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Note

"Chinese Characteristics" in Corporate Clothing: Questions of Fiduciary Duty in China's Company Law

Michael Irl Nikkel

INTRODUCTION

In 1978, under the leadership of Deng Xiaoping, the People's Republic of China (PRC) began a second long march¹ toward a modified free-market economy.² In the intervening two decades, China's market reforms have created an unprecedented period of economic growth for the country.³ The growth has not gone unnoticed abroad. Since 1990, American companies have

1. The People's Republic of China (PRC) came into existence in 1949 after Mao Zedong and his Communist revolutionaries went on a 5,000-mile "long march" through China in order to drive Chiang Kai-shek's flagging Guomindang government from the mainland to Taiwan.

2. "[T]he Third Plenary Session of the 11th Central Committee of the Communist Party of China . . . launched a policy of economic reform and opened China to increased contacts with the outside world." Andrew Xuefeng Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 UCLA PAC. BASIN L.J. 62, 65 (1993).

3. "Between 1978 and 1993, China approved over 172,000 FDI [foreign direct investment] contracts with total utilized capital exceeding fifty-nine billion dollars, propelling it into the ranks of major users of FDI in the developing world." Wei Jia, *Tidal Changes in Chinese Foreign Investment Laws and Policies*, 2 TUL. J. INT'L & COMP. L. 23, 24 (1994). According to official statistics, foreign investment in China rose 49% from the first nine months of 1993 to the same period in 1994. *Investment Continues to Grow in China*, Xinhua News Agency, Oct. 23, 1994, available in LEXIS, NEXIS Library, XINHUA File. In addition, China continues to experience one of the world's steepest real economic growth rates—a healthy nine percent in 1994. Alan W.N. Kitchin et al., *Doing Business in Asia: Focus on Japan, India, and Vietnam*, A.L.I.-A.B.A. COURSE OF STUDY, Sept. 29, 1994, available in WESTLAW, ALL-ABA Database.

Others have advised foreign investors to exercise caution in the market. See the advice given by Todd Carrel & Richard Hornik, *A Chinese Gold Rush? Don't Hold Your Breath*, N.Y. TIMES, Sept. 14, 1994, at A19. Carrel and Hornik portend that the "latest American bout of Sinophilia tramples economic horse sense." *Id.* They report that the "economic backwardness" of China, including its lack of sufficient investor protections, stymies commercial success and creates overall losses for United States companies and individuals operating in the market. *Id.*

directly invested more than fifteen billion dollars into China through joint ventures and wholly foreign-owned enterprises established on the mainland.⁴ By 1994, worldwide contracted foreign direct investment in China surged to eighty-one billion dollars.⁵

Despite the Chinese government's 1988 "austerity measures,"⁶ and the latest two-year round of centrally mandated tight money policies,⁷ China continues to strengthen the role of free-market forces in its economy.⁸ This market reform movement derives in part from China's experience with its grossly inefficient state-owned enterprises (SOEs).⁹ In restructuring these debt-ridden entities and transitioning to a market economy, China sees the opportunity to provide greater investment alternatives for its domestic and foreign investors.¹⁰ In the late-1980s China began to accommodate investors by allowing Western-style companies to emerge replete with shares, sharehold-

4. *Investment Data*, CHINA BUS. REV., May-June 1995, at 32, 33; Jia, *supra* note 3, at 41-42; see also John J. Oslund, *Chinese Puzzle: Minnesota Has Idea for Dealing With Trade Dilemma—A Code of Conduct*, MINNEAPOLIS STAR TRIB., May 19, 1994, at D1 (reporting that Minnesota companies are investing significantly in China).

5. *Investment Data*, *supra* note 4, at 32.

6. In an effort to slow down what it viewed as an overheated economy and double-digit inflation, the Chinese government limited the availability of operating credit and raw materials. See Nicholas D. Kristof, *China Again Moves Central Planning to Center Stage*, N.Y. TIMES, Mar. 21, 1989, at A1; Nicholas D. Kristof, *State's Share of Businesses Falls in China*, N.Y. TIMES, Mar. 20, 1989, at D4.

7. See Kathy Chen & Joseph Kahn, *China Applies the Brakes to Reforms*, WALL ST. J., Apr. 7, 1995, at A10. The Beijing government has been striving to quell a persistent nationwide inflation rate that averaged 25% in 1994. *Id.* At the opening of the Third Plenum of the Eighth National People's Congress on March 5, 1995, China's Prime Minister Li Peng detailed plans to slow down the lifting of price controls and to improve the food supply through central mandates. Mark O'Neill, *China Admits Policy Mistakes on Inflation*, Reuter Newswire-Far East, Mar. 5, 1995, available in WESTLAW, INT-NEWS Database.

8. Examples include China's enactment of such pro-business legislation as a private enterprise law, a bankruptcy law and a joint venture law. See generally Alison W. Conner, *To Get Rich is Precarious: Regulation of Private Enterprise in the People's Republic Of China*, 5 J. CHINESE L. 1, 5, 17 (1991) (detailing the rise, decline and eventual revival of private enterprise in China since 1978).

9. See *China to Sacrifice Failures*, LLOYDS LIST, May 28, 1994, available in WESTLAW, INT-NEWS Database; Foo Choy Peng, *State Sector Holds Key to Future; Economists Agree on Need to Tackle Problem of SOEs*, S. CHINA MORNING POST, July 7, 1994, Chinese Bus. Rev. Section, at 1; Zhou Weirong, *National Enterprises Face Further Reforms*, CHINA DAILY, Oct. 4, 1994, at 2.

