders.

Under the lens of agency theory, minority shareholders are the principals who make capital contributions but do not make decisions on investment management. Controlling shareholders are agents who can influence and even control decision-making but may pursue their own benefits at the expense of the minority shareholders. Such agency problems, usually termed as horizontal agency problems, arise due to the divergence of interests of controlling shareholders and minority shareholders. A major concern in China's companies is the protection of minority shareholders from expropriation by controlling shareholders.

Although controlling shareholders can appoint those who represent their interests to be directors, and usually have fewer collective action problems in monitoring directors than dispersed shareholders do, vertical agency problems with delegated management cannot be overlooked either. As shown in the judicial decisions in Chapter 5, small-and-medium-sized companies fall short on well-maintained internal governance.[4] As for large companies, supervisory boards are only able to play a minor role, if not none at all, in monitoring the exercise of managerial power because of the lack of authority, information, and incentives.[5] Independent directors in listed companies usually provide consultancy and various kinds of resources and connections, as many listed companies invite former government officials or experts in different areas.[6] At the board meetings, directors might be more prudent in the presence of independent directors. Such influence is of course positive but not equivalent to a continuous and systematic supervision force. Besides, a frequent criticism is that the independent directors in China's listed companies are virtually

[3] See *supra* Section 3.4.2 Internal Governance.
[4] See *supra* note 40 in Chapter 5.
[5] Jay Dahya, Yusuf Karbari, Jason Zezong Xiao, Mei Yang, 'The Usefulness of the Supervisory Board Report in China', (2003) 11 *Corporate Governance International Review*, pp. 308-321.
[6] Lihong Wang, 'Protection or Expropriation: Politically Connected Independent Directors in China', (2015) 55 *Journal of Banking and Finance*, pp. 92-106.

not independent.[7] In other words, in current corporate practice, internal governance cannot effectively check and control management regularly.

In the SOEs, the special identity of the controlling shareholders yields thorny vertical agency problems. In the centrally planned era, SOEs were merely production units that did not enjoy management autonomy but had to stick to the fixed plan of output and price made by the state government. After corporatization of the SOEs in the 1990s, delegated management has become possible and the government has come to play a shareholding role.[8] At the central level, the State-owned Assets Supervision and Administration Commission (SASAC) under the State Council, owns and controls the SOEs that occupy significant industries such as infrastructure construction, telecommunication, banking, energy, and so on. Local government agencies play an equivalent role in local SOEs.[9]

Seen from a view of agency theory, there exist multi-layered agency relationships in the SOEs, but no real owner, or ultimate principal, is in place to monitor the agents.[10] In particular, directors and officers are in charge of managing the SOEs and accountable to their principals—government shareholders. The state government, on behalf of all the people, owns the state-owned assets and designates the particular agency (SASAC) to be the owners and shareholders of the SOEs. However, people do not have enough political or economic power to monitor the government agency in terms of the operation of state-owned assets in China. Unlike private companies that have equity owners, and residual claimants, whose single goal is to pursue the best interests of the firm, and in turn, to maximize their investment returns, SOEs do not have real owners with direct stakes in the firm, and therefore, watch the business operation closely.

Moreover, directors and officers in the SOEs usually need to consider industrial policies and political goals when formulating business strategies and transaction plans because of government influence. The government agency plays a dual role as the shareholder of the SOEs and regulatory authority over the SOEs.[11] As such, it is inevitable that the resolutions of shareholders meetings in the SOEs are mixed with regulatory goals and industrial

[7] See, e.g., Juan Ma and Tarun Khanna, 'Independent Directors' Dissent on Boards: Evidence from Listed Companies in China', (2016) 37 *Strategic Management Journal*, pp. 1547-1557.
[8] See *supra* Section 3.3.1.3 Corporatization and advancing corporate governance (1993-present).
[9] See *supra* note 59 in Chapter 3 for detailed information about central SOEs (中央企业).
[10] See *supra* note 108 in Chapter 3 and the accompanying text.
[11] See *supra* Section 3.4.1.2 Government control and also Chenxia Shi, Political Determinants of Corporate Governance in China (New York: Routledge, 2012), p. 249.

policies, even though the government agency attempts to put up a Chinese wall to separate the different functions.

The shareholding function is virtually performed by individual officials whose objective is to be promoted to a higher political ranking position. These government officials are simply bureaucratic superiors to the directors in the SOEs. Accordingly, the benchmarks for assessing the performance of the directors in the SOEs are not purely for the sake of the company's interest, but probably include connections with those superior officials. Besides, multiple goals *per se* disturb the assessment of management performance, making it more difficult to identify the economic outcome attributable to the decision-makers, which entices them to moral hazard.[12]

It is not only likely that the directors and officers in the SOEs would misuse their managerial power to 'steal' and 'shirk'.[13] They may also act in collusion with government officials who encroach upon state assets in various ways, which is partially due to the lack of real owners. Notably, directors in the SOEs and local government officials unlawfully gain considerable personal benefits by buying out SOEs that have been intentionally undervalued by fraud.[14]

Similarly, 'tunnelling' the profit and funds of listed companies by controlling shareholders and directors is also notoriously common, especially in the state-owned company group. Before the IPO, quality assets and profitable business were concentrated in the company that applied for the IPO, while inferior assets and debts were arranged in other related companies in this group.[15] When the IPO was approved and funds were raised, other related companies and even the parent holding companies siphon the profits and premium value of the shares of the listed company to pay off debts or sustain the operations of un-listed companies in the group. In this pattern, the interests of minority shareholders in listed companies can be severely harmed. Even worse, investment confidence is greatly undermined.

[12] See *supra* note 106 in Chapter 3 and the accompanying text.
[13] See *supra* note 100 in Chapter 2 and the accompanying text.
[14] In June 2004, an economist Lang, Xianping has sparked off a series of debates over the drain and loss of state assets in the SOEs reforms. Amongst others, extensive discussions considered whether management buy-out (MBO) is the proper approach to privatization of the SOEs because of the recurrence of corruption and scandals.
[15] Yuan Ding, Hua Zhang, Junxi Zhang, 'Private vs. State Ownership and Earnings Management: Evidence from Chinese Listed Companies', (2007) 15 *Corporate Governance An International Review*, pp. 223-238.

In addition to these problems observed in the lens of agency theory, traditional issues with the SOEs including 'soft budget constraint' and overdue policy burdens, though lessened through decades of reforms, still cast a shadow over the efficiency of the SOEs. In economic parlance, political interference incurs substantial political costs and increases agency costs.[16] Despite mixed ownership reform, the actual effect of this reform in promoting the efficiency of the SOEs remains at present unpredictable.[17]

As examined in Chapter 3, in China, market mechanisms can only discipline management behaviour in a limited manner. Nowadays, directors and managers in private companies tend to run businesses diligently, to ensure that their firms survive and grow, because product and services markets are increasingly competitive. Profit growth, increase in market shares, and other similar signals from product markets are used to measure the quality of business decisions by directors and managers and linked to their remuneration.

The above signals from product markets are not as significant for assessing the performance of directors and officers in the SOEs. Most SOEs are monopolies in their respective markets, and hence, are not exposed to intense competition. The remuneration for directors and officers in the SOEs has an upper limit to maintain a small gap with employees. As a result, directors in the SOEs do not need to be sensitive to the signals from product markets, as their counterparts in private companies usually do.

Although by many different measures, China's stock market has developed fast in only three decades, this market only presents a secondary channel for domestic firms to raise funds. For companies listed on the stock exchanges, their operational status is not timely and precisely signaled by stock prices due to the flaws in the information disclosure system, not to say the performance of directors and officers therein. Moreover, the market for corporate control is not active because potential bidders need to buy a very large fraction of shares to prevail as the largest shareholders in order to control the firm. This means that directors and officers in listed companies are not under substantial threat of replacement in case of a takeover.[18]

In sum, China's companies usually have a concentrated ownership structure, and therefore, agency problems between controlling shareholders and minority shareholders are prevalent. Vertical agency problems are also serious, to a varying extent, in different types

[16] See *supra* note 107 in Chapter 3 and the accompanying text.
[17] See *supra* note 62 in Chapter 3 and the accompanying text.
[18] See *supra* Section 3.5 Market Mechanisms and Incentives.

of companies. Directors and officers in the SOEs are not exposed to intense market pressure nor are they under close monitoring by shareholders. Thus, they have more chances to commit self-regarding actions. Government interference exacerbates such moral hazard, because a business decision does not intend to maximize the company's interest anyway and it is confusing that the sub-optimal outcome is attributed to the decision maker or to other policy goals. Listed companies are required to institute a standard internal governance system by the securities regulations. The standard governance system partially mitigates management opportunism. However, listed companies are not free from vertical agency problems, since the external disciplining force from the stock market and the market for corporate control is rather weak.

6.2.2 Design and Formulation of Directors' Duties and Liabilities in Legislation

Chapter 4 briefly introduced the overall legal hierarchy in China and reviewed the evolution of corporate, securities, and bankruptcy legislation in the transitional period. Business entities and market transactions did not naturally emerge in China's centrally planned system. In the 1990s, the Company Law, Enterprise Bankruptcy Law, and Securities Law were enacted, as instruments for overall economic reforms by introducing the legal regimes and business models from western countries.[19] To keep the economic reforms under government control, administrative sanctions and criminal penalties were adopted in these laws, as the primary regulatory approaches to rampant misuse of corporate form to escape debts.

As the overall economy has become more market-oriented, a round of major revisions has been made to these laws in 2005 and 2006. Amongst others, the Company Law has changed its regulatory notion into the promotion of private autonomy by an extensive use of default rules.[20] In tandem, private litigation is expressly confirmed to enforce legal rights and remedy losses. In this way, judicial review becomes a major regulatory approach to wrong-doing in corporate scenarios, replacing the previous regulatory approaches that were primarily dependent on public enforcement.

With regard to the regulation of managerial behaviour, before the major revision in 2005, the Company Law simply commanded directors and officers to maintain the company's interest and strictly prohibited behaviour that could involve personal interest. It did not

[19] See *supra* Section 4.2.5 Summary.
[20] See *supra* note 26 in Chapter 4.

provide the form of liabilities, how a director can be held liable, and who has the legal standing to hold directors liable, which considerably weakened the effectiveness of the general requirement.

Now the legal strategy, *i.e.*, directors' duties and liabilities have been basically instituted. The Company Law specifies what duties directors and officers owe to their companies, clarifies that directors and officers should be liable for the losses caused by breach of legal duties, and confirms private litigation to hold wrong-doers liable. Specifically, the Company Law introduces the concept of fiduciary duties from the common law tradition and spells out that directors and officers owe duties of loyalty and care to the companies they serve. In addition to their duties to companies, directors and officers must abide by laws, administrative regulations, and the company's articles of association (AOA) when they exercise managerial power. Moreover, there is a prohibitive list of breaches of duties of loyalty, including asset misappropriation, usurping corporate opportunities, engaging in the same business as the company does, and various forms of self-dealing transactions. Once there are losses caused by violations of laws, administrative regulations, and company's AOA, shareholders and companies can file a lawsuit before the courts to hold directors and officers liable for their respective losses. In addition, the shareholders derivative action is imported from the US, along with the fiduciary duties of loyalty and care, to overcome the obstacle that directors and officers are reluctant to represent their companies to sue their peers. Shareholders, in the name of their company, may file a lawsuit against the directors for the companies' losses.

Chapter 4 conducts a doctrinal analysis into the meaning and contents of the above legal rules and finds some missing pieces of the puzzle and obscurity.[21] First, directors' duties of loyalty and care do not have their respective standards and test for private parties to predict and for judges to determine whether certain behaviour breaches the general duties of loyalty and care.

As the prohibitive list reads, any transaction and conduct tainted with the interest of any other party than the company's interest should be approved by a shareholders meeting and should comply with the company's AOA. Or else, such conduct is a breach of the duty of loyalty, and therefore, prohibited. The prerequisite of approval is set to filter out transactions that are potentially prejudicial to the company's interest. However, there is a

[21] See *supra* Section 4.3.2 General Duties.

lack of mandatory requirements concerning the information disclosure by the interested director and the withdrawal of interested parties from the approval procedure, not to say the provisions regarding the legal consequences of the failure to fulfil these requirements. Wrong-doers can exploit these loopholes to continue transactions that benefit themselves but at the expense of the company, as long as they can mislead shareholders into approving the transactions.

Above all, it is not sensible to strictly prohibit the transactions and conduct that have not undergone due approval or do not comply with the company's AOA but are likely to benefit the company.[22] In sum, it is not enough to deal with various forms of intentional infringement of the company's interests by procedural requirements and compliance with the *ex ante* arrangements. Therefore, it is necessary to define the standard of the duty of loyalty and its meaning, and a judicial review should examine the merits of the specific transactions and conduct.

The duty of care is almost an empty term in the Company Law, as it has no definition of the duty of care nor is there a list of classic types of breaches of the duty of care, such as the prohibitive list of breaches of the duty of loyalty. The law does not prescribe the requirement of the duty of care or the manner of exercising managerial powers which fulfils this duty. Negligent or imprudent decisions may cause great losses to the company and the shareholders. If the decision makers have to compensate all the economic losses, no one will ever want to take the risk of making decisions. Thus, it is necessary to establish mechanisms for risk diversification and limiting individual monetary liabilities.

Second, it is not clear whether the breaches of the duties of loyalty and care are the causes of actions to hold directors liable, since the liability provision only includes violations of laws, administrative regulations, and the company's AOA. Owing to such obscurity, the disputes rendered to the courts are screened, and the scope of judicial discretion is restricted.