10. Marcus W. Brauchli, *With China's Economy Cooling, Beijing Renews Rhetoric on Regaining Taiwan*, WALL ST. J., Feb. 3, 1995, at A8. For a detailed analysis of foreign investment in China, see generally Jia, *supra* note 3.

ers, and public offerings on foreign stock exchanges and its own newly-created Shanghai and Shenzhen exchanges.¹¹ A series of local laws and national administrative opinions regulated these new companies until China's National People's Congress enacted the country's first-ever national Company Law in December 1993.¹² Today, foreign corporations increasingly see the purchase of a minority equity stake in Chinese listed companies as a means of bypassing extended joint venture negotiations and government approvals, thereby gaining a quick foothold on the mainland.¹³ Because these companies are governed by the new Company Law, this Note undertakes a critical analysis of the shareholder investment protections afforded by the Company Law and China's governmental structures.¹⁴

11. Marcus W. Brauchli & Kathy Chen, *Major Chinese Firms May Offer Shares in Hong Kong, but Gripes, Doubts Occur*, WALL ST. J., Feb. 12, 1993, at A11; Renee Lai, *Firm Readies for HK Listing; Chengdu Telecom Restructures for Float in Territory*, S. CHINA MORNING POST, Oct. 4, 1994, at 5. Brilliance China Automotive Holdings was the first mainland Chinese company to list on the New York Stock Exchange. *Bumpy Road for Car Groups*, FIN. TIMES, Nov. 18, 1993, Section III, at IX. In October 1994, Chinese officials estimated the number of New York Stock Exchange-listed companies at ten, with three more on the way. Zhao Renfang, *China Gradually Entering World Capital Market—An Interview with Chinese CSRC Chairman*, Xinhua News Agency, Oct. 7, 1994, available in LEXIS, NEXIS Library, XINHUA File (paraphrasing remarks made by Liu Hongru, Chairman of the China Securities Regulatory Commission). Prior to the formation of shareholding companies, the only investment vehicles available to foreigners were joint ventures or wholly foreign-owned enterprises, both of which required substantial outlays not commonly associated with private investments. See Yabo Lin, *New Forms and Organizational Structures of Foreign Investment in China Under the Company Law of the PRC*, 7 TRANSNAT'L LAW. 327, 333 (1994).

12. The Zhonghua Renmin Gongheguo Gongsifa [Company Law of the PRC] became effective on July 1, 1994. The full text of the Company Law is translated into English in CHINA'S COMPANY LAW: THE NEW LEGISLATION 7 (Guiguo Wang trans., 1994) [hereinafter Company Law].

13. See Karen Cooper, *Investors Exploit China Loopholes*, EVENING STANDARD, Aug. 24, 1995, at 36, available in LEXIS, WORLD Library, ESTAND File; Tony Walker, *Ford Skates Around Chinese Freeze: Share-Buying Avoids the Joint Ventures Ban*, FIN. TIMES, Sept. 7, 1995, at 16; see also Joseph Kahn, *Chinese Markets Soar on Interest by Foreigners: Class A Share Reform Could Widen Holdings but Obstacles Remain*, ASIAN WALL ST. J., Sept. 6, 1994, at 1, available in WESTLAW, WSJ-ASIA Database ("Fueled by news of strong interest from foreign brokerage firms eager to invest in China's domestically traded Class A shares, the nation's stock market indexes on Monday surged to their highest levels of the year.").

14. "China's expanding economy has attracted billions of dollars of foreign investment, but Beijing has made limited progress in setting up regulations to protect those investments." *Dealing with China: Lawyer Discusses Investor Protection*, ASIAN WALL ST. J., Apr. 25, 1994, at 3, available in WESTLAW, WSJ-ASIA Database [hereinafter *Dealing with China*].

Although aimed at making managers answerable to shareholders,¹⁵ China's new Company Law contains conflicting provisions that could undermine the accountability inherent in the corporate setting.¹⁶ This Note critiques these dissonant provisions and the challenges associated with China's underdeveloped legal system. These problems assume added importance as the number of investors from the United States, Europe and the Pacific Rim continues to swell.¹⁷ Part I provides a glimpse of China's business past, identifies the reasons for the Company Law's promulgation, and examines the systemic inadequacies of China's current governmental structure that will affect the Law's viability. Part II provides an overview of shareholder, director and managerial responsibilities in the new Chinese companies and examines their correlation with corporate fiduciary duties under United States law. Part III analyzes the tension created between the managers of majority state-owned joint-stock companies formed under the Company Law and their minority shareholders. Part IV suggests changes that might give investors more meaningful protection from a director or manager's breach of corporate fiduciary duties. This Note concludes that China should strengthen its progressive Company Law by giving shareholders an adequate means of redress against managers who breach their official duties.

15. See *infra* notes 78-85 and accompanying text (discussing Chinese management's need for accountability).

16. See *infra* text accompanying notes 72-73 (discussing the inherent accountability provided by a business form where directors and managers are required to answer for their business decisions to shareholders who have a direct pecuniary interest in the company). The idea for this Note derived from a meeting with University of Minnesota Law School Professor of Chinese Law, Tahirih V. Lee after a conversation Professor Lee had with Mr. Yanlei Wu. Interview with Tahirih V. Lee in Minneapolis, Minn. (Sept. 8, 1994). Mr. Wu is an attorney with the law firm of Latham & Watkins in Washington, D.C. The author of this Note wishes to express his thanks to Professor Lee for commenting on an earlier draft of this article as well as providing insight into China's unique and often misunderstood *tese* (characteristics).

17. Total foreign direct investment in China has increased over 600% since 1991. *Investment Data*, *supra* note 4, at 32. The bulk of this investment in recent years has come from Hong Kong, Taiwan, the United States, Japan and Germany. *Id.* at 33.

I. THE LONG MARCH TO MARKET REFORM

A. CORPORATE ACTIVITY AND REGULATION PRIOR TO 1978

The corporate form of business is not new to China.¹⁸ Foreign companies established a stronghold in the country after the Opium War of 1840.¹⁹ Recognizing the need to "promote the creation of Chinese companies to compete with the foreigners who were producing and marketing their goods on Chinese soil,"²⁰ the late Qing dynasty promulgated its own company law in 1904.²¹ The succeeding Nationalist government continued the Qing's reforms by codifying a new company law in 1929.²²

Under Mao Zedong's leadership, the Chinese Communist Party (the Party) took a far different approach to corporate enterprise when it assumed power in 1949. The Party briefly allowed the 11,298 existing companies to remain in operation before it declared the corporate enterprise inimical to socialism.²³ By the early 1950s, the Party had nationalized or collectivized all privately-held companies.²⁴ Party directives and Maoist ideology, rather than market-oriented supply-and-demand forces, governed SOEs.²⁵

Other private enterprises, including more than one million individual businesses and partnerships existing when the Communists came to power, also experienced harsh treatment by the Chinese government after 1949.²⁶ The Party's policy evolved quickly from guarded toleration to socialist integration to ruth-

18. See generally ZHONGGUO ZHENGQUAN SHOUCHE [CHINA SECURITIES HANDBOOK] 513-16, 527-29 (Liu Hongru ed., 1992) (providing historical background of China's securities market) [hereinafter CHINA SECURITIES HANDBOOK].

19. See Qian, *supra* note 2, at 64 n.6.

20. William C. Kirby, *China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China*, 54 J. ASIAN STUD. 43, 43 (1995).