To be more specific, only when a dispute involves conduct that is subject to explicit terms, either in laws and regulations, or stipulated in an agreement, is this dispute more likely to be accepted and addressed by a court. To avoid controversy on their judicial decisions, judges abstain from interpreting and applying the general principle of the duties

[22] See *supra* 4.3.2.2 Duty of loyalty in Chapter 4.

of loyalty and care. This is also confirmed by the sample judicial decisions in Chapter 5.[23] Thus, at the law-making level, the usefulness of directors' duties of loyalty and care is undermined.

General duties of loyalty and care are also used to regulate particular types of management actions. According to the Securities Law, directors and officers in the listed companies are required to ensure the veracity, accuracy, and completeness of the information disclosed to the public. Moreover, the Administrative Measures on Information Disclosure by Listed Companies, a regulatory document issued by the CSRC, further delineates that directors and officers should perform the information disclosure duty faithfully and diligently and should continuously monitor and be informed of the operational and financial status of the company.[24] How directors and officers implement the requirement is considered by the CSRC in dealing with misrepresentations and imposing administrative sanctions. However, the precise meaning and the standard of these requirements remain vague. Even worse, the Enterprise Bankruptcy Law states that directors are liable when their breaches of duties of loyalty and care cause the company's bankruptcy.[25] However, it does not specify to whom directors are liable and for which losses.

In sum, modern corporate legislation in China has a history of merely three decades, taking shape in the 1990s when economic activities and corporate practices started to burgeon and being revised as the economic reforms deepened. In general, the concepts, norms, and legal instruments governing the formation and governance of a company are formulated by emulating the company laws in western countries. Before the 2006 revisions, the legislative purpose was to provide modern corporate form as a means to transform traditional SOEs, and accordingly the legislative approach was to give instructions by mandatory rules. The currently effective company law has relaxed the mandatory requirements which were rigid and limited to ever-changing practices, and has adopted a bundle of default rules to allow flexible arrangement by internal agreement. This reflects that the regulatory approach is shifted from administrative restrictions *ex ante* to judicial review *ex post*.

[23] See *supra* 5.2.2.3 Interpretation and application.
[24] See *supra* note 98 in Chapter 4.
[25] See *supra* Section 4.4 Directors' Liabilities to the Company's Creditors.

The legal norms regarding the exercise of managerial power were also revised by introducing the concept of the fiduciary duties of loyalty and care and explicitly granting shareholders and companies a private right of action to bring lawsuits against directors and officers. In this way, the legal duties are broadened to address both ‘stealing’ and ‘shirking’ on the part of directors and officers, and the legal consequences for breach of such duties are hardened by out-of-pocket monetary liabilities.

However, the design and formulation of the fiduciary duties and liabilities are far from delicate and sophisticated. Major flaws that may greatly undermine the effectiveness of the duty and liability strategy in practice can be observed in the following aspects. First and foremost, directors’ duties are spelled out like a general principle without clear definition or standard. Thus, it would be quite difficult to interpret and apply such principle-like rules in a specific scenario, especially for China’s judges who have limited discretion to do so.

Second, the rules regarding typical breach of the loyalty duty are specified without consideration of the information asymmetry between directors and shareholders. Similarly, no procedural rule is provided to shift the burden of proof, even though directors usually have the information advantage. Third, monetary liabilities for a breach of the duty of care are not particularly addressed in law. It is unreasonable and unfeasible to hold directors liable for all losses caused by their (grossly) negligent decisions. Thus, how to avoid the over-deterring effect on directors and to realize the coverage of compensation for economic losses is worth careful study and sophisticated design.

6.2.3 Enforcement of Directors’ Duties and Liabilities

Chapter 5 reviewed previous empirical studies, and conducted a qualitative and quantitative analysis into 243 judicial decisions. It reports that private enforcement against management wrong-doing is not as rare as previously found. Around one-third of all cases of monetary liabilities for management wrong-doing are particularly against directors. Nevertheless, the number of lawsuits regarding directors’ liability is still small relative to the number of the companies all over the country.[26] All of the cases deal with disputes arising from small and medium-sized companies. There is no lawsuit against directors in listed companies or in SOEs. Thus, the enforcement of directors’ liabilities remains at low levels, and monetary liabilities play a limited, but increasingly active role in deterring management wrong-doing.

[26] See *supra* note 6 in Chapter 5 and the accompanying text and supra Section 5.2.2.1 Source and data.

Previous studies found that the facts and issues involved in sample cases are not complex and are largely attributable to weak internal governance system.[27] However, sample cases show that the complaints become more diverse and encompass different aspects of business operations; some even make allegations against professional judgement based on industry knowledge. Some companies in the sample have been running at a loss for years or are even in the vicinity of insolvency, or the defendants have been dismissed or removed from directorial positions.[28] These companies and their shareholders are usually reluctant to file a lawsuit to challenge directors' decisions unless they cannot obtain reconciliation with the directors, or their co-operative relationship has already broken down.[29] Quite a few cases merely identified the responsibilities of directors for their wrong-doing but did not uphold the claim of monetary liabilities due to a lack of causal links.

Besides, no single case expressly alleged a breach of the duty of care; however, a large number of cases challenged the reasonableness of directors' conduct or decisions. This means that directors still need to be wary of monetary liabilities for negligent and reckless mistakes. Overall, the liability risk for breach of the duties of loyalty and care is not high for directors in small and medium-sized companies and almost non-existent in listed companies or state-owned companies.[30]

A range of factors in the procedural rules pose obstacles to the prospective plaintiffs, especially to minority shareholders who initiate derivative actions. First, no particular rules deal with the burden of proof with regard to the cases of directors' liabilities. Only the general principle—the one who makes claims bears the burden of proof for most civil disputes can be referred to, which means that the extensive burden of investigations and evidence collection rests with the plaintiffs, whereas the defendants obviously have information advantages.[31]

Second, the allocation of cost between the shareholder plaintiffs and the beneficiary of derivative actions, *i.e.*, their companies, is far from satisfactory. According to the new judicial interpretation, only if and until the court upholds some or all of the claims, would the expenditure incurred in litigation be possibly reimbursed. In effect, only disputes

[27] See *supra* Table 5.5 Plaintiffs Claims and Win Rates and the accompanying text.
[28] *Ibid.*
[29] *Ibid.*
[30] See *supra* Section 5.2.2.2 Major features of sample cases and supra Table 5.1 Involved Companies.
[31] See *supra* discussions of Procedural hurdles in Section 5.2.3 Explanations for the Enforcement Pattern.

involving clear and straightforward facts and governed by well-articulated rules would be rendered to the courts, since risk-averse plaintiffs can estimate their win rate and the corresponding litigation costs on a reliable basis. In a contrast, new, complex, and contentious issues would be left unsettled, which would widen the gap between the law in books and the law in action, and the gap between legal strategy and practical needs.

Third, the restriction of the use of contingency fees in actions with multiple plaintiffs is also responsible for the dearth of actions against directors in large companies. In accordance with the shareholding threshold for the legal standing to file a derivative action, the number of shareholder plaintiffs in large companies, especially the listed ones, cannot be small. Without a contingency fee, it is financially burdensome for shareholders to file a lawsuit for the company's sake.

In addition to the hostile procedural rules, the courts may abstain from handling the claims against the directors in SOEs and listed companies, because those claims can be politically sensitive and may embroil the judges in tensions between different interest groups.[32] Moreover, the courts are susceptible to party-government intervention in individual cases. It is not rare that the courts follow the instructions of the local government or the party committees to address the disputes, for the sake of either regional growth or sustaining illicit political nepotism or collusion between businessmen and government officials.[33] Therefore, individual shareholders are not confident of being treated fairly and impartially and have to seek other solutions. Another concern for the prospective plaintiffs is whether the judges are capable of handling allegations involving complex business transactions.

6.2.4 Normative Role of Directors' Duties and Liabilities

Chapter 2 reviewed and outlined the theoretical rationale for directors' duties and liabilities. The theoretical analysis can be used to identify the function that the legal strategy is expected to perform in China. In general, the duty and liability strategy virtually provides shareholders and companies with a back-up instrument to control management wrong-doing and a remedial channel for their losses, if any. The liability regime is indispensable as a remedy for the agency problems. Shareholders may stipulate the rules in the company's AOA with regard to the authority, conditions, and procedures, for specific

[32] See *supra* note 94 in Chapter 4 (Donald C. Clarke and Nicholas C. Howson, 2012), pp. 254-257.
[33] *Ibid.*

types of issues and transactions. However, these rules cannot be sufficiently specific to designate proper behaviour for every future contingency. Nevertheless, the general duties of loyalty and care are always applicable. The courts, at the request of a shareholder or company plaintiff, examine the circumstances and determine whether directors have fulfilled their duties. In this way, the gaps in the incomplete internal rules are bridged. Directors and officers, in turn, cannot simply exploit the loopholes in the internal rules for self-regarding behaviour at the expense of the company.

One-shot theft usually involves fraud and fabrications. Stock markets cannot automatically detect, signal, and punish such wrong-doing, because share price is formed mainly according to the information disclosed. Private parties, such as insiders or whistle-blowers, may file a lawsuit to hold wrong-doers liable when they discover or obtain some information about one-shot theft. Moreover, a litigation procedure can facilitate information discovery through procedural and evidence rules. Monetary liabilities for breach of the duty of loyalty, usually a sum of the compensation for the losses and confiscation of illegal gains, are sufficient to deter one-shot theft. Thus, the liability strategy is undisputedly necessary to deter one-shot theft.

In contrast, it has long been debated whether judges should tackle the issue of whether directors have exercised reasonable care in making decisions. Opponents argue that judges have hindsight bias against risk-taking and lack the business knowledge and skills to assess the merit of decisions. Moreover, monetary liabilities for honest and negligent mistakes may cause directors to refrain from making risky decisions, which will also be undesirable to both investors and companies. Besides, it is strongly asserted that market mechanisms are more efficient in disciplining and incentivising managerial conduct than the liability regime.

Following the debate, there is a clarification of the usefulness of monetary liabilities for a breach of duty of care by Holger Spamann, and it is argued that the usefulness of the liability strategy is virtually a cost-benefit matter.[34] The liability incentive is based on a direct and independent signal of the directors' behaviour, a judicial decision. In particular, judges review the factual circumstances, evaluate the appropriateness of the challenged actions, and determine whether directors have exercised reasonable care and whether they

[34] See *supra* note 148 in Chapter 2 (Holger Spamann, 2016).

are liable for the losses caused. The quality of judicial decisions is central to the benefit of the liability incentives.

Liability incentives not only deter managerial slack but also complement other incentive schemes linked to market signals. To be specific, executive compensation has come under heavy criticism for inducing management short-termism. Particularly, directors and officers tend to pursue the increase in stock price and accounting figures in a short period so that they are better paid. With liability deterrent, compensation packages can be adjusted so that directors and officers are still incentivised to pursue their companies' best interest but less sensitive to the market trend.[35]

However, judicial review is costly because of the human and financial resources invested in the litigation procedures. When market mechanisms, especially the stock markets, are functioning efficiently and generating precise and informative signals, such as share prices, the relative benefit of the judicial decisions would become limited. Owing to its high cost, the liability strategy is less desirable. Thus, the usefulness of the legal strategy is contingent upon the market environment and judicial infrastructure.

In China, directors' duties and liabilities can be of great necessity and significance, since management opportunism is not substantially controlled either by market forces or by internal governance. As examined in Chapter 3, the share prices in China's stock market cannot efficiently and precisely indicate the value and potential of the listed companies; the incentive schemes based on the share prices would accordingly deviate from the intended effect, *i.e.*, aligning individual interests with the company's interests. Notably, a great majority of companies are not publicly listed companies and they do not even have share prices in real time. As such, judicial decisions almost become the only reliable signals of managerial conduct, and thus, the relative benefit of the liability incentives is especially large, even though the cost of obtaining the liability incentive in China is not low either.

Besides, managerial autonomy and internal governance are relatively new to ordinary businessmen. They are unaware of the significance of a company's AOA. How to exercise managerial power is not specified in the company's AOA *ex ante*. Monitoring devices are not well instituted or continuously maintained. Considering such governance deficiencies, the general duties and award of liabilities can be very useful to deter managerial wrong-doing.

[35] *Ibid*.

6.3 Conclusions

The legal strategy of directors' duties and liabilities is currently playing a minor role in alleviating vertical agency problems in China. Private actions are infrequently initiated. Only the directors in small and medium-sized companies might be sued for breaches of duty of loyalty. Those in the SOEs and listed companies are virtually exempted from monetary liabilities for their wrong-doing. With regard to the directors in listed companies, the enforcement of information disclosure duties is mainly dependent on administrative sanctions. Yet, even the maximum fine for violations of information disclosure requirements does not give directors much suffering. Taken together, the under-enforcement of directors' liabilities is striking. Without sufficient enforcement action, monetary liabilities would be perceived as only existent in the statutes, and not the intended deterrent in managerial practices.

Considering the context where management behaviour is not sufficiently disciplined or incentivised, the monetary liability strategy is expected to actively function to deter 'shirking' as well as 'stealing'. Or else, managerial conduct can be arbitrary and even detrimental to the company and shareholders. So far market mechanism is not developed to the extent that share prices and other signals can efficiently and precisely indicate business operation and directors' performance. Internal governance does not institute an effective monitoring force. Thus, the benefit of the legal strategy would surely outweigh the cost of its enforcement, as analysed above.