21. *Id.*

22. *Id.* at 51-52 (providing a brief history of China's corporate regulatory past prior to the formation of the Communist state under Mao Zedong).

23. *Id.* at 56.

24. *Id.*

25. Donald C. Clarke, *What's Law Got to do With it? Legal Institutions and Economic Reform in China*, 10 UCLA PAC. BASIN L.J. 1, 5-6 (1991). Production directives proffered by China's central government were never as extensive as the former Soviet Union's. *Id.* This may have enhanced the Chinese government's willingness to accept economic reform under Deng Xiaoping beginning in 1978. Mr. Clarke notes that "[i]n 1977, before reform, some forty percent of investment in state units was not centrally planned. Between 1982 and 1985, that figure rose to sixty percent, an extraordinary number for a centrally planned economy." *Id.* at 6.

26. Conner, *supra* note 8, at 3-5.

less suppression.²⁷ The shift in policy reflected the Party leadership's determination to eliminate any remaining vestiges of capitalism, to develop China's infrastructure and to create a strong, prosperous "New China."²⁸ As a result, by 1978 less than 150,000 persons engaged in private business, and no stock companies existed.²⁹

B. FOUNDATIONAL REFORMS AND DISCREPANCIES IN THE POST-1978 ERA

1. Renewed Privatization

Under Deng's leadership, China cautiously renewed the viability and protection of private business.³⁰ In 1981, China began allowing private enterprises to operate through extensive statutory and policy changes.³¹ Further, China revamped its constitution in 1982³² and recognized the "rights" of "individual businesses" and "private enterprise,"³³ even though the changes

27. *Id.*

28. See generally JOHN N. HAZARD, COMMUNISTS AND THEIR LAW 177-80 (1969) (elucidating the plight of capitalist enterprise in China). For a discussion of the alternative strategies of socialist development attempted in China during the period, see Peter Van Ness & Satish Raichur, *Dilemmas of Socialist Development: An Analysis of Strategic Lines in China, 1949-1981*, in MARKET REFORMS IN SOCIALIST SOCIETIES: COMPARING CHINA AND HUNGARY 143 (Peter Van Ness ed., 1989).

29. Conner, *supra* note 8, at 5.

30. Matthew D. Bersani, *Privatization and the Creation of Stock Companies in China*, 1993 COLUM. BUS. L. REV. 301, 303. This is different from the reform minded, formerly communist countries of Eastern Europe in which some countries took a deliberate and immediate stance embracing private ownership of various industries. *Id.*

31. The first of such laws was Guowuyuan Guanyu Chengzhen Feinongye Geti Jingji Ruogan Zhengcexing Guiding [Certain Policy Provisions by the State Council of the PRC Relating to the Non-agricultural Individual Economy in Cities and Townships] art. 5 (promulgated July 7, 1981), in 1 ZHONGGUO JINGJI GUANLI FAGUI WENJIAN HUIBIAN [PROVISION AND DOCUMENT COLLECTION OF THE MANAGEMENT OF CHINA'S ECONOMY] 377-79 (Jilin Renmin Chubanshe [Jilin People's Publishing House] 1985). "Individual enterprises" obtained their legal status with the passage of Zhonghua Renmin Gongheguo Minfa Tongze [The General Rules of the Civil Law of the PRC] § IV, art. 28 (adopted Apr. 12, 1986), translated in 3 COMMERCIAL, BUSINESS AND TRADE LAWS: PEOPLE'S REPUBLIC OF CHINA 59, 71-72 (Owen D. Nee ed., 1987) [hereinafter Civil Law].

32. ZHONGHUA RENMIN GONGHEGUO XIANFA [CONSTITUTION OF THE PRC] arts. 8 and 11 (adopted Dec. 4, 1982), translated in 4 CONSTITUTIONS OF THE COUNTRIES OF THE WORLD 35, 39 (Albert P. Balustein & Gisbert H. Flanz eds., 1992) [hereinafter CHINESE CONST.].

33. These terms refer to the type of private ownership allowed in China prior to the formation of stock companies which, in recent years, consisted of small, family type businesses with no shareholding system. Preston M. Tor-

did not clearly articulate these rights.³⁴ These provisions, however, laid the foundation for China's new conception of private ownership and control of business enterprise.³⁵

The Civil Law of 1986 expanded upon the statutory revisions and re-established a legal basis for private business in its corporate form.³⁶ The Civil Law provides for the regulation of

bert, *China's Evolving Company Legislation: A Status Report*, 14 Nw. J. INT'L L. & Bus. 1, 2 (1993).

34. For example, it was unclear whether the owner of a business had a right to bring suit in one of the local People's Courts for breach of contract. Bersani, *supra* note 30, at 304 n.16.

In April, 1988, the National People's Congress directly granted legal protections to the private sector by amending the 1982 Constitution to provide that the "state protects the lawful rights and interests of the individual economy," thereby allowing owners to sue for business related infringements. CHINESE CONST., *supra* note 32, art. 11, at 63 (amended Apr. 12, 1988). The amendment provides that the state is to "exercise[] guidance, supervision and control over the private sector economy." *Id.* Thus, prior to the Company Law's formation, private ownership of business seemed to take a back seat to the state's power to direct the management of that business.

Later that summer and in the following year, the State Council, the highest regulatory authority in China, clarified the amendment by issuing interpretive regulations defining private enterprise, providing rules for its establishment and dissolution and exerting control over its labor relations and financial affairs. See Zhonghua Renmin Gongheguo Siying Qiye Suodeshui Zhanxing Tiaoli [Provisional Regulations of the PRC Concerning Income Tax on Private Enterprises] (promulgated June 25, 1988); Zhonghua Renmin Gongheguo Siying Qiye Zhanxing Tiaoli [Provisional Regulations of the PRC Concerning Private Enterprises]; Guanyu Zhengshou Siying Qiye Touzizhe Geren Shouru Tiaojieshui De Guiding [Provisions Relating to the Imposition of Individual Income Regulatory Tax on Investors in Private Enterprises] (promulgated June 25, 1988), all translated in E. ASIAN EXECUTIVE REP., Oct. 15, 1988, at 26, available in LEXIS, NEXIS Library, EASIAN File.

35. See Conner, *supra* note 8, at 19 (outlining the provisions pertaining to private enterprise). The reform measures significantly impacted the private sector. According to official statistics, by June 1994 there were more than 31 million self-employed in China with registered funds totaling more than 100 billion yuan (US\$12 billion) and business volume of more than 265 billion yuan (US\$31.9 billion). *Beijing Newspaper Highlights*, Xinhua News Agency, Sept. 25, 1994, available in LEXIS, NEXIS Library, XINHUA File.