However, there are a series of challenges in the design, formulation, and enforcement of directors' duties and liabilities in China. First, the transplantation of the fiduciary duties of loyalty and care to China, a transitional civil law country, poses twofold challenges. One is the codification of legal technicalities, embodied in the case law, into statutory rules. The other challenge involves the distribution of law-making power between the legislature and judiciary.[36]

In particular, China's legal system follows the civil law tradition and the judges generally interpret and apply the statutory rules to address disputes.[37] It can be contentious

[36] See *supra* note 74 in Chapter 4 (Katharina Pistor and Chenggang Xu, 2003).
[37] Michael Irl Nikkel, "'Chinese Characteristics' in Corporate Clothing: Questions of Fiduciary Duty in China's Company Law", (1995) 80 *Minnesota Law Review*, p. 513.

that the judges innovatively interpret the legal rules beyond their literal or original meaning.[38] However, the fiduciary duty originated from the common law tradition. The reason why the fiduciary duty principle can deal with any business decisions is because judges enjoy discretionary power to interpret and apply the general term in a particular scenario. As such, the authority, expertise, and experience of judges largely determine the application and development of the fiduciary duty law. Furthermore, it is not possible to develop competent courts overnight.

Second, the function of legal strategy could be limited to small and medium-sized companies. Private actions can hardly fight against the directors and officers in the SOEs and listed companies. The judicial branch in China is susceptible to the party-government interference, and thus, is unable to make an impartial decision when the dispute involves politically and economically powerful parties. Moreover, mass incidents are sensitive in China, and accordingly, class actions are supressed. Although shareholders derivative action is imported, the procedural rules are not designed to deal with the special issues in such actions, such as information asymmetry between plaintiffs and defendants and the unreasonable proportion of benefit and cost for plaintiffs. Thus, at present, the liabilities of the directors in the SOEs and listed companies can hardly be enforced through private actions.

Third, corporate governance in China is under-developed. Private autonomy is not made best use of to suit the operational conditions. It would be a challenge for ordinary companies to calibrate monetary liabilities for the breach of the duty of care to properly deter negligent decision making, which is unfavourable to the efficacy of the duty of care.

6.4 Policy and Legal Recommendations

(1) To list the enhancement of directors' duties and liabilities on the policy agenda

The Company Law has been comprehensively revised and has been frequently given authoritative interpretations by the SPC since 2005.[39] However, the strategy of directors'

[38] See *supra* Section 5.2.2.3 Interpretation and application.
[39] For the revision of the Company Law, see *supra* Section 4.2.2.
Judicial Interpretation I by the SPC in 2006 explains how the cases before the 2006 revision of the Company Law should be addressed.
Judicial Interpretations II by the SPC in 2008 specifically clarifies the meaning of the rules regarding insolvency and liquidation.
Judicial Interpretation III by the SPC in 2010 mainly involves the issues pertaining to capital contribution, the establishment of companies, and shareholding status.

duties and liabilities is not an area of focus. The Judicial Interpretations only clarify a few procedural issues regarding shareholders derivative actions.[40] In practice, very few shareholders and companies use this legal strategy to protect their interests, which policymakers do not yet perceive as an issue, or at least not a pressing one.

Inactive enforcement does not mean that management practice is quite satisfactory or that very few disputes over business decisions take place. As illustrated and analysed in Chapter 5, the legal vagueness, procedural hurdles, and weak judicial institutions together contribute to a paucity of litigation. Shareholders and companies are reluctant to bear the high costs of suing for unpredictable outcomes. In this regard, to enhance the design of directors' duties and liabilities and activate the enforcement calls for multiple efforts and even for institutional reforms in the long run.

More notably, the liability regime is highly desirable in the current context because 'stealing' and 'shirking' are not effectively controlled by alternative mechanisms. As corporate form did not spontaneously develop in Chinese enterprises but was a transplant from abroad only four decades ago, internal governance in practice is often inconsistent with the mandatory model in the Company Law. The monitors such as independent directors and supervisory boards are condemned as window dressing. Internal governance strategies to monitor managerial performances are not effective in China.

In addition, unlike in the US and other well-developed market economies, China's stock market and managerial labour market are still primitive. The stock market can hardly claim to play a pricing and disciplining role very well.[41] The market for corporate control has not been fully invigorated, even though the split-share structure reform allows the circulation of shares that used to be non-tradable.[42] Without a mature and strong market in place, directors and officers are less wary about the market consequences of their performances, and shareholders and companies may even not be able to detect managerial wrong-doings merely from market signals. When investors, or even prospective shareholders, have no assurance of accountability in the management of their investment, companies must assume an extra burden and cost to raise funds. Thus, it is of crucial importance to enhance and activate the liability regime to deter 'slack' as well as 'stealing' on the part of directors.

Judicial Interpretation IV by the SPC in 2017 inclusively fills in the gaps of the rules with regard to the validity and revocation of the resolutions, shareholders' information right, dividend distribution, preemptive rights, and reimbursement of litigation expenditure in derivative actions.

[40] See Article 1 in the Judicial Interpretation I and Article 24, 25, and 26 in the Judicial Interpretation IV.

[41] See *supra* note 134 in Chapter 3 and the accompanying text.

[42] See *supra* note 136 and note 137 in Chapter 3 and the accompanying text.

(2) To re-shape the design of the legal strategy

The fundamental issue with the design and formulation of the duty rules lies in whether the courts have the discretion to interpret general terms and even develop sub-standards. Statutory rules cannot precisely specify every future contingency *ex ante*. The approach of simply relying on the statutory rules but constraining judicial discretion does not suffice to address the management issues arising from complex and constantly changing business practices. To increase the usefulness of private actions against managerial wrong-doings and intensify the judicial review of business decisions, it is necessary to amend the relevant substantive rules, procedural rules, and even rules regarding the burden of proof.

- *Explicitly include breach of duties of loyalty and care as the cause of actions*

At present, only violations of laws, administrative regulations, and the company's AOA are expressly confirmed as the legal grounds for lawsuits against directors.[43] This reflects that the regulatory approach is mainly based on fixed rules, either in law or in private agreement. Moreover, Chinese judges are not supposed to play an active role in developing rules in the overall legal system. Therefore, astute practitioners can always circumvent the rules with well-conceived schemes, because the *ex ante* stipulations would inevitably contain loopholes, or at least be incomplete and lack clarity. The victims may frequently be faced with the problems that no rules govern suspicious conduct, and hence, they cannot file or establish claims to seek remedies.

To overcome such shortcomings, it is recommended that the causes of action should be more inclusive and flexible, by embedding a breach of the duties of loyalty and care in the liability provision. In this way, prospective plaintiffs have legitimate cause to bring complex complaints, especially those falling in regulatory gaps, to the courts. Of course, it would be necessary to articulate the standards and other associated rules for the general duties of loyalty and care, or else a lack of predictability would make the liability strategy cumbersome for prospective plaintiffs.

- *Clarify the standard for the duty of loyalty*

With regard to the duty of loyalty, the Company Law provides a list of classic breaches thereof and a general term without clear definition. Then, there is a lack of legal basis for the courts to determine whether a director has fulfilled the duty of loyalty, when

[43] See Art. 147 in the Company Law.

managerial behaviour does not take a form easily categorized in that list. As shown in the analysis of the judicial decisions in Chapter 5, many allegations of the breach of the duty of loyalty do not belong to the prohibitive list.[44] The courts are forced to employ the general principles in the property and torts law to address those allegations.[45]

As for conduct that falls within the enumerated items in the prohibitive list, the courts mainly examine whether the required approval has been obtained and the compliance with the company's AOA is maintained.[46] They do not address the substance of the conduct or transactions, because the legal provision does not provide a substantive standard. However, the SGM's approval and compliance with the company's AOA do not guarantee reasonableness and fairness of the disputed transaction to the company.[47] Thus, not only is a clear standard for the duty of loyalty necessary, but it should also be used as the ultimate test for directors' conduct in self-dealing transactions.

With reference to the definition in the 2013 Guidelines and the US corporate laws,[48] the standard can be raised as 'prioritizing the company's interest' in the event of a conflict of personal interests with the company's interests. Moreover, directors should be encouraged to avoid a conflict of interests by shifting the burden of proof to the plaintiffs. In particular, if the deal is submitted to the disinterested decision-makers, the directors only need to prove that they have fully disclosed material facts to the disinterested decision-makers to defend against the claim of breach of the loyalty duty. If the directors did not withdraw from decision-making, they have to prove that the deals are entirely fair to the company.

- *Make the rules for the approval of self-dealing transactions specific*

Due approval in tandem with compliance with the company's AOA has been set as the precondition for deals involving conflict of interests, including self-dealing transactions, engaging in the same business as the company does, utilizing corporate opportunities, and so on. However, there are no particular rules for the major aspects of the approval procedure.

[44] See *supra* Table 5.5 Plaintiffs' Claims and Win Rates and the accompanying analysis in Chapter 5.
[45] See *supra* note 36 in Chapter 5.
[46] See *supra* note 39 in Chapter 5.
[47] See *supra* note 60 in Chapter 4.
[48] The 2013 Guidelines refers to the Guidelines of Shanghai Stock Exchange on Appointment and Conduct of Directors of Listed Companies issued in 2009 and revised in 2013.
See supra note 109 in Chapter 2 for the case law of duty of loyalty in the US.

To ensure the independence and reasonableness of the approval resolution, it is necessary to impose information disclosure requirements on the interested directors. Further, any interested individuals should compulsorily withdraw from voting on the proposed deals. Specifically, interested directors should be required to disclose the existence of the conflict of interests fully and sufficiently, and how this conflict could influence the deal under discussion and negotiation.

The burden of proof regarding information disclosure and breach of duty of loyalty in self-dealing transactions can be as follows: interested directors must prove that they have fulfilled the information disclosure requirement. If they do so successfully, those who vote on the deal should be responsible for the approval. Conversely, the approval body claims and proves that the interested directors did not meet the disclosure requirement to the extent that the approval was mistakenly made. Then the interested directors need evidence showing they have fulfilled their duty of loyalty by demonstrating the entire fairness of this transaction to the company.

- *Establish the rules for the duty of care*

The currently effective company law only attaches the tag of ‘duty of care’ to the general duty provision. The empty term ‘duty of care’ seems to simply endorse and foster a trustworthy management culture. This legislation gap partially leads to confusion and inconsistency in judicial practices.

To deter management slack via the liability regime effectively, it is of a great necessity to set forth a series of workable and well-balanced rules. They can be for: (1) the standard of due care; (2) allocation of the burden of proof between the opposing parties; (3) confirmation of the corporate autonomy of limiting the liabilities for breach of duty of care; (4) and liability insurance to diversify risk.

Apart from the due care standard, another important element is how to limit personal monetary liability within a reasonable range. Holding directors liable for all the losses arising from their negligent mistakes could bankrupt them, and thus, no individual would take up directorial positions. At the other extreme, granting them complete immunity from monetary liabilities would eliminate any deterrence to imprudence and negligence. Thus, it is also necessary to grant private authority to limit the range of monetary liabilities personally assumed and to develop insurance to control legal risks and indemnify actual losses.

- *To clear the procedural hurdles in private litigation*

Law enforcement is critical to the efficacy of the legal rules. If directors are rarely sued or held liable for a breach of duties, they would not take their legal duties seriously. As reported in Chapter 5, very few actions have been initiated against directors in large companies limited by shares (CLS) and no cases involved listed companies or SOEs. To stimulate private actions to enforce directors' liabilities, it is important to clear the hurdles in the procedural rules and allocate the cost and risk of litigation among the plaintiffs, defendants, and beneficiaries.

First, the shareholding threshold for derivative actions in CLSs is too high, and it is time consuming and costly to gather the holders of adequate shares to sue. Quite often, minority shareholders need to employ derivative actions to protect their interests, whereas controlling shareholders simply replace the directors they do not like. A large CLS or a listed company usually has numerous minority shareholders who each hold only a tiny fraction of the company's shares. As such, the collective shareholding by only a few minority shareholders does not suffice. Thus, lowering the shareholding threshold would be favourable for minority shareholders who need to sue and reduce the cost arising from collective actions problems. The proper extent to which the shareholding threshold should be lowered has to be carefully considered, since frivolous and opportunistic litigation is also not desired.

Second, procedural rules need to further reduce the litigation costs that shareholder plaintiffs have to assume. It is irrational to let the plaintiffs pay the litigation fee, lawyers fee, and devote their own time and energy to file a lawsuit that would not benefit themselves proportionally, especially in case of a large company. The new Judicial Interpretation approves the reimbursement of reasonable litigation expenditures by the company to shareholder plaintiffs only when the claims are all or partially upheld.[49] With this new rule, shareholder plaintiffs may have the chance of bearing almost no litigation expenditure. However, it is quite difficult for minority shareholders to predict the win rate, as directors have information advantages over them, and they still need to be prepared to pay for all the litigation expenditure anyway. Thus, the financial concern remains a discouragement to minority shareholders.

[49] Judicial Interpretation IV for the Company Law by the SPC in 2017.

The following methods are proposed as options to further ease the economic burden of shareholder plaintiffs. The filing fee and litigation fee, charged by the courts, might be set as a flat fee no matter what amount of monetary liability is claimed. This would be especially beneficial to minority shareholders in a large company. Their liability claims usually involve large sums of money. A proportion of the amount claimed can be much higher than the flat fee.

With regard to the lawyers' fee, the contingency fee arrangement is obviously more preferential to minority shareholders. Another way is to render the assumption of all the litigation cost to the court as a claim in the derivative action. Based on the substance of the fact, the court may decide whether the claims are material to the company's interest and decide on the allocation of cost. Yet, this method presents a challenge to the courts.

Third, the contingency fee arrangement motivates lawyers to play a pro-active role in shareholders derivative actions. It is advisable to officially permit and advocate such an arrangement in all the shareholders derivative actions, no matter how many shareholders sue and participate in the litigation procedure. A contingency fee *per se* means almost no or very little cost of legal services to shareholder plaintiffs. Moreover, an entrepreneurial lawyer can handle the collective action problems that numerous plaintiffs inevitably have.[50]

(3) To build an independent and competent judicial branch

An independent and competent judicial branch is integral to the rule of law in general and decisive to the effectiveness of directors' duties and liabilities in particular. From the perspective of law and economics, the benefit of the liability strategy is largely dependent on the quality of judicial decisions. The legal strategy is more desirable when judicial decisions can precisely signal management. Conversely, judicial errors, judicial hindsight, lack of competence, and ineffective information discoveries in the courtroom would all impair the precision and truthfulness of the judicial decisions.

To increase the usefulness of the legal strategy, judges need to be able to analyse complex commercial issues, properly assess the merit of managerial conduct and transactions, and innovatively interpret the meaning and standard of law in various

[50] Jonathan R. Macey and Geoffrey R. Miller, 'The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform', (1991) 58 *The University of Chicago Law Review*, p. 116.

business scenarios. Whenever the disputes involve multiple plaintiffs or large companies with government backgrounds, the courts can retain an independent and impartial status to address such disputes. For all of these purposes, a series of measures is proposed to counteract the impact of judicial deficiency for the present, and institutional reforms are called for as well.

First, it is imperative to grant the judges greater discretionary power and raise the level of judicial competence in tandem. Particularly, judges need to develop expertise in corporate governance and company law matters. Judicial discretion is a prerequisite for the viability of the strategy of directors' duties and liabilities. Only sticking to the fixed rules is not enough to handle the disputes arising from complicated and changeable business practices, no matter how well the rules are written in advance. However, directly empowering the judges to make law is not realistic in China's legal system. Thus, an initial step for advocating judicial discretion is refining terms that are too general and obscure to be applicable. With more lawsuits on directors' liabilities, it is necessary to expand judicial discretion. Besides, the SPC issuing guiding cases and authoritative interpretations may promote the exercise of judicial discretion in the judicial system and maintain a relatively unified interpretation and application of the law nationwide.

China's judicial competence has sufficiently improved over recent years, an important goal pursued by judicial reforms. The systems for recruitment, selection, training, and promotion of judges are established, standardized, and fully implemented. Today, the majority of judges in the intermediary and higher-level courts have a university education background and have passed the national judicial examination. Very recently, the quota system for judges has been experimented in pilot areas, which means that only a proportion of court personnel who have extensive trial experience and professional expertise, can be selected as judges.[51] Those who are not competent enough would assume the role of trial support and administrative functions.

Nevertheless, rapid economic growth and structural transition continuously bring about complicated disputes entangled with competing concerns. In addition to the institutional reforms, the courts can improve the capabilities of judges by means of well-organized training and seminars. In these meetings, judges may have considerable discussions on

[51] For more information about the quota system for judges, see the White Paper issued by the SPC 'Judicial Reform of Chinese Courts', available at http://english.court.gov.cn/2016-03/03/content_23724636_10.htm (accessed 23/03/2019).

recent controversies and share their experiences from judicial practices. Moreover, it would be meaningful to keep effective channels, formal and informal, for communications with business practitioners, industry experts, academic scholars, and even other enforcement agents. In doing so, the experience, knowledge, and skills of the judges can be sufficiently strengthened and adapted better to the economic and societal changes.

Second, judicial independence is critical to the protection of investors and the enforcement of liabilities of those directors in economically and politically powerful companies. However, China's courts are usually under undue interference, which is ingrained in the fundamental political system.[52] Obtaining judicial independence would be an arduous and multi-faceted task.

The Party leadership is firmly asserted no matter what measures and efforts are undertaken in the judicial reforms. The party committees have significant influence in the selection and appointment of judges. The only expectation, for the present, is that the Party may adopt proper standards and due procedures to assess the qualification of the candidates.

The local government controls the budget level of the court at the corresponding level, and accordingly, may pressure the court in particular cases. As local governments in China consider regional economic growth as the top priority on policy agenda, it is no surprise that they may instruct courts to refrain from rendering decisions which may adversely affect the local economy. Therefore, procedural rules should allow plaintiffs to choose a court in other localities than the defendant's domicile. In this way, the plaintiff's interests would not be prejudiced.

In addition to undue party-government interference, the people's congresses and the procuratorates may also intervene in individual cases. For the courts to remain independent, it is necessary to clarify the line between supervision and undue intervention. The procuracy supervision should be limited to ethical or corruption issues of judges. People's congresses must avoid interfering with the outcome of individual cases and the suitability of judicial decisions.

Third, China's courts should have stronger political power to resist interference and gain more authority in dealing with complex and sensitive disputes. State revenue, rather than local revenue, should fund the courts and the welfare of judges. Jurisdictions across the

[52] See *supra* Section 5.2.3 Explanations for the Enforcement Pattern: judicial deficiency.

country can be re-divided in a manner that a local court may have jurisdiction over several parts of different administrative areas. Local protectionism can, therefore, be greatly undermined. Yet, any measure intended to elevate the role and power of the judicial branch in the overall political system might be resisted by the government, legislature, procuratorate organs, or other state organs, as it would tilt the previous balance of power allocation.

(4) To reinforce administrative enforcement against and increase the penalties for misrepresentations

The information disclosure system underpins the stock market and ameliorates the agency problems between the investors and inside controllers of the listed companies. China's regulatory authorities used to keep a very low level of enforcement intensity, which is insufficient to maintain the pricing and disciplining functions or promote the development of the stock market.[53] In 2016, when the new chairman of the CSRC took office, a wave of regulatory and enforcement campaigns have been launched. The number of cases under investigation and those already decided increased exponentially in one year, which reflects the regulatory agency's determination to tackle violations of the Securities Law. However, it is not clear whether there remains to be an increasing trend of enforcement actions.

In the furtherance of the information disclosure system, it is necessary to maintain the momentum of vigorous enforcement campaigns, or business practitioners might adopt an opportunistic compliance strategy. Namely, companies might fulfil the information disclosure requirements when an enforcement campaign targets misrepresentations, but do otherwise upon the closure of the campaign. As such, the ups and downs of enforcement intensity can also be a disturbing factor to the market order.

It is necessary to alleviate the under-enforcement and selective enforcement problems to level the playing field for all listed companies. The state-owned companies, especially those related to the central government, should not be given immunity from administrative sanctions. The number of state-owned companies is decreasing; however, the aggregate market capitalization of these companies still prevails over others. Thus, it is not possible to ignore the detrimental effect arising from selective enforcement. Capital resources

[53] Chunxin Jia, Shujun Ding, Yuanshun Li, and Zhengyu Wu, 'Fraud, Enforcement Action, and the Role of Corporate Governance: Evidence from China', (2009) 90 *Journal of Business Ethics*, pp. 561-576.

would be misled to flow to those listed companies that are actually not as profitable as publicly disclosed.

The regulatory authorities, including the regional offices of the CSRC, need to employ more high-tech tools to analyse the disclosed data and information and expedite the regulatory responses to suspect cases. In addition to repeated and severe violations of information disclosure requirements, the regulatory authorities should also pay attention to minor infractions, accounting irregularities, and inadequate reports. Such an enforcement approach will send a message that listed companies should not overlook minor issues nor risk committing serious violations.

Besides, an increase in the maximum penalty is strongly called for. The present upper limit of the administrative sanctions is disproportionately low. Companies and involved directors and officers do not suffer significant monetary liabilities, which greatly limits the usefulness of administrative enforcement against misrepresentations.

Last but not least, the staffing and budget level of the CSRC and its regional offices need to be raised to better deal with the increasing caseload and the investigation of complex business issues. The staff's expertise, technological capabilities of the authorities and cooperation within and between different divisions and offices are all conducive to forceful enforcement actions, and therefore, continuous and all-round efforts should be made to improve these aspects and factors.

6.5 Future Research

A series of interesting topics related to directors' duties and liabilities are worth follow-up discussions. For instance, whether the duties of loyalty and care should have different standards and tests for independent directors, supervisory board members, and senior managers, since they perform different functions from what executive directors usually do in the operation of a company, but the currently effective rules do not address such differentiation. How to distribute monetary liabilities among directors and other involved officers is unclear in law. In addition, in different types of transactions, the standard of due care can vary greatly and more specific and sophisticated rules are necessary. Legal scholars can focus on one type of transactions, such as merger transactions, to discuss a proper test to determine the fulfilment of the duties of loyalty and care. Furthermore, how to formulate and develop the duty of care in corporate statutes remains a challenging task. More general and fundamental questions such as how the statutory rules can grow to accommodate the emerging issues in business practice must trigger a widespread and theoretically meaningful debate.

In addition to private litigation and administrative sanctions, how criminal penalties play a role in deterring the misappropriation of a company's assets and other intentional infringement of the rights and interests of companies and shareholders is also an attractive question. In particular, China has a tradition of employing criminal penalties as the major tool of social control and the criminal law imposes criminal liabilities on directors and officers of listed companies to punish asset misappropriation and other types of wrong-doing. Considering that the investigation and prosecution of a crime is more costly than private enforcement and such problems as corruption of enforcement agents, it is necessary to investigate the effectiveness and efficiency of criminal liabilities. Besides, the comparison between private litigation, administrative sanctions, and criminal penalties in combating management wrong-doing can also greatly enrich the understanding of the general proposition—law matters to corporate governance, and provides a basis for optimizing the overall regulatory approach.

Future studies can employ the methodology of interviews and questionnaires to obtain first-hand information about the black box (board of directors) and reveal how directors and officers respond to liability risks and the extent to which the legal rules may influence their decision-making and managerial behaviour. Case studies would also be useful in illustrating how informal institutions and extra-legal instruments, if any, play a role in disciplining directors and officers in listed companies and SOEs where it seems that the liability strategy is almost dormant. Moreover, it is not advisable to overlook how cultural and traditional factors affect the resolution of disputes pertaining to management wrong-doing.

6.6 Final Remarks

Managerial performance would be best incentivised by the synergy between market mechanisms, legal strategies, governance devices, and incentive schemes. Directors' duties and liabilities are like a sword hanging over directors. Whether this sword really falls or is only window dressing and whether it is sufficiently sharp to deter managerial wrong-doing can considerably influence management practice.

The usefulness of the liability strategy depends on multiple factors, including the quality of legislation, enforcement intensity, the competence of the judges and regulatory agencies, and even cultural values and traditional reasons. Thus, the enhancement of this legal strategy cannot simply boil down to efforts in a single aspect like law-making; and broadly speaking, the improvement in corporate governance requires a multi-pronged approach.

For either task above, it is important to understand that legal scholars, and even lawmakers, judges, and regulatory authorities need to step out of their professional zones. They should look from different perspectives and other disciplines, into how boards of directors are making business decisions and how they react to market trends. With a comprehensive understanding of managerial behaviour and commercial practice, lawmakers, judges, and regulatory authorities will perform their respective functions in a more pragmatic and suitable manner. The legal strategy can be better designed and more effectively enforced to deter managerial wrong-doing. Eventually, this will facilitate management accountability and protect investors' interests better.

Appendix A: Judicial Decisions Involving Breach of Directors' Duties

No	Parties	Court	Claims of Plaintiff(s)
1.	Anhui Jintun property development company v. Yao Jixin, Hu Yueming and Anhui gold lion mining company	Anhui Province Suzhou City Intermediary People's Court (2013) no. 00071	Failure to obtain the bank loan for the company due to the breach of duties of loyalty and care
2.	Zhou Zenan v. Shenzhen city taiyang decoration engineering company	Guangdong Province Shenzhen City Intermediary People's Court (2013) no. 2046	Misappropriation of corporate fund
3.	Guangzhou Bester software company v. Luo Yanhui	Guangdong Province Guangzhou City Tianhe District People's Court (2013) no. 960	Violation of the company's internal financial rules with fabricated invoices
4.	Li Tong v. Liu Zhenhai	Tianjin City First Intermediary People's Court (2013) no. 111	Entering into a contract that assigned corporate revenue to a third party
5.	Tianjin Jingtian trade company v. Ren Xinqiang	Tianjin City First Intermediary People's Court (2012) no. 612	Arbitrary transfer of the company's asset at low price
6.	Longhui company v. Shu	Hunan Province Chenxi County People's Court (2013) no. 51	Providing guarantee for personal debt with the company's asset
7.	Xindaoxin amusement park design and consultancy (Shanghai) company v. Wang Li and Zhuhai decoration project company	Shanghai City Jing'an District People's Court (2013) no. 510	Misappropriation of corporate fund and usurpation of corporate opportunities
8.	Wang Kai v. Liu Peirong	Beijing City Xicheng District People's Court (2013) no. 08371 Beijing City Second Intermediary People's Court (2014) no. 03218	Making payment without due authorization
9.	Ningbo Peihe farming machinery company v. Wu Xinxing and Shi Jianming	Zhejing Province Ningbo City Jiangdong District People's Court (2012) no. 2187-1	Misappropriation of corporate fund by receiving payment to the company via personal account
10.	Wang Xudong v. Sichuan Luzhou bridge and road company	Sichuan Province Luzhou City Intermediary People's Court (2012) no. 687	Making payment on behalf of the company to the party that has not been duly authorized in the transaction
11.	Liu Gangliang v. Ren Yonghu	Shanxi Province Shenmu County People's Court (2013) no. 02231	Mismanagement causing losses to the company