China enacted laws pertaining to joint ventures between foreign companies and domestic entities early in the reform process. See The Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment (adopted July 1, 1979); The Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures (adopted Apr. 13, 1988), all available in LEXIS, ASIAPC Library, CHINAL File. While these laws provided a basis upon which the Chinese government could draw while developing the Company Law, they do not deal with private ownership by investors of the entity being created as the Company Law does.

36. Kirby, *supra* note 20, at 43 (discussing the history of China's corporatization process). For the Civil Law, see Civil Law, *supra* note 31. China's State Council in 1988 enhanced China's Civil Law with the promulgation of the

business and personal relationships among Chinese citizens, between "legal persons," and between citizens and "legal persons."³⁷ Entities such as joint ventures, SOEs and new companies are examples of the "legal persons" contemplated by the law. In other words, the "legal persons" the law creates can be fictional corporate persons. They obtain this status when the enterprises are established in accordance with the appropriate law.³⁸ Accordingly, the Civil Law guarantees that once establishment and registration are complete, an enterprise is a "legal person" that has the capacity for civil rights in conducting lawful activities—it may lawfully conduct business under the protection of law.³⁹ As a "legal person," the entity gains a judicial remedy in the event of a contractual or other breach of law by another company, a joint venture, an SOE or a Chinese citizen.

2. China's Administrative Agency Quandary: Decentralization as Progress and Paralysis

Codification of China's laws in the last two decades has brought major difficulties because China lacks dependable local enforcement agencies needed to protect newly formed private enterprises.⁴⁰ At this stage of reform, the power of the local Party hierarchy often overrides the wishes of the central government in enforcing national laws. For example, local Party officials might require a new company to obtain one set of operation permits that conflict with national regulations.⁴¹ This problem

Provisional Regulations of the PRC Concerning Private Enterprises, *supra* note 34. These provisional regulations were "formulate[d] to encourage and guide the healthy development of private enterprises, [and] to safeguard their legal rights and interests." *Id.* art. 1. Interestingly, limited liability companies, even at this early date, were listed as a type of private enterprise under the purview of the law. *Id.* art. 6.

37. Civil Law, *supra* note 31, art. 2.

38. *Id.* art. 37. The entity must have the necessary funding to bear civil liability and properly register its name, organizational structure, place of business, and designate a person or persons who will represent the enterprise in capacity as a legal person. *Id.* arts. 37 and 38.

39. *Id.* arts. 36, 41.

40. "The most enlightened policies are useless if for some reason they cannot be implemented." Clarke, *supra* note 25, at 3 (elucidating the relationship of economic reform and legal reform). See generally POLICY IMPLEMENTATION IN POST-MAO CHINA (D. Lampton ed., 1987) (providing a collection of studies on the enforcement issue in China).

41. Problems have surfaced in ways that are well known to foreign business persons and stem from a variety of factors. See Margaret L.H. Png, *Equity Joint Ventures in the People's Republic of China: Problems that Continue After More than a Decade Under the Open Door Policy*, 24 Case W. Res. J. Int'l L. 589, 618-20 (1992) (detailing the account of two joint ventures where local authori-

stems from the broad political and economic decentralization that has occurred since the early 1980s.⁴²

In the years after the economic reforms began, the provinces and municipalities accumulated power through the decentralization process.⁴³ A fragmented polity has emerged whereby provincial and local Party officials are able to act independently of the central government.⁴⁴ As the Beijing government gives localities more discretion to meet centrally created production goals,⁴⁵ provincial and municipal authorities tend to enforce national laws and regulations only when the laws benefit their lo-

ties went outside of the Joint Venture Laws to interfere with a manager's employment status in the venture); James D. Zirin, *Markets and the Rule of Law*, FORBES, Sept. 12, 1994, at 114 (stating that the "Chinese court system is capricious, communist and presumptively corrupt"). This could also be due to unfamiliarity by local officials of the new legislation that China has produced. The education process for local officials about new laws sometimes takes years to accomplish. This author, after speaking with several dual U.S. and Chinese licensed attorneys, discovered that the attorneys often had to educate local officials about new laws and registration processes that the local officials were supposed to implement, simply because the officials were unaware of their responsibilities.

42. Clarke, *supra* note 25, at 14. Law-making at the local level gained increased respect in 1985 when the Supreme People's Court of China held that the judiciary would recognize provincial legislation as being applicable in its adjudication of economic disputes. FAZHI RIBAO [LEGAL SYSTEM DAILY], Dec. 11, 1985. Albert H.Y. Chen denotes the extent of local lawmaking when he says that:

The quantity of local regulations which have been made since 1979 is now significant and demonstrates that the PRC law-making system is no longer the highly centralized one which it had been in the period 1954-1978. Thus, in the period 1979-1988, 1,233 pieces of local regulations . . . were made, among which 90.2% were made at the provincial level The content of local regulations is also significant in the sense that some cover topics which, at the time of their enactment, were not yet regulated by national legislation, and hence the local regulations on these topics paved the way for the subsequent enactment of national legislation on the topics.

ALBERT H.Y. CHEN, AN INTRODUCTION TO THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA 87 (1992). This is true for the Company Law.

43. Clarke, *supra* note 25, at 14-15.

44. Mini-kingdoms are created in which province is pitted against province to draw in the perks of state-run industry and foreign investment. See Kevin Murphy, *For Many China Firms, an Order to Sink or Swim*, INT'L HERALD TRIB., Aug. 13, 1993, available in LEXIS, NEXIS Library, IHT File. (reporting that Beijing closed more than 1000 unauthorized development zones which were offering tax concessions and other incentives to encourage foreign investment outside of central government supervision).

45. See Barry Naughton, *China's Experience with Guidance Planning*, 14 J. COMP. ECON. 743, 745 (1990) (discussing China's failure in guidance planning which has resulted in high levels of instability and persistent imbalance of the economy). Local authorities, especially prior to reform, had to fulfill mandatory production targets set in Beijing whether or not they matched with their enter-

cale or when Beijing imposes specific pressure upon them.⁴⁶ The inability of the central government to enforce its legislation is, therefore, a major obstacle to the progress of China's reforms.⁴⁷

3. The Enduring Problem of Judicial Deference to the Party Within China

China's court system plays only a small role within the government hierarchy. The standing of the courts continues to be an impediment to enforcing laws passed by the central government.⁴⁸ Unlike the United States, where judgments in one state are respected by another under the Full Faith and Credit Clause,⁴⁹ the courts of one Chinese province may decide not to enforce an extraterritorial decision when it has a negative im-

prise's capabilities. Wang Haibao, *Greater Power for the Enterprises, in CHINA'S ECONOMIC REFORMS* 67, 67 (L. Wei & A. Chao eds., 1982).

46. See Li Maoguan, *Why "Laws Go Unenforced"*, *BEIJING REV.*, Sept. 11-17, 1989, at 17, 18. "[T]he congruence of interests of the enterprise and its [governing body] means that legal supervision will often be nothing more than self-supervision, with predictable consequences." Clarke, *supra* note 25, at 71. "Where local authorities do not implement the law, remedies are essentially nonexistent." *Id.* But c.f. Seth Goldberg, *Internal and External Forces: Why and How the Major Record Companies Will Successfully Access the Chinese Market*, 7 *N.Y. INT'L L. REV.* 45, 49 (1994) (citing evidence suggesting that Beijing's reluctance to enforce certain laws on a regional basis is due to lack of incentive, not ability). However, "[s]tarting last month with a 16-point plan aimed at tightening credit and regaining control of an economy splintering into regional and municipal power centers, the deputy prime minister, Zhu Rongji, has targeted China's economy for sweeping structural change." Murphy, *supra* note 44.

47. "Now, it is historically difficult to enforce judgments in China . . ." *Dealing with China*, *supra* note 14; see also Andrew Xuefeng Qian, *Why Does Not the Rising Water Lift the Boat? Internationalization of the Stock Markets and the Securities Regulatory Regime in China*, 29 *INT'L LAW.* 615, 627 (1995) ("Indeed, enforcement activity in China is so far not significant, particularly in cases involving overseas investment.").

48. China has four levels of general jurisdiction "People's Courts" and various specialized courts. See Zhonghua Renmin Gongheguo Renmin Fayuan Zuzhifa [Law of the PRC on the Organization of People's Courts] (amended 1983), in *ZHONGGUO FALU NIANJIAN* [LAW YEAR BOOK OF CHINA] 221-23 (Falun Chubanshe [Law Publishing House] 1987). Although they have the putative authority to make cross-jurisdictional and bureaucratic rulings, enforcement is often difficult. See *infra* text accompanying notes 49-53 (discussing enforcement difficulties). The cases reported by China's highest level court, the Supreme People's Court, cannot be cited by lower courts and usually include little or no legal reasoning. Nanping Liu, "Legal Precedents" with Chinese Characteristics: Published Cases in the Gazette of the Supreme People's Court, 5 *J. CHINESE L.* 107, 108 (1991). It was not until 1985 that the Court began to publish cases in the *Zuigao Renmin Fayuan Gongbao* [Gazette of the Supreme People's Court]. *Id.* at 107.

49. U.S. CONST. art. IV, § 1.

pact on an enterprise in the local district.⁵⁰ Because China is a civil law country, local courts do not necessarily follow the decisions of China's highest court in Beijing.⁵¹ Further, the strength of the Party allows local Party officials to subvert court orders without consequence.⁵² A court is dependent on the Party for

50. Yao, *Bingchu Difang Baohu Zhuyi, Yi Fa Weihe Qiye Quanyi* [Get Rid of Local Protectionism: Uphold the Rights and Interests of Enterprises According to Law], FAZHI RIBAO [LEGAL SYSTEM DAILY], Apr. 14, 1989, at 3. The GUANGMING RIBAO [GUANGMING DAILY] conveyed the following report:

It happened that an economic and trade company of Shenzhen made a deal on plywood with the Dalian Liansuo Company. The Dalian company had delivered the payment, but the company in Shenzhen failed to fulfill its part of the contract. In December 1990, the Liaoning Advanced Court ruled that the Shenzhen company must pay the other party a 14 million yuan indemnity, including principal and interest. In 1991, the Dalian Intermediate People's Court filed the case for law enforcement. For three years and more in its wake, the Dalian authorities made four trips to Shenzhen on that matter, but in vain. During the last trip to Shenzhen, cadres and policemen from the people's court forcefully closed down the company concerned in accordance with the law, having found its account number despite the fact that the company had already changed its name. However, when the cadres and policemen began to implement the money transfer, they discovered that the sum had already been transferred in secret under the pretext that the bank had to protect its loans. The cadres and policemen visited around various departments, argued strongly on just grounds, propagated the law, and fought for the support and cooperation of related departments. Pressed by the law and facts, eventually the bank had to cooperate with the court, and transferred the sum to Dalian.

Song Yanrong, *Difficulties in Justice Courts' Law-Enforcement*, Feb. 20, 1995, at 4, translated and microformed on F.B.I.S.-CHI 95-054, *Article Views Difficulty in Enforcing Court Rulings*, Mar. 21, 1995, at 57, 57-58.

51. Even if local courts in China were to follow precedent, it might be years before they would respond to matters in the same fashion as courts in the United States. One commentator noted that with regard to securities laws in the United States, the common law tradition has enabled a "huge web" to develop through the enactment of a series of federal and state laws with subsequent court interpretation of those laws. Qian, *Why Does Not the Rising Water Lift the Boat?*, *supra* note 47, at 625.

52. Usually, judges lack bureaucratic rank within the party and thus authority to enforce the court's judgments against higher level officials. Clarke, *supra* note 25, at 66 (listing problems with China's court system). Although denied by party leadership, there continues to be evidence that local party secretaries and committees review and approve important decisions. *Id.* at 62-63 (stating that, although the official theory is that Party leadership is to be exercised at the level of legislation or general policy making, not in the adjudication of special cases, breaking old habits has proved difficult).