12.	Henan Yaohuachun wine company v. Luo Erren	Henan Province Xuchang City Intermediary People's Court (2013) no. 218	Failure to properly keep original receipts and the account record, causing the receivables not paid
13.	Zhuang Wulong v. Chen Donghang	Hainan Province Higher People's Court (2013) no. 4	Misappropriation of corporate fund
14.	A company v. Wu B and Huang C	Shanghai City First Intermediary People's Court (2013) no. 737	Usurping customer resource
15.	Chen Jia v. Huang Xiaogang	Zhejiang Province Shaoxing City Keqiao District People's Court (2013) no. 278	Misappropriation of corporate fund
16.	Yang v. Qian	Shanghai City Yangpu District People's Court (2013) no. 407 Shanghai City Second Intermediary People's Court (2013) no. 890	Misappropriation of corporate fund by means of personal account
17.	Shenzhen Zhontailai investment companies v. Ma Huilai and Ma Ningshen	Guangdong Province Higher People's Court (2013) no. 28	Providing loans in violation of regulations
18.	Chen v. Xu and Yu	Sichuang Province Puzhou City People's Court (2013) no. 668	Misappropriation of corporate fund
19.	Yu Fengbing v. Shenzhen Simaidi technology development company	Guangdong Province Shenzhen City Intermediary People's Court (2013) no. 385	Opening up a personal account to save corporate fund
20.	Shanghai A company v. Ma, Xu, Qian and Shanghai B company	Shanghai City Minxing District People's Court (2013) no. 21	Engaging in the same business as the company runs
21.	Li, Gu v. Shanghai Kailing metal product company	Shanghai City Second Intermediary People's Court (2012) no. 1205	Misappropriation of corporate fund
22.	Tong Wen, Mo Haijun v. Hu Haibo and Li Hong	Guangxi Zhuang Autonomous Region Guilin City Intermediary People's Court (2013) no. 183	Causing losses to shareholders
23.	Xinyang shengda trading company v. Zhao Xinjian	Henan Province Xinyang City Intermediary People's Court (2012) no. 69	Misappropriation of corporate fund and purchase of non-performing debts
24.	Xiamen Zhangyitong industrial trading company v. Wang Baiyuan and Dai Zhiqiang	Fujian Province Xiamen City Intermediary People's Court (2013) no. 516	Breach of the duties of loyalty and care
25.	Ningbo Jinhe magnet company v. Zhang Weize	Zhejiang Province Ningbo City Yinzhou District People's Court (2013) no. 68	Selling the products in storage at low price and breach of the duty of care
26.	Zhang Lai v. Lin Fengjiao and Zhejiang Tai'an security technology company	Zhejiang Province Hangzhou City Intermediary People's Court (2013) no. 554	Engaging in the same business as the company runs
27.	Li Guohua and Cao Yong v. Shenzhen Yongchaotai industrial company and Shenzhen Shanwei marketing company	Guangdong Province Higher People's Court (2013) no. 209	Making investment in another firm which competes with the company

28.	Zhongwang company v. Chi fei and Xu Xiqing	Shandong Province Zibo City Intermediary People's Court (2014) no. 2	Returning corporate seals, licence and documents
29.	Qin Zhidong and Hou Xuefeng v. Xu Xiangguo and Xu Xianjun	Neimenggu Autonomous Region Huhehot City Intermediary People's Court (2014) no. 1127	Failure to obtain government approval for the project, causing losses to the company; misappropriation of corporate fund
30.	Beijing Faboyang international technology development company v. Chen Xilian	Beijing City First Intermediary People's Court (2013) no. 13957	Engaging in the same business as the company runs
31.	Ma Lijuan v. Sun Jianqiang	Zhejiang Province Changxing County People's Court (2014) no. 647	Providing guarantee without due approval of shareholders meeting
32.	Sichuan Huineng nonferrous metal company v. Li Shiquan	Sichuan Province Higher People's Court (2014) no. 667	Arbitrary disposal of corporate assets
33.	Zhang Yichao, Yuan Che v. Huang Xiuran and Bai Jingyu	Chongqing City the Fifth Intermediary People's Court (2014) no. 05636	Violation of tax laws, causing the company sanctioned.
34.	Zhu Jiongming v. Pan Peicong, Pan Peifang, Tingyu group company and Shanghai Daoyu Logistic Company	Shanghai City Pudong New District People's Court (2014) no. 3602 Shanghai City First Intermediary People's Court (2015) no. 565	Self-dealing transaction for the transfer of equity interest
35.	Deng Huifang v. Wang Kai and Shenzhen Boerte Investment Company	Guangdong Province Shenzhen City Intermediary People's Court (2014) no. 2528	Breach of the duties of loyalty and care
36.	Wei Yueping v. Li Jingsheng	Beijing City First Intermediary People's Court (2014) no. 2528	Failure to pay the debt to the company
37.	Wang Qiang v. Tan lv, Ren Jicheng, Fang Zhou	Hunan Province Changsha City Intermediary People's Court (2014) no. 04169	Engaging in the same business as the company runs
38.	Ningbo gangzhonglv international logistic company v. Hong Bin	Shanghai City Pudong District People's Court (2013) no. 3820 Shang City First Intermediary People's Court (2015) no. 107	Transferring the company's business in related party transaction at extremely low price
39.	Loudi auction company v. Yanga Yani	Hunan Province Loudi City Louxing District People's Court (2012) no. 889	Engaging in the same business as the company runs
40.	Zhengmin v. Guangzhou Xiangfengsheng trading company and Chen Shaohui	Guangdong Province Guangzhou City Intermediary People's Court (2014) no. 430	Breach of the duty of care
41.	Hangzhou Ruili real estate company v. Hangzhou Xinsheng real estate development company and Ye Chaosheng	Zhejiang Province Hangzhou City Bijiang District People's Court (2014) no. 640 Zhejiang Province Hangzhou City Intermediary People's Court (2014) no. 2590	Causing losses to the company (delay in performance of contract) and overlapping of personnel with the related company

42.	Hangzhou Baikang medical technology v. Zhang Yijun	Zhejiang Province Suzhou City Xihu District People's Court (2014) no. 485	Holding back the seals of the company after being dismissed
43.	Tian Guisheng, Wei Chi and Zhou Tianrun v. Diao Jian	Sichuan Province Jianyang City People's Court (2014) no. 1190	Payment of the company's debt with company's facilities without due approval
44.	Shanghai Ruolai internet technology company v. Shanghai Chengguan internet technology company and Yang Minjie	Shanghai City Changniu District People's Court (2014) no. 1415	Transferring the company's game software without consideration
45.	Anqiu Wenrui Filtering Machinery Company v. Wang Xinjian and Sun Zehai	Shandong Province Anqiu City People's Court (2014) no. 132	Tax frauds, causing the company sanctioned.
46.	Hou Yuquan v. Zhang Ximing and the liquidation team of Panshi Material Company	Jilin Province Panshi City People's Court (2013) no. 11	Infringing the company's property right
47.	Jiangsu Jinshida biotechnology company v. Lou Xiaoying	Jiangsu Province Nanjing City Qixia District People's Court (2014) no. 235	Misappropriation of corporate fund
48.	Shanghai Bohua gene chip technology company v. Mao Yumin, Louyi, Shanghai Bohu investment consultancy company	Shanghai City Pudong New District People's Court (2013) no. S3191	Transferring the company's asset via related party transaction, causing losses to the company
49.	Changzhou Sanli equipment and engineering of environment protection company v. Zou Yan and Dai Xiaoping	Jiangsu Province Higher People's Court (2012) no. 0050	Self-dealing transactions and engaging in the same business as the company runs
50.	Sanming Huaneng hydraulic pump valve company v. Yan Qunli	Fujian Province Sha County People's Court (2014) no. 1317	Mismanagement causing product defect and return of the products.
51.	Li Ming v. Ling Hongyue, Ling Jiyue, Zhuhai Maiteer metal surface processing technology company	Guangdong Province Zhuhai City Intermediary People's Court (2014) no. 209	Making use of related party transaction to conceal the payment to family members
52.	Beijing Lianhe light technology company v. Lv Min	Beijing City Second Intermediary People's Court (2014) no. 07002	Occupying the company's facilities
53.	Wang Min v. Gu Nianhua and Guweiqi company	Jiangsu Province Wuxi City Chong'an District People's Court (2013) no. 1550	Holding the company's licence and occupying the company's property
54.	Siyang Xiantahui textile company v. Yu Jianfen	Jiangsu Province Suqian City Intermediary People's Court (2013) no. 0140	Breach of the duty of care
55.	Chen Gangqiang v. Li Jianhua	Beijing City First Intermediary People's Court (2014) no. 04526	Tunnelling the company's profit to personal account and his own company

56.	Li Bin v. Sun Jianguo and Suzhou Weisiman biological medicine company	Tianjin City Higher People's Court (2014) no. 0043	Transferring the company's asset without compensation
57.	Zhong Zhifeng v. Zhang Yangzhi	Hubei Province Xiaogan City Intermediary People's Court (2013) no. 0044	Misappropriation of corporate fund
58.	Changchun assembly company v. Zhang Qing	Jilin Province NongAn County People's Court (2014) no. 2	Causing losses to the company
59.	Shanghai Shizhen information technology company v. Li Wangdong, Hu Juan, and Shanghai Haochen information technology company	Shanghai City Minhang District People's Court (2013) no. 1645	Usurpation of corporate opportunities, engaging in the same business as the company does, and arbitrarily transferring the company's inventory
60.	Zhangye Bowen human resource development company v. Liu Chuanwen	Gansu Province Zhangye City Intermediary People's Court (2014) no. 226	Engaging in the same business as the company runs
61.	Guangdong Zhongxing hydraulic power company v. Li Yanfang	Guangdong Province Guangzhou City Intermediary People's Court (2014) no. 270	Engaging in the same business as the company does and usurpation of corporate opportunities
62.	Lv Zhengfan v. Bao Guowu, Chen Haoran, and Zhuhai city Haoda trading company	Guangdong Province Higher People's Court (2013) no. 68	Transfer of the company's shares at low price
63.	Pinghu machinery company v. Wen Yu	Shanghai City Second Intermediary People's Court (2014) no. 103	Misappropriation of the company's fund
64.	Yang Guizhi v. Gao Gengren	Hebei Province Shijiazhuang City Intermediary People's Court (2014) no. 00107 Hebei Province Shijiazhuang City Intermediary People's Court (2015) no. 00174	Misappropriation of the company's fund and failure to go through the annual approval procedure, causing business suspension
65.	Lin Honghai v. Yao Huixian	Shanghai City Second Intermediary People's Court (2013) no. 1302	Transfer of the company's asset at low price and misappropriation of the payment
66.	Haian Wanhe company v. Guo Wenshan	Jiangsu Province Higher People's Court (2013) no. 0895	Purchase of automobiles at high price
67.	Jiangsu Yashen logistic company v. Kong Dejun and Wang Yanrong	Jiangsu Province Suzhou City Wujiang District People's Court (2013) no. 0895	Purchasing transportation vehicles at high price
68.	Shanghai Tianen insulating material company v. Zhang Xianming	Shanghai City Second Intermediary People's Court (2013) no. 1414	Engaging in the same business as the company runs

69.	Ji Guoqiang v. Chen Baoliang	Shanghai City First Intermediary People's Court (2014) no. 818	Causing losses to shareholders' interests
70.	Chen Zhixiong v. Chen Zhiwen	Jiangxi Province Higher People's Court (2014) no. 13 Jiangxi Province Higher People's Court (2014) no. 80	Improperly dealing with the disputes involving the company by permitting delay payment of rent to the company
71.	Li Wanfu and Li Fuzhen v. Zhu Guohua and Zhu Zhiping	Inner Mongolia Autonomous Region Hulun Buir Cith Intermediary People's Court (2014) no. 5	Misappropriation of corporate fund
72.	Zhongwang company v. Chen Xukui	Shandong Province Higher People's Court (2014) no. 244	Holding back the company's licence, seals, and account books without due capacity
73.	Zhigao exploration group company v. Tang Jinrong and Jianou food company	Fujian Province Nanping City Intermediary People's Court (2013) no. 128	Holding back the company's licence, seals, and account books without due capacity
74.	Gaohong overseas company v. Xu Feng and Zhao Min	Fujian Province Sanming City Intermediary People's Court (2013) no. 167	Holding back the company's licence, seals, and account books
75.	Jiangsu Sunan special equipment group company v. Zhao Haihua	Jiangsu Province Suzhou City Intermediary People's Court (2014) no. 0164	Failure to ensure the company to perform the contract, causing losses to the company
76.	Zhejiang Sanshi group company v. Fang Hao	Anhui Province Suzhou City Intermediary People's Court (2013) no. 00094	Breach of the duty of loyalty and care
77.	Shen Ping v. Chen Zhangwei	Zhejiang Province Jiaxing City Nanhu District People's Court (2014) no. 453	Misappropriation of corporate fund
78.	Lu Guohua and Bao Yimin v. Gu Jun and Ai Xi	Chongqing City Higher People's Court (2015) no. 02809 Chongqing City Higher People's Court (2015) no. 00166	Payment of personal expenses from the company's fund
79.	GuoZhigang v. Fang Xinhui	Ningxia Autonomous Region Longde County People's Court (2015) no. 89	Entering into a cooperation contract in violation of the articles of association
80.	Tengzhou Zhengyu real estate development company v. Gong Youmen	Shandong Province Higher People's Court (2015) no. 96	Misappropriation of corporate fund
81.	Qingtao Harmoni international trading agency company v. Li Mingshan and An Shanji	Shandong Province Qingdao City Laoshan District People's Court (2014) no. 506	Misappropriation of corporate fund