An example of this process in action is enforcement of the Bankruptcy Law of China. See Zhonghua Renmin Gongheguo Qiye Pochanfa [The Law of the People's Republic of China Governing Enterprise Bankruptcy] (1986), in E. ASIAN EXECUTIVE REP., Mar. 15, 1987, at 23, available in LEXIS, NEXIS Library, EASIAN File. Since enactment of the law in 1986, only 2000 of the 29,520 SOEs running in the red have filed for bankruptcy protection. *China Plans New Bankruptcy Law*, WALL ST. J., Dec. 30, 1994, at A5. Through February 1991,

enforcement of its decisions; a court's own enforcement department may refuse to provide the assistance necessary to implement the court's order after issuance.⁵³

Although China has made valiant efforts to reform its legal system in the past decade and a half, courts continue to display slavish obedience to the Party's authority.⁵⁴ In an attempt to combat this problem, Beijing officials have repeatedly called for the separation of the Party hierarchy from the judiciary.⁵⁵ The legal system, however, continues to lag behind the pace of progress in the economy⁵⁶ and it is likely that the Party does not wish to see any real encroachment on its own power. Thus, a judgment obtained by a shareholder/owner of a company against

final dissolution occurred at only one of these state-owned firms. See Clarke, *supra* note 25, at 52 (analyzing the effectiveness of the law in guiding enterprise behavior). China recently began drafting a new bankruptcy law in an attempt to combat this problem. *China Plans New Bankruptcy Law*, *supra*, at A5 (reporting on China's intention to draft a new bankruptcy law to "meet the requirements of a market economy"); see also Qiao Gangliang, *Don't Shy Away From Litigation in China*, *ASIAN WALL ST. J. WKLY.*, Apr. 3, 1995, at 12 (positing that there are three additional reasons why litigation is difficult or not relied on: (1) precedents have no binding effect on lower courts because China is a civil law country, and not a common law country; (2) Chinese courts are inadequately equipped to handle complex litigation; and (3) less-than-expected monetary damages result when a case is decided in favor of the plaintiff because China does not yet recognize indirect and intangible damages); Yungeng Hu & Jeffrey Sweet, *Basics, Not Guanxi, Should Drive China Deals*, *ASIAN WALL ST. J. WKLY.*, Jan. 16, 1995, at 14 (providing an example of a case between Chongqing Industrial and Commercial Bank and the Chongqing Textile Industrial Bureau where, although "a court ruled in favor of the plaintiff and allowed the bank to seize the bureau's property, the court's order proved unenforceable" because local police arrived to protect the government when the bank attempted to seize the bureau's property).

53. Song, *supra* note 50, at 58 (listing the causes for difficulties in law enforcement).

54. See, e.g., William P. Alford, "Seek Truth from Facts"—Especially When They Are Unpleasant: America's Understanding of China's Efforts at Law Reform, 8 UCLÁ PAC. BASIN L.J. 177 (1990) (analyzing the impediments that have impaired and threaten to continue to retard our understanding of Chinese legal development, and seeking to reveal why China's judiciary remains inextricably linked with and subservient to the Communist Party). The courts, furthermore, tend to be staffed largely by personnel who lack knowledge of the proper role of the court system and of legal concepts. *Id.* at 183.

55. See *China Reforms Handling of Civil Lawsuits*, Xinhua News Agency, Aug. 30, 1994, available in LEXIS, NEXIS Library, XINHUA File (explaining China's efforts to handle civil lawsuits in conformity with international practice).

56. "It was learned that, in 1993, more than 100 law enforcement workers were beaten to death or wounded in implementing court rulings across China." Song, *supra* note 50, at 58; see also Donald C. Clarke, *Dispute Resolution In China*, 5 J. CHINESE L. 245, 253-86 (1991) (discussing the in-court and out-court mediation which constitutes the major dispute resolution in China).

its officers and management could be nearly impossible to enforce if it does not benefit the local economy.⁵⁷

The failings of China's People's Court system often results in inadequate legal protection, causing business interests to avoid bringing their cases to court.⁵⁸ Furthermore, although formal litigation seems abhorrent to Chinese cultural tradition,⁵⁹ history shows that given a court system which facilitates litigation, Chinese business persons, similar to their Western counterparts, will sue to redress wrongs.⁶⁰ In the interim, an enterprise's shareholders, whether Chinese or foreign, usually

57. "Some local leaders have intervened in the enforcement of court rulings, proceeding from local, partial interests, and a situation has surfaced in which there are difficulties in enforcement of court rulings in one's own locality, with still greater difficulties in enforcement in cases straddling other localities." Song, *supra* note 50, at 58; see also Marcus W. Brauchli & Joseph Kahn, *Honeymoon's Over*, WALL ST. J., Dec. 2, 1994, at 1 (reporting that the "honeymoon" between China and foreign business is ending because of China's constantly shifting, arbitrary policies and reluctance to pay debts); Joseph Kahn, *Sensitized by China's Unpaid Bills, Banks, Brokers Tighten the Spigot*, WALL ST. J., Dec. 16, 1994, at 16 (relating that foreign banks providing credit lines for Chinese companies to trade futures and foreign exchange on overseas markets, say they expect to curtail their lending sharply in light of disputes over unpaid obligations); *Review and Outlook: Big Mac Meets Big China*, WALL ST. J., Dec. 2, 1994, at 14 (commenting on the difficulties faced by Western companies doing business in China and noting that McDonald's was recently ordered to vacate a site in Beijing in favor of a new development project).

58. One commentator noted:

As a U.S.-trained Chinese lawyer practicing in Beijing, it is my belief that American interests in intellectual-property protection can be best served by engaging Chinese courts, not avoiding them. The value of winning a case under Chinese law goes well beyond specific damage awards, because it puts all Chinese people—consumers and competitors—on notice that foreign businesses will use legal remedies to demand fair treatment from the Chinese legal system.

Qiao, *supra* note 52, at 12.

59. See generally Lucie Cheng & Arthur Rosett, *Contract with a Chinese Face: Socially Embedded Factors in the Transformation from Hierarchy to Market, 1978-1989*, 5 J. CHINESE L. 143, 157-62 (1991) (analyzing the proper role of law in the resolution of contract disputes within Chinese relational communities).

60. See generally Tahirih V. Lee, *Courts and Commercial Dispute Resolution in Early Twentieth Century Shanghai*, 47 U. MIAMI L. REV. 1335 (1993) (telling the story of the courts and the marketplace in Shanghai before 1949 and revealing the significance in the study of the relationship between legal and economic processes).

must rely on mediation and arbitration,⁶¹ or the more common route of *guanxi* (personal connections),⁶² to resolve disputes.

C. IMPETUS, JUSTIFICATION AND THE REVIVAL OF COMPANY FORMATION

1. China's Rising Investor Class as a Motivation for Company Law Enactment

China's move toward company formation is partly motivated by the surge in domestic personal wealth that has occurred since 1978.⁶³ Private citizens in China have \$361 billion in personal savings available for investment.⁶⁴ The Chinese government is attempting to "tap into the well of 'mattress money' that is kept by individuals"⁶⁵ to create more capital for expanding industries. It wants to provide a mechanism to raise

61. See, e.g., Michael Palmer, *The Revival of Mediation in the People's Republic of China: (2) Judicial Mediation*, in YEARBOOK ON SOCIALIST LEGAL SYSTEMS 145, 147 (W.E. Butler ed., 1989) (discussing China's emphasis on extrajudicial, as well as judicial mediation of disputes).