82.	Huang Zhongqing v. Qu Jinglu	Beijing City Dongcheng District People's Court (2014) no. 09581	Engaging in the same business as the company runs
83.	Guangdong Nanxiu E-commerce trading company v. Feng Qiruo and Shenzhen Yuanzheng culture development company	Guangodng Province Guangzhou City Tianhe District People's Court (2012) no. 4393	Usurpation of exclusionary right of publishing a magazine
84.	Ma Lijuan v. Sun Jianqiang	Zhejiang Province Huzhou City Intermediary People's Court (2015) no. 125	Providing guarantee to a third party without due approval of shareholders meeting
85.	Shenyang Yaoshun property management company v. Wang Yali	Liaoning Province Shenyang City Intermediary People's Court (2015) no. 00410	Forming another company to engage in the same business as the company runs and usurpation of corporate opportunities
86.	Nanjing Hebote laundry company v. Liang Wen	Jiangsu Province Nanjing City Intermediary People's Court (2015) no. 65	Misappropriation of the company's remuneration and undermining internal financial system
87.	Xu Chuande v. Wang Qisheng and Qingyang county culture development company	Anhui Province Chizhou City Guichi District People's Court (2015) no. 00072	Engaging in the same business as the company runs
88.	Jiaozuo municipal construction group company v. Li Suting	Henan Province Jiaozuo Intermediary People's Court (2015) no. 00050	Making loans to a third party, causing losses to the company
89.	Shanghai Wencheng energy management company v. Yu Chaolong	Shanghai City Chongming District People's Court (2014) no. 255	Misappropriation of corporate fund
90.	Liu Wenjie v. Cai Yonghua	Jiangsu Province Nantong City Intermediary People's Court (2014) no. 0423	Misappropriation of corporate fund
91.	Zhongshan Changhzou group company v. Huang Zhihong, Huang Peihai and Huang Rongcan	Guangdong Province Zhongshan City First People's Court (2014) no. 2260	Reduction of the borrower's payment and interest
92.	Xu Gan, Wang Wenjin, Zhao Yuefeng and Yang Yijie v. Sun Huazhong	Hunan Province Zhuzhou City Lusong District People's Court (2014) no. 224	Breach of the duty of loyalty
93.	Xiangguo International electric technology company v. Robert Walter Roche	Shanghai City Qingpu District People's Court (2014) S1636	Recruiting counsel without due approval
94.	Ninde Longwei real estate development company v. Ruan Chongliu	Fujian Province Ningde City Intermediary People's Court (2015) no. 1246	Holding back the company's licence and seals without due capacity

95.	Baosheng group company v. Luigi Migliorini	Jiangsu Province Higher People's Court (2015) no. 00016	Recruiting a legal counsel at unreasonably high price
96.	Beijing Jinglu technology development company v. Wei Yueping	Beijing City Haidian District People's Court (2015) no. 05812	Holding back the company's seals and licence without due capacity
97.	Tang Xiangsheng, Yang Daping, Zuo Fuhe, Gao Min, Li Guihua v. Peng Jisheng	Chongqing City Fifth People's Court (2015) no. 02809	Transfer of the company's real estate at unreasonably low price
98.	Jinan Dongfang company v. Li Jiabin and Jinan Dongfang Weitai machinery company	Shandong Province Higher People's Court (2015) no. 532 Shandong Province Jinan City Intermediary People's Court (2015) no. 38	Engaging in the same business as the company runs
99.	Li Jianjun v. Xia Min	Beijing City Daxing District People's Court (2014) no. 13220	Holding back the company's licence and seals after being dismissed
100.	Shanghai Changrun real estate company v. Liang Chengjia	Shanghai City Minhang District People's Court (2014) no. 934 Shanghai City Minhang District People's Court (2014) no. 948	Making payment in violation of the company's finance workflow, causing losses to the company
101.	Ruian Hailan trading company v. Gao Wenxiang, Ruan Min	Zhejiang Province Ruian City People's Court (2015) no. 319	Misappropriation of corporate fund
102.	Shen Chunhai v. Liu Zhen	Beijing City First Intermediary People's Court (2015) no. 7729	Misappropriation of corporate fund
103.	Fu Weiyong v. Hu Xiaojian	Jiangxi Province Xiyu Intermediary People's Court (2015) no. 126	Misappropriation of corporate fund
104.	Liu Fang v. Lu Shengping, Wang Guangjun and Shenyang Zhongtian automobile cast part company	Liaoning Province Shenyang City Intermediary People's Court (2015) no. 01467	Arbitrarily rendering the company's office to a third party for business operation
105.	Defan construction consultancy company v. Zhang Qiao and Zhou Shimiao	Shanghai City Huangpu District People's Court (2014) no. 980	Engaging in the same business as the company runs and usurpation of corporate opportunities
106.	Wang Weihua v. Hu Guangsheng, Lu Ping, Lu Lisha and Shenzhen Juhe composite material company	Guangdong Province Shenzhen City Nanshan District People's Court (2014) no. 437	Engaging in the same business as the company runs and arbitrarily transferring the IP right to themselves

107.	Beijing Beiderui bio-technology company v. Lv Shen	Beijing Second Intermediary People's Court (2015) no. 12246	Holding back the company's licence and seals without due capacity
108.	Wang Lu v. Zhao Jianzhong	Beijing City Xicheng District People's Court (2015) no. 00631	Breach of the duty of care and arbitrarily submitting the government approval, causing the company suspended
109.	Zeng Wensheng v. Luo Gengxin	Guangdong Province Shenzhen City Intermediary People's Court (2015) no. 531	Misappropriation of the corporate fund and arbitrarily paying more construction fee than the due amount
110.	Yunan Ruilijiang trading company v. Sun Peng	Yunan Province Kunming City Wuhua District People's Court (2015) no. 1143	Entering a contract at unreasonably low price, causing losses to the company
111.	Hubei Enshi logistic and trading company v. Zhang Jie and Du Rongzhong	Hubei Province Enshi Tujia and Miao Autonomous Prefecture Intermediary People's Court (2015) no. 00457	Arbitrarily lowering the quality of products in the contract, causing losses to the company
112.	Shenyang Fuyun Carriage company v. Tong Yu, Hu Zhiyuan	Liaoning Province Shenyang City Heping District People's Court (2014) no. 00016	Self-dealing transaction
113.	Shenyang Yuanwang technology company v. Feng Shuying	Liaoning Province Shenyang City Intermediary People's Court (2015) no. 886	Misappropriation of corporate fund
114.	Puyang international trading company v. Zhang Guohui	Henan Province Higher People's Court (2015) no. 01077	Engaging in the same business as the company runs
115.	Zhou Jielin v. Liu Zhibiao	Hunan Province Hengdong County People's Court (2015) no. 54	Usurpation of corporate companies
116.	Kuang Wensheng, Liang Wenge, Zhang Chifen v. Huang Mingjie, Zhang Zhaofeng	Guangdong Province Guangzhou City Intermediary People's Court (2015) no. 886	Tax frauds under the cover of perks and other compensation, causing the company sanctioned by the tax authority
117.	Shanghai ** entertainment company v. Tang **	Shanghai City Baoshan District People's Court (2014) no. 1629	Breach of the duties of loyalty and care
118.	Chengdu Hengfeng packaging company v. Zhou Jiuning and Lv Ziqing	Sichuan Province Chengdu City Longquanyi District People's Court (2015) no. 2216	Improper dealing with the dispute against the company
119.	Situ Zhi v. Huang Suling, Shenzhen Runtong magnesium materials company	Guangdong Province Shenzhen City Intermediary People's Court (2014) no. 1733	Engaging in the same business as the company runs

120.	Ningbo Kaiyuan company v. Kong Weiliang and Ningbo Kaiyuan real estate company	Zhejiang Province Ningbo City Intermediary People's Court (2014) no. 4	Inflation of the project cost by outsourcing the project at unreasonably high price
121.	Xiamen Haiyang southern plastic container company v. Deng Huifang, Wang Kai, and Shenzhen Boteer investment company	Guangdong Province Shenzhen City Nanshan District People's Court (2014) no. 598	Engaging in the same business as the company runs and usurpation of corporate opportunities
122.	Liang An v. Cai Shuzhong and Yu Jiehua	Shanghai City Second Intermediary People's Court (2015) no. 576	Breach of the duties of loyalty and care and engaging in the same business as the company runs
123.	Cai Yuxiang v. Wang Jinfeng	Shanghai City Songjing District of People's Court (2015) no. 702	Collusion with another company to enter a renting contract at unreasonably low price
124.	Li Jian v. Hao Guidong and Tonghua mining group company	Jilin Province Higher People's Court (2015) no. 22	Selling fine coal at low price
125.	Beifang technology (Asia) company v. Meng Tao	Tianjin City Higher People's Court (2016) no. 274	Breach of the duties of loyalty and care
126.	Chengdu online trading company v. Yang Feixiang	Sichuan Province Chengdu City High-tech Industry Development District People's Court (2016) no. 11122	Self-dealing transactions
127.	Weifu (Hangzhou) precision machinery company v. Ma Guosheng and Hangzhou Weifu smart technology company	Zhejiang Province Hangzhou City Intermediary People's Court (2016) no. 5972	Engaging in the same business, self-dealing transaction, and misappropriation of corporate fund
128.	Xiangyang Xunda transportation company v. Zhang Jun and Yu Xiaobo	Hubei Province Xiangyang City Xiangyang District People's Court (2016) no. 1583 Hubei Province Xiangyang City Intermediary People's Court (2017) no. 469	Starting a new firm to engage in the same business as the company runs
129.	Guangzhou Daimengfei cosmetics company v. Chen Yan	Guangdong Province Guangzhou City Intermediary People's Court (2016) no. 6787	Misappropriation of corporate fund and breach of the duty of care
130.	Hangzhou leilong internet technology company v. Guo Jian	Zhejiang Province Hangzhou City Binjiang District People's Court (2016) no. 2061	Breach of duty of care, infringing upon other's IP right
131.	Jiuzhou securities companies limited by shares v. He Nian	Supreme People's Court (2016) no. 265	Misappropriation of clients' fund in violation of the Securities Law

132.	Nanjing nanhua information technology company v. Xin Yingmei and Wang Xiaogang	Jiangsu Province Higher People's Court (2015) no. 00680	Engaging in the same business as the company runs
133.	Huang Xunzhang v. Wen Anmin	Beijing City Chaoyang District People's Court (2013) no. 35146	Giving the page of newspaper taken by the company for advertisement to a third party for free
134.	Li Ming v. Ling Hongyue, Ling Jiyue	Guangdong Province Zhuhai City Intermediary People's Court (2016) no. 615	Paying for a third party's pension and insurance
135.	Qi Hualin v. Li Fei	Shanxi Province Hanzhong City Intermediary People's Court (2016) no. 132	Mismanagement causing pipeline scrapped
136.	Shenzhen Dadi property management company v. Xie Yuntian	Guangdong Province Shenzhen City Intermediary People's Court (2016) no. 2755	Offering the company's real state for sale at low price
137.	Shijiazhuang Mancang medical equipment company v. Ma Zhiqiang, Feng Junxian	Shijiazhuang City Luquan District People's Court (2016) no. 15	Buying and selling counterfeit drugs, causing the company punished
138.	Baoji Huifeng construction company v. Liu Jinhu, Liu Liqiang, Li Xinya	Shaanxi Province Baoji City Weibin District People's Court (2016) no. 1098	Breach of the duties of loyalty and care
139.	Li Jianjun v. Xia Min	Beijing Second Intermediary People's Court (2016) no. 2831	Misappropriation of corporate fund
140.	Beijing Xinlei real estate management company v. Zhang Guiqi	Beijing City Haidian District People's Court (2015) no. 10893	Resigning without due procedure
141.	Zhang Yonglin, Zhang Chaofen v. Shi Changquan, Li Huaquan, Chen Yunwang	Chongqing City Yubei District People's Court (2015) no. 1338	Usurpation of corporate opportunities and engaging in the same business as the company runs
142.	Shanghai international tourism company v. Ni Jiali	Shanghai City Jingan District People's Court (2015) no. 1338	Usurpation of corporate opportunities and engaging in the same business as the company runs
143.	Dalian Zhongjia trading company v. Fan Heli	Liaoning Province Dalian City Intermediary People's Court (2016) no. 1455	Misappropriation of corporate fund for purchase of personal real property
144.	Foshan City Bihui high purity coating company v. Lan Hongming	Guangdong Province Foshan City Nanhai District People's Court (2016) no. 3911	Purchase of facilities not compatible with the company's production and without due authority

145.	Du Jiake, Luo Sheng v. Huizhong and Xi'an Guangmao property management company	Shaanxi Province Higher People's Court (2016) no. 270	Failure to obtain all the government approval for the project, causing delayed performance and more payment
146.	Huai An Henglong real estate development company v. Wang Shuilin and Huai An property management company	Jiangsu Province Huai An Economic and Technology Development District People's Court (2015) no. 247	Starting a new company with a third party and usurpation of corporate opportunities
147.	Zhong Bo v. Zhong Shouwen and Kashgar Huaxin investment company	Xinjiang Uygur Autonomous Region Kashgar Prefecture Intermediary People's Court (2016) no. 385	Making payment of land transfer *ultra vires*
148.	Wang Zhiyao v. Chen Chao, Dengjia	ZhejiangProvince Ningbo City Jiangdong District People's Court (2015) no. 2921	Breach of duties of loyalty and care
149.	Liu Jianhao v. Liu Jianwei	Shanghai City Jinshan District People's Court (2015) no. 1329	Receiving the payment of transportation fee from the company's clients
150.	Haili welfware group company v. Fang Weiwen	Shandong Province Tai'an City Intermediary People's Court (2014) no. 2	Abuse of power to settle the dispute
151.	Wu Xiaoping v. Li Ziqiang, Liu Yuemei	Guangdong Province Zhongshan City First Intermediary People's Court (2015) no. 3297	Misappropriation of corporate fund
152.	Zanpeila amusement equipment (Suzhou) company v. Fei Renzu	Jiangsu Province Suzhou City Huqiu District People's Court (2015) no. 00003	Misappropriation of corporate fund
153.	Hangzhou sea food company v. Wen Xianming	Zhejiang Province Hangzhou City Gongshu District People's Court (2014) no. 1132	Misappropriation of corporate fund
154.	Xiao Tinghua v. Zhang Nengtian	Hubei Province Wuhan City Donghu New Technology Development District People's Court (2015) no. 00891	Breach of the duty of loyalty and paying the workers in violation of internal rules
155.	Zhai Yuqi v. Ma Jinlong	Hebei Province Tangshan City Fengtan District People's Court (2015) no. 2	Related party transaction
156.	Zhang Chenwei, Shen Shiguan, Shen Weizhong v. Wang Xiaobing	Shanghai City Jinshan District People's Court (2015) no. 1258	Taking the company's receivables into personal account
157.	Shanghai Huace materials technology company v. Shen Li and Li Ruifeng	Shanghai City Minhang District People's Court (2015) no. 2542	Usurpation of corporate opportunities
158.	Chen Jing v. Jin Wuguang and Dai Cangjie	Zhejiang Province Yongjia County People's Court (2015) no. 628	Misappropriation of corporate fund and engaging in the same business