62. Hu and Sweet describe the workings of *guanxi* as follows:

Foreign companies find that, in certain areas of Chinese business, few or no laws apply. In these ambiguous situations, they propose a legal framework for the due diligence process, only to find their Chinese counterparts offering instead *guanxi* to help if anything goes wrong. In the worst cases, false documents are provided through *guanxi* to overcome difficulties. Westerners tempted by these offers would never dream of taking such a leap in their home countries.

Hu & Sweet, *supra* note 52, at 14.

63. The Chinese savings rate is about one-third of the country's gross domestic product, making the Chinese some of the biggest savers in the world. Thomas T. Vogel, Jr., *The Cash Cache*, WALL ST. J., Oct. 2, 1995, at R10.

64. CPC Plenum to Okay China's Ninth Five-Year Plan, Asian Political News, Sept. 25, 1995, at 5, available in WESTLAW, FARNEWS Database; see also Sally Gibson, *Gold Fever Strikes as Chinese Seek Haven for Bloated Savings*, NIKKEI WKLY., May 17, 1993, at 23 (stating that recent demands for gold by the Chinese are due in part to their high levels of private savings). In addition, the lifestyles of Chinese are changing rapidly, with lavish dinners and expensive vehicles becoming more commonplace. See Anne F. Thurston, *A Society at the Crossroads*, CHINA BUS. REV., May-June 1994, at 16 ("Fortunes are now pursued with the same single minded enthusiasm that once characterized political campaigns against landlords and rightists."). Prices for property sold privately have escalated to the point that some areas of the country are more expensive to live in than many U.S. cities. See, e.g., Mitchell Pacelle & Joseph Kahn, *For U.S. Developers, China Offers Opportunity, Risk*, WALL ST. J., Oct. 18, 1994, at B4 (detailing the head-long rush by developers to build office space in China's largest cities). Some commentators believe that China's government sees this trend as a threat to its political legitimacy and ability to lead. Bersani, *supra* note 30, at 304 (explaining China's motivation for privatization).

65. Edward F. Webre, *Companies Limited by Shares—A New PRC Investment Vehicle*, in 1 CHINA'S NEW COMPANIES: NATIONAL FRAMEWORK 2, 5 (Philip Rapp & Nicole Yuen eds., 1993) [hereinafter CHINA'S NEW COMPANIES].

capital from domestic and foreign investors.⁶⁶ A system of shareholding and stock exchanges provides the most effective vehicle for tapping into the vast pool of underutilized capital.

Since 1986, the government has allowed thousands of formerly state-run enterprises to convert to stock companies.⁶⁷ Companies are now listing on the newly-formed Shanghai and Shenzhen stock exchanges, as well as on a few foreign exchanges.⁶⁸ A particularly revealing facet of most of these offerings, however, is that China's government, through its various ministries, maintains a controlling share in the new venture.⁶⁹ The state is thereby able to continue its control over the economy and business operations in China. Accordingly, this new method of privatization is in essence merely a form of limited privatization.⁷⁰ This limited privatization allows the Party to draw on the Marxist principle that so long as the government retains a majority share in the enterprise it remains in the "people's" hands.⁷¹

66. See Torbert, *supra* note 33, at 11-13 (discussing the implications of the Company Law for foreign investors in China).

67. They were created under the then-existing local regulations. Nicole S. Yuen, *Introduction to 1 CHINA'S NEW COMPANIES*, *supra* note 65, at ii [hereinafter Yuen, *Introduction*].

68. See, e.g., Li Hong, *More State Firms Liable for Profits and Losses*, CHINA DAILY, Aug. 12, 1993, at 1 (stating that China plans to transform one-third of its state firms into companies with limited liabilities, many of which will list on the Chinese markets); David Whittall, *Heavy Hitting H Shares: Baring H Share Index*, CHINA BUS. REV., May 1994, at 44 (tracking the development of China's securities market since 1990).

69. Ren Kan, *The State of the State's Shares*, CHINA DAILY, May 3, 1993, at 3 (introducing the three types of shares for domestic shareholders in China).

70. Bersani, *supra* note 30, at 306 (analyzing China's privatization scheme). See generally Andrei A. Baev, *Civil Law and the Transformation of State Property in Post-Socialist Economies: Alternatives to Privatization*, 12 UCLA PAC. BASIN L.J. 131, 185-87 (1993) (discussing the reasons for government control over economies in socialist countries).

This limited privatization also answers some of the "old guard's" concerns that SOE assets will be sold at below value when an SOE is listed on the new exchanges. Yuen, *supra* note 67, at vii (discussing roadblocks to China's privatization drive). Their fear is that the state will lose out financially by selling or transferring its assets to the state-owned turned private enterprises. Beijing attempts to ameliorate these concerns in the new Company Law by providing that state-owned assets cannot be converted at depressed prices. Company Law, *supra* note 12, art. 81.

71. See Bersani, *supra* note 30, at 305-06 (explaining the rationalization of "the basic principle of Marxism that the 'ownership of the means of production' must remain in the hands of the state as surrogate for all the people"). "At the core of the [reforms] will be the separation of government and enterprise—or more precisely, the separation between the Government's economic management functions and its role as the custodian of state assets." Xiao Yu, *China*:

2. The Condition of State-Owned Enterprise as a Motivation for Company Law Enactment

In Western corporate organizations management is accountable to shareholders through the shareholders' voting rights.⁷² Shareholders have a direct monetary interest in the company's profitability and, in theory, will elect new management when the current management fails to act in the shareholders' best interests.⁷³ The possible loss of employment is an inherent motivational reality that spurs management toward profitable business decisions.

China's government now recognizes this aspect of corporate structure as a powerful incentive.⁷⁴ Due to the poor economic performance of SOEs, this motivational force has become a major impetus behind the enactment of the Company Law and China's shift toward a market economy.⁷⁵ A brief examination of China's post-Mao policy on SOE management structure⁷⁶ and the difficulties China faces in developing a market-driven economy helps provide an understanding of the role management

Backing for State Firms, S. CHINA MORNING POST, Nov. 7, 1994, at 4. Beijing is able to squelch the people's demand for investment opportunities, while remaining in control of their investments. Bersani, *supra* note 30, at 306.