159.	Zhongxin Guoan electricity power company v. Qi Lu	Liaoning Province Shenyang City Intermediary People's Court (2015) no. 1550	Arbitrarily moving facilities to the subsidiary company
160.	Guangzhou Huayi International auction company v. Gu Shu'an	Guangdong Province Guangzhou City Intermediary People's Court (2015) no. 1229	Knowingly accepting the fake product for auction
161.	Jiang Xiaofeng v. Mao Ziming	Guangxi Autonomous Region Hezhou City Intermediary People's Court (2016) no. 1040	Privately entering contract with a third party to rent the company's building
162.	Xu Junjie, Wu Yun v. Fang Peng, Xu Jianyi	Zhejiang Province Hangzhou City Intermediary People's Court (2016) no. 1427	Settling the dispute with the employee with unreasonable compensation
163.	Wang Qingsheng v. Wang Fengcheng	Shandong Province Weihai City Intermediary People's Court (2016) no. 690	Mismanagement leading to the company insolvent and misappropriation of corporate fund
164.	Sichuan Yinshan photoelectricity technology company v. Zhou Yong	Sichan Province Chengdu City Intermediary People's Court (2016) no. 1	Holding back the company's seals and accounting books
165.	Jiangsu Shuntian international group company v. Wang Junmin	Jiangsu Province Nanjing City Intermediary People's Court (2016) no. 574	Economic crimes and embezzlement, causing losses to the company
166.	Liu Yang v. Su Qihao	Chongqing City First Intermediary People's Court (2017) no. 4831	Misappropriation of corporate fund (return of loans and retainer fee)
167.	Suzhou media and advertismenet company v. Chang Junjun	Jiangsu Province Suzhou City Intermediary People's Court (2016) no. 8629	Misappropriation of corporate fund
168.	Shanghai Jilong automation technology company v. Wang Qingsheng	Shanxi Province Taiyuan City Xiahualing District People's Court (2017) no. 3227	Engaging in the same business as the company runs
169.	Rizhao Xinmei real estate development company v. Zhang Songlin	Shandong Province Rizhao City Intermediary People's Court (2017) no. 2074	Defrauding in obtaing loans in violation of laws
170.	Lejiao information technology company v. Sun Dawei and Li Meng	Jiangsu Province Suzhou City Xiancheng District People's Court (2016) no. 5286	Starting a new firm which engages in the same business
171.	Beijing Shenzhou information technology company v. Yang Lichun and Lu Rongjie	Beijing City First Intermediary People's Court (2017) no. 9059	Transfer of the company's IP right for free to another firm
172.	Chengdu Yuju technology company v. Zhu Wenqi and Chengdu Binde technology company	Sichuan Province Dujiangyan City People's Court (2016) no. 371	Take a similar position in another firm which engages in the same business as the company runs
173.	Wuwei village investment company v. Wu Daosen	Gansu Province Wuwei City Intermediary People's Court (2017) no. 981	Renting warehouse at low price

174.	Shanghai Qingma publishing company v. Rao Xueman, Gu Aishan	Beijing City Dongcheng District People's Court (2015) no. 11571	Engaging in the same business as the company runs
175.	Qinghai Jinsanjiao flour company v. Liu Lifeng and Bai Mingjie	Qianghai Province Xining City Intermediary People's Court (2017) no. 146	Self-dealing transaction
176.	Hangzhou Daqi kids' clothing company v. Xu Wei	Zhejiang Province Hangzhou Intermediary People's Court (2017) no. 4793 Zhejiang Province Hangzhou Yuhang District People's Court (2016) no. 6226	Engaging in the same business as the company does
177.	Guangzhou Hongxin real property management company v. Gao Fengling	Guangdong Province Guangzhou City Intermediary People's Court (2017) no. 17746	Taking a dual role in another company
178.	Qidong Kailai real estate development company v. Wang Wei and Zhao Peng	Jiangsu Province Nantong City Intermediary People's Court (2017) no. 1813	Improper disposal of the company's debts
179.	Yiwu small product information technology company v. Wang Peichang	Henan Province Puyang City Intermediary People's Court (2017) no. 2540	Breach of the duties of loyalty and care
180.	Li Jicheng v. Gan Shan	Zhejiang Province Higher People's Court (2017) no. 622	Misappropriation of corporate fund
181.	Shanghai Fumi culture company v. Zuo Chunju	Shanghai First Intermediary People's Court (2017) no. 10301	Breach of duty of care and delay in payment
182.	Gaomi Kaidi investment and management company v. Qian Xianchen	Shandong Province Gaomi City People's Court (2017) no. 4891	Arbitrarily providing guarantee for personal debt and selling the company's asset
183.	Wu Youhong v. Zhang Zhong	Jiangsu Province Zhejiang City Intermediary People's Court (2017) no. 2601	Misappropriation of corporate fund to pay personal debt
184.	Guanlin company v. Huang Qifen	Fujian Province Higher People's Court (2017) no. 43	Arbitrarily hiring recruiting counsel to seek CEO candidate
185.	Shanghai Guangwan construction design consultancy firm v. Wan Gujian	Shanghai City Pudong New District People's Court (2017) no. 20934	Misappropriation of corporate opportunities and engaging in the same business as the company does
186.	Siping Hongji real property limited company v. Wang Yabin	Jilin Province Siping Tixi District People's Court (2017) no. 571	Arbitrarily disposing of the company's asset at unreasonable low price
187.	Tang Congmiao, Zhang Xiaoying v. Yang Ali	Guangdong Province Shenzhen City Futian District People's Court (2017) no. 16526	Receiving commission paid to the company by personal bank account

188.	Tan Jianer v. Zheng Dan	Shanghai City Songjiang District People's Court (2016) no. 20217	Usurpation of corporate opportunities and divulging the corporate's secret and client resources
189.	Li Yiwei v. Wang Dong and Su Wei	Hubei Province Zaoyang City People's Court (2016) no. 1698	Engaging in the same business as the company runs
190.	Guangxi Liujiang hengze real estate development company v. Liang Yijian	Guangxi Zhuang Autonomous Region Liujiang County People's Court (2017) no. 2304	Misappropriation of corporate fund
191.	Yunxi Binhewan hotel company v. Wang Chuandi	Hubei Province Yunxi County People's Court (2016) 1259	Over-pricing the cost of a project
192.	Shanghai Zhaolin gymnastic company v. Ge Yijiong	Shanghai City Pudong New District People's Court (2017) no. 42948	Engaging in the same business as the company runs and withholding student resources
193.	Huayuan renting company v. Jiang Wenhui	Beijing City Chaoyang District People's Court (2017) no. 13538	Buying cars for himself from corporate fund
194.	Li Haining v. Yang Lichun and Lu Rongjie	Beijing City Haidian District People's Court (2015) no. 24997	Engaging in the same business and transferring the company's IP right
195.	Tuo Xizhong v. Tuo Dapeng and Tuo Xiquan	Hebei Province Higher People's Court (2017) no. 504	Making loans to a third party to obtain the land parcel
196.	Fugeshen machinery construction (Shanghai) company v. Hu Jianwei	Shanghai City Second Intermediary People's Court (2017) no. 7018	Arbitrarily paying the bonus to himself
197.	Fengshun Yifeng transportation company v. Tian Sheng	Guangdong Province Meizhou City Intermediary People's Court (2017) no. 675	Providing welfare to people who are not employees
198.	Liu Yikui v. Liu Chengping and Sichuan Degang group company	Sichuan Province Deyang City Intermediary People's Court (2017) no. 550	Signing acceptance bills without contractual basis
199.	Simante micro-display (Shenzhen) company v. Hu Qiusheng	Guangdong Province Higher People's Court (2016) no. 70	Responsibilities of capital contribution were not fulfilled
200.	Shiyan zhongbai culture product company v. Ma Like	Hubei Province Shiyan City Maojian District People's Court (2016) no. 2792	Breach of duties of loyalty and care
201.	Li Jinqiu v. Li Qi	Beijing City Daxing District People's Court (2017) no. 6448	Transfer of the company's asset at low price
202.	Guilin Liudianban food company v. Hu Haibo	Guangxi Zhuang Autonomous Region Guilin City Intermediary People's Court (2017) no. 1675	Misappropriation of corporate fund and holding back the company's materials after being dismissed

203.	Zhang Xiaochuan, Yang Guifang v. Tu Jianghong	Chongqing City Nanchuan District People's Court (2017) no. 3176	Making loans without due authority
204.	Zibo Qiyuan construction design company v. Ma Zhiqiang	Shandong Province Zibo City High-tech Industry Development District People's Court (2017) no. 853	Misappropriation of corporate fund
205.	Chen Genxi, Jiang Binghui v. Cai Maoquan	Shanghai City Pudong New District People's Court (2017) no. 32174	Fabricating wages and other expenditure
206.	Hangzhou aquaculture company v. Wen Xianming, Xu Tong	Zhejiang Province Hangzhou City Xiacheng District People's Court (2016) no. 8362	Misappropriation of corporate fund
207.	Tianxiang investment consultancy company v. Ji Songqiao	Beijing City Haidian District People's Court (2015) no. 02739	Making loans without due approval and failure to make payment in compliance with the contract
208.	Jiang Jun, Li Quan v. Zhang Jinfeng, Shanghai Miheng Medical Equipment Sales Center	Shanghai City Higher People's Court (2017) no. 22	Arbitrarily transferring the company's fund to another company's fund
209.	Jiangxi Yichun Zhonggong group company v. Ruan Dongrong and Jiangxi Pugang company	Jiangxi Province Higher People's Court (2017) no. 269	Fabricating transactions to transfer corporate fund
210.	Chongqing Zhongqi xinan automobile group company v. Xie Yong	Chongqing City Yubei District People's Court (2017) no. 8337	Engaging in the same business as the company runs
211.	Suzhou Hengting electronic company v. Li Liang and Zhou Wei	Jiangsu Province Suzhou City Huqiu District People's Court (2016) no. 3054	Holding the company's seals and licence after being dismissed, abuse of power to pay wages
212.	Wuxi Zhongou education consultancy company v. Guo Yun and Wuxi Yuguo media company	Jiangsu Province Higher People's Court (2017) no. 1197	Causing losses to the company by related party transactions
213.	Shanghai Jinting cultural communication company v. Song Haitao	Guangdong Province Foshan City Intermediary People's Court (2017) no. 758	Misappropriation of corporate fund
214.	Shanghai Zhongqiao education development company v. Xu Li	Shanghai City First Intermediary People's Court (2017) no. 5255	Transfer of the company's asset, causing losses to the company
215.	Zhejiang Bokai meter company v. Ye Dafu	Zhejiang Province Hanghzou City Intermediary People's Court (2017) no. 2043	Misappropriation of corporate fund under the cover of unclear entry of expenditure
216.	Guangdong Purun environment protection technology company v. Zhou Cong Zhang	Guangdong Province Jiangmen City Intermediary People's Court (2017) no. 881	Engaging in the same business as the company runs

217.	Xiamen Shengyuan rubber and plastic company v. Lv Fangzong	Fujian Province Higher People's Court (2017) no. 44	Breach of duties of loyalty and care and arbitrarily confirm price increase of the project
218.	Wu Youhong v. Zhang Zhong	Jiangsu Province Zhenjiang City Jingkou District People's Court (2017) no. 762	Misappropriation of corporate fund
219.	Guizhou Xianggui investment company v. She Meilin	Guizhou Province Guiyang City Intermediary People's Court (2017) no. 374	Entering into a contract without due approval of shareholders meeting
220.	Aili Wensen (Beijing) material company v. Yang Wenshuang	Beijing City Dongcheng District People's Court (2017) no. 8157	Misappropriation of corporate fund and starting a new company
221.	Suqian Ruiyou renewable energy company v. Wang Jianfang	Jiangsu Province Suqian City People's Court (2017) no. 353	Breach of the duty of care, causing corporate licence improperly used
222.	Su Qihao v. Liu Yang	Chongqing City Yubei District People‘s Court (2016) no. 16004	Misappropriation of corporate fund
223.	Tianjin Xunshan internet technology company v. Li Hongtao	Tianjin City Nankai District People's Court (2017) no. 3757	Self-dealing transactions
224.	Shenzhen Baiheng electronic company and Zeng Zhixiong v. Chen Xi	Guangdong Province Shenzhen City Intermediary People's Court (2017) no. 103	Misappropriation of corporate fund
225.	Shangguan Yiwu v. Ma Xuewen	Shandong Province Yancheng County People's Court (2015) no. 820	Improperly dealing with the disputes with a third party
226.	Xianggang Xujun company v. Zou *	Shenzhen City Qianhai District People's Court (2016) no. 238	Misappropriation of corporate fund
227.	Liao Minxia v. He Boning	Guangdong Province Foshan City Intermediary People's Court (2017) no. 2268	Vexatious arbitration
228.	Guangdong Ailehuo company v. Li Gaosheng, He Liping	Guangdong Province Foshan City Intermediary People's Court (2017) no. 2094	Misappropriation of corporate fund
229.	Shanghai Jinglian information technology company v. Zhang Danyu	Beijing City Xicheng District People's Court (2016) no. 25254	Usurpation of corporate opportunities
230.	Nanjing guotai fire extinguishing company v. Wang Changcai	Jiangsu Province Nanjing City Intermediary People's Court (2016) no. 10564	Starting a new firm which engages in similar business to the company runs
231.	Shanghai Lemeng information technology company v. Wu Minchun	Shanghai City Second Intermediary People's Court (2016) no. 1156	Inflating expenditure and refusing to return corporate fund
232.	Hebei Ruihe glass fiber company v. Zhang Litai	Hebei Province Higher People's Court (2017) no. 99	Failure to ensure the company to pay tax, causing the company sanctioned

233.	Li Hao v. Zhang Youwei and Guangdong Tianma tourist agency company	Guangdong Province Guangzhou City Intermediary People's Court (2016) no. 18843	Entries to record with fabricated invoices
234.	Chongqing Changshou transportation renting company v. Li Xuefeng	Chongqing City Changshou District People's Court (2015) no. 06092	Increasing directors' remuneration without resolution of shareholders meeting
235.	Chengdu Shuyunyuan culture development company v. Chen Xiaodong	Sichuan Province Chengdu City Intermediary People's Court (2016) no. 11401	Engaging in the same business and usurpation of corporate opportunities
236.	Guangzhou Miaoyizhai bio-technology company v. Huo Guangsen and Deng Meixian	Guangdong Province Guangzhou City Intermediary People's Court （2016） no. 17726	Misappropriation of corporate fund
237.	Yuan Min, Pan Hui, Peng Ling, Jiang Yuxia v. Huang Qiren, Huang Wei, Shu Tao, Xu Youming	Sichuan Province Higher People's Court (2016) no. 950	Starting a subsidiary company without approval of shareholders meeting
238.	Tongdali company v. Xin Fengqin	Liaoning Province Higher People's Court (2016) no. 832	Transfer of company's real property without due approval of shareholders meeting
239.	Wu Jie v. Shu Jie	Jiangsu Province Suzhou City Intermediary People's Court (2017) no. 9744	Failure to fulfill the duty in liquidation procedure
240.	Yang Ziyuan v. Chen Jing	Guangdong Province Foshan City Intermediary People's Court (2017) no. 881	Failure to obtain all the government approval
241.	Kunming Yunan wining company v. Wu Hongliang	Fujian Province Higher People's Court (2016) no. 1521	Self-dealing transactions
242.	Sichuan Dawo renovation company v. Tong Xu	Sichuan Province Tongjiang County People's Court (2017) no. 2828	Holding the company's licence and seals
243.	Zhao Yuwun v. Zhao Haiyang	Hubei Province Wuhan City Intermediary People's Court (2017) no. 1939	Arbitrarily terminating contract and misappropriation of corporate fund

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Summary

Management behaviour is undisputedly pivotal to a company's operation and performance. How to incentivize and discipline management behaviour is a common concern in practice, and a fundamental problem of corporate governance. In law, there is worldwide convergence of the rules regarding directors' duties and liabilities. Various jurisdictions have introduced the fiduciary duties of loyalty and care from the US corporate law systems to strengthen directors' obligations, but the practical effect varies across countries. This thesis focuses exclusively on directors' duties and liabilities in China, examines how fiduciary duty is incorporated into corporate legislation, and analyses how such duties and liabilities function and ameliorate the agency problems in this particular context.

The functional inquiry is based on the theoretical discussions from a law and economics perspective. Agency theory identifies the conflict of interests in a corporate scenario, explains why managers or controlling shareholders might misuse controlling power, and generally assesses the utility, limitation, and cost of internal monitoring forces, incentive schemes, and external market mechanisms in disciplining management opportunism. Following the roadmap of the agency theory, this thesis examines the ownership structure and internal governance of China's companies and observes that concentrated ownership is commonplace and internal governance mechanisms might not sufficiently monitor and control management behaviour as corporate practices have developed relatively recently.

Moreover, a historical review of enterprise development shows that state control and family control remain in many companies and might exacerbate the expropriation of minority shareholders' interests by managers and controlling shareholders. Meanwhile, share prices and other signals in the markets are not informative about a company's profitability, since the stock market has not achieved fully-fledged development and the market for corporate control has just emerged. Thus, an alternative mechanism is needed to curb management opportunism in China.

To better understand the necessity, rationale, and working mechanism of directors' duties and liabilities, this thesis reviews previous discussions, including the analysis of the fiduciary duty from the view of incomplete contract theory, the LLSV empirical studies, and cost-benefit analysis of the monetary liability for breach of the duty of care. In essence, general duties are adopted to fill in incomplete management contracts to regulate business decision-making in varying circumstances. Monetary liabilities can generate a deterrent effect. When the relative benefit of monetary liabilities outweighs the cost of enforcement, the enforcement of liabilities is highly desirable. Nevertheless, the relative benefit of monetary liabilities is contingent on the efficient and informative nature of the share price and other signals. In line with such cost-benefit analysis, this thesis observes that the relative benefit of monetary liabilities is considerable in China, since share prices and other market signals are not as efficient and informative as their counterparts in developed markets.

This thesis examines the design and formulation of directors' duties and liabilities and recognizes the challenges facing the Chinese judges who do not have discretion to interpret

and apply a general term. Meanwhile, an analysis of judicial decisions from 2013 to 2017 presents a general picture of the enforcement practice. Private actions against directors' wrong-doing are relatively inactive but not completely dormant in small and medium-sized companies. However, directors in the SOEs and listed companies are rarely sued and are almost free from monetary liabilities. Besides, a literature review of the administrative sanctions imposed on listed companies shows that directors in listed companies are under increasingly intense pressure to fulfill the information disclosure duty, even though the amount of the fine is too small. Overall, directors' duties and liabilities play a limited role in deterring management opportunism in China.

To bridge the gap between normative role and current state of directors' duties and liabilities, this thesis identifies the reasons for the underenforcement of directors' liabilities, including procedural hurdles, unreasonable cost burden, and perceived deficiencies in the judiciary. Finally, a series of measures are proposed to enhance the applicability of the relevant legal rules and to encourage private actions against management wrongdoing.

Samenvatting

Managementgedrag is in hoge mate bepalend voor het functioneren en de prestaties van een bedrijf – daarover bestaat weinig discussie. In de praktijk worstelt men echter vaak met de vraag, hoe 'goed' managementgedrag gestimuleerd kan worden en welke maatregelen bij ongewenst gedrag kunnen worden genomen. In het kader van corporate governance is dit een fundamenteel probleem. De wetgeving met betrekking tot de plichten en aansprakelijkheid van bestuurders ontwikkelt zich wereldwijd in dezelfde richting. In diverse rechtsgebieden zijn, om de plichten van bestuurders sterker in de wet te verankeren, de fiduciaire plichten loyaliteit en zorg uit het Amerikaanse stelsel van ondernemingsrecht overgenomen, maar het effect daarvan in de praktijk verschilt van land tot land. In deze thesis, die uitsluitend ingaat op de plichten en aansprakelijkheden van bestuurders in China, wordt onderzocht op welke wijze fiduciaire plichten in het ondernemingsrecht zijn opgenomen. Daarbij wordt geanalyseerd welk effect dergelijke plichten en aansprakelijkheden hebben en hoe ze in deze specifieke omgeving het principaal-agentprobleem verkleinen.

De centrale vraag is gebaseerd op theoretische discussies vanuit de vakgebieden rechten en economie. De principaal-agenttheorie maakt duidelijk dat er in bedrijfsomgevingen belangenconflicten bestaan, hetgeen verklaart waarom controlerende aandeelhouders hun macht kunnen misbruiken en geeft een algemene analyse van het nut, de beperkingen en de kosten van interne controle, stimuleringsregelingen en externe marktmechanismen als disciplinaire maatregelen tegen opportunistisch gedrag van managers. In dit proefschrift wordt, met de principaal-agenttheorie als routekaart, de eigendomsstructuur en de interne aansturing in Chinese bedrijven onderzocht. Daarbij wordt geconstateerd dat geconcentreerd eigendom gebruikelijk is en de interne controlemechanismen mogelijk onvoldoende zijn om toezicht uit te oefenen en te sturen op managementgedrag.

Daarnaast wordt de ontwikkeling van bedrijven vanuit historisch perspectief besproken, waarbij wordt aangegeven dat veel bedrijven nog steeds door de staat en families worden aangestuurd en dat dit de mogelijkheden voor managers en controlerende aandeelhouders om tegen de belangen van minderheidsaandeelhouders in te gaan, verder vergroot. Daar komt bij dat aandelenprijzen en andere marktsignalen geen informatie over de winstgevendheid van een bedrijf geven, omdat de aandelenmarkt nog niet volledig is ontwikkeld en de markt voor bedrijfscontrole nog maar kort geleden is ontstaan. Er zijn in China dus andere mechanismen nodig om opportunistisch gedrag van managers tegen te gaan.

In deze scriptie wordt, om meer inzicht te krijgen in de noodzaak, logica en werking van plichten en aansprakelijkheden voor bestuurders, bestaand materiaal besproken, waaronder de fiduciaire plicht vanuit de theorie over onvolledige contracten, de empirische studies van LLSV en een kosten-batenanalyse van financiële aansprakelijkheid bij schending van de zorgplicht. In wezen worden algemene plichten toegepast om tekortkomingen in onvolledige managementovereenkomsten op te vangen en zo in uiteenlopende situaties de zakelijke besluitvorming te regelen. Aansprakelijkheid kan een afschrikkende werking hebben. Waar aansprakelijkheid ten opzichte van dure publieke handhaving voordelen oplevert, is het zeer wenselijk dat het aansprakelijkheidsrecht wordt ingezet. Hierbij geldt wel dat de relatieve voordelen van aansprakelijkheid afhankelijk zijn van de efficiëntie waarmee aandelenprijzen en andere signalen tot stand komen en van de informatieve waarde van deze signalen. Op basis van zo'n kosten-batenanalyse wordt in dit proefschrift vastgesteld dat het relatieve voordeel van aansprakelijkheid in China aanzienlijk is, omdat aandelenprijzen en andere marktsignalen niet zo efficiënt tot stand komen en niet zo informatief zijn als in andere grote landen, in ontwikkelde markten.

In dit proefschrift worden de opbouw en de formulering van plichten en aansprakelijkheid van bestuurders onderzocht en wordt ingegaan op de problemen waar Chinese rechters, die niet bevoegd zijn om algemene plichten te interpreteren en op te leggen, mee te maken hebben. Aan de hand van een analyse van rechterlijke uitspraken in de periode 2013-2017 wordt een algemeen beeld gegeven van de handhaving in de praktijk. Privaatrechtelijke maatregelen tegen bestuurders die zich misdragen komen in het midden- en kleinbedrijf niet vaak voor, maar er zijn wel gevallen te noemen. Toch worden bestuurders van staatsbedrijven en beursgenoteerde bedrijven bijna nooit vervolgd of financieel aansprakelijk gesteld. Verder is literatuuronderzoek uitgevoerd naar de bestuurlijke sancties die aan beursgenoteerde bedrijven zijn opgelegd. Daarbij is gebleken dat bestuurders van beursgenoteerde bedrijven steeds sterker onder druk staan om aan hun informatieplicht te voldoen, ondanks het feit dat de boetes voor schending van deze plicht te laag zijn. In het algemeen spelen de verplichtingen en de aansprakelijkheid van bestuurders in China slechts een beperkte rol als het gaat om het voorkomen van opportunistisch gedrag van managers.

In dit proefschrift wordt beoogd de kloof te overbruggen tussen de normatieve rol die plichten en aansprakelijkheden van bestuurders zouden moeten spelen en de huidige status ervan, door vast te stellen om welke redenen er te weinig op de plichten van bestuurders wordt gehandhaafd. Dit zijn onder andere procedurele hindernissen, onredelijk hoge kosten en vermeende tekortkomingen van het rechtsstelsel. Tot slot worden maatregelen voorgesteld die de toepasbaarheid van de betreffende rechtsnormen zouden verbeteren en het nemen van privaatrechtelijke maatregelen tegen misdragingen van bestuurders zouden aanmoedigen.

Curriculum vitae

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Short bio	
I am a PhD candidate at the Erasmus School of Law (ESL). I received my master and bachelor degrees in law at China University of Political Science and Law (CUPL). I'm a banking and finance and outbound M&A lawyer in China. My research interests include company law and securities laws and regulations.	
Education	
PhD candidate—Erasmus School of Law, Erasmus University Rotterdam	2011-2020
Master in Law—School of Comparative Law, China University of Political Science and Law	2008-2011
Bachelor in Law—School of International Law, China University of Political Science and Law	2004-2008
Work experience	
Banking and finance/outbound M&A lawyer at Deheng Law Offices in Beijing	2018-2020
Intern in Siemens (China) Department of Tax	2010

PhD Portfolio

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PhD training

EGSL courses	***year***
Academic Writing in English	2011-2012
Introduction to Research Methods	2011-2012
Empirical Studies	2013
Specific courses	***year***
Gerzensee Study Center Advanced Dotoral Courses	2015
Seminars and workshops	***year(s)***
ECLC brown bag lunches	2012-2014
ECLC seminars	2012-2014
EDLE seminars	2011-2014
Yearly seminar 'Future of Law and Economics'	2012-2014
Presentations	***year***
Presentations on PhD thesis chapters at the ECLC seminars	2013-2015
Presentations on PhD thesis chapters at the EDLE seminars	2012
Attendance (international) conferences	***year***
Chicago University 'Law and Economics Summer Institution'	2014