72. See, e.g., MINN. STAT. § 302A.437(1) (1994) (establishing the shareholders' right to take action by voting).

73. 2 MODEL BUSINESS CORP. ACT ANN. §§ 7-3, 7-91 (3d ed. 1985).

74. See Peng, *supra* note 9, at 1 (reporting on recent discussions by Chinese economists on the state sector's continued financial difficulties and Beijing's response).

75. David Ho, *China's Company Law: Something Concrete to Go By*, E. ASIAN EXECUTIVE REP., Feb. 15, 1994, at 9, available in LEXIS, NEXIS Library, EASIAN File. By 1956, SOEs made up almost all of the enterprises in the PRC. See Hazard, *supra* note 28, at 179 (discussing the overwhelming prominence of state direction in enterprise development). Today, they continue to account for the largest part of the market. Small state-owned enterprises number more than one million and there are more than 200,000 large and medium-sized SOEs. *State-Owned Enterprises' Development Prospects*, BBC Summary of World Broadcasts, Aug. 12, 1994, available in LEXIS, NEXIS Library, BBCSWB File. They continue to account for almost 50% of the national gross industrial value and 60% of government revenue. *Id.*

76. The Chinese version of an SOE is different from that instituted in the former Soviet Union. The majority of China's SOEs are not held by the central government, but rather by local, provincial, and municipal governments. See Clarke, *supra* note 25, at 5-6 (noting the minimal central commodity planning in China compared to the former Soviet Union). This adds to the difficulties encountered by the central government in enforcing its mandates. See *supra* text accompanying notes 40-47 (noting the tendency of local authorities to only enforce national regulations that benefit their locale).

should play in companies formed under the new Company Law.⁷⁷

By the end of 1994, forty-one percent of China's SOEs were running in the red.⁷⁸ Many commentators on China point to inferior management as one of the most significant factors affecting the poor performance of SOEs.⁷⁹ Substandard management stems in part from the relationship between local Communist Party officials and SOE management.⁸⁰ The Party forces SOE managers, many of whom are Party officials, to walk a tightrope between answering its requests and meeting production goals that originate in Beijing.⁸¹ Managers are, therefore, often unable to focus on the enterprise's profitability. SOE managers must adhere to the interests of local Party officials.⁸² This subordination to the Party leads to widespread inefficiency and corruption.⁸³ Managers are not forced to answer to those who have

77. For a valuable collection of articles on Chinese reforms, see generally *THE POLITICAL ECONOMY OF REFORM IN POST-MAO CHINA* (Elizabeth J. Perry & Christine Wong eds., 1985).

78. *China Plans New Bankruptcy Law*, *supra* note 52, at A5. Forcing China's SOEs into bankruptcy has been difficult. *Id.* According to China's State Economic and Trade Commission, only 2000 of the almost 30,000 state-owned industrial enterprises suffering losses have applied for bankruptcy since 1986, *id.*, despite the fact that by February 1994, SOEs were running at a deficit of more than twenty-nine billion yuan (US\$3.5 billion), Ho, *supra* note 75, at 9.

79. *CPPCC Members on State Enterprises*, Xinhua News Agency, Mar. 11, 1994, available in LEXIS, NEXIS Library, XINHUA File. See Ho, *supra* note 75, at 9 (discussing rationales for the Chinese government's plans to inculcate competition into state enterprises); Michael Hirsh, *China: Anatomy of a Privatization—Yizheng Chemical Fiber*, INSTITUTIONAL INV., April 30, 1994, at 85.

80. An example of this exists in an SOE manager's right to hire and fire employees. "[T]he right to hire and fire appears to exist . . . in name only. Enterprises almost uniformly report that [the] provisions of the State-Owned Enterprise Law cannot be realized in practice" because of the party controls on enterprise. Clarke, *supra* note 25, at 43 (footnotes omitted).

81. See generally *id.* at 45-51 (discussing the ambiguity of provisions making the SOE director the "central" figure in the organization, yet requiring him to "accept supervision" from the Party hierarchy overseeing the enterprise).

82. See Roy F. Grow, *Resolving Commercial Disputes in China: Foreign Firms and the Role of Contract Law*, 14 Nw. J. INT'L L. & BUS. 161, 166 (1993) (describing the changing allegiances of the Chinese factory manager). In doing so, the manager hoped to acquire "more personnel, lower [production] targets, increased pay for workers, and new equipment;" all measures of success for the SOE. *Id.*

83. See, e.g., Rone Tempest, *China: Curious Chinese Make Crime Pay*, GUARDIAN, Nov. 7, 1994, available in WESTLAW, INT-NEWS Database ("Even senior Chinese officials admit that corruption has become rampant since Deng Xiaoping began liberalizing the economy. . . . [T]he special prosecutor's office has handled 2,143 cases of corruption since 1990. The cases involved 41 senior officials, including two ministers."); Thurston, *supra* note 64, at 18 (stating that

a real financial stake in the business's performance—the shareholders.⁸⁴ Beijing recognizes that real accountability to shareholders who can fire substandard management gives SOE leaders the necessary incentive to ensure that they use their best efforts to turn a profit.⁸⁵

3. China's Gradual Shift Toward Company Formation

The Chinese began experimenting with stock companies to satisfy Beijing's call to increase SOE productivity.⁸⁶ The process began in an *ad hoc* manner when China allowed, and in some cases even forced, SOE employees to acquire shares in their SOEs under Party policy decisions.⁸⁷

This slow, deliberate approach was consistent with the usual course of Chinese law making. First, China usually allows provincial and municipal bodies to experiment with various reform measures.⁸⁸ The Beijing government then formulates its own policy at the national level based on successful local regulation.⁸⁹ Beijing followed this approach when it enacted China's new Company Law.⁹⁰

economic reforms are leading to corruption and uncertainty for the people and that "the communist hierarchy has gone topsy-turvy").

84. Ho, *supra* note 75, at 9 (discussing the difficulties with China's past system of SOE management).

85. "[B]ased on the reality of joint-stock enterprises, [we must] work creatively and promote the development of the joint-stock system's standardized operations, so that enterprises constantly improve economic returns." Wang Linhua, *Characteristics of and General Plan for Party Committee's Leadership of Joint-Stock Enterprises*, LINGDAO KEXUE [LEADERSHIP SCI.], Jan. 11, 1995, at 36, 36-37, translated in and microformed on F.B.I.S.-CHI 95-067, *Article on Party Role in Joint-Stock Enterprises*, Apr. 7, 1995, at 33.

86. See *supra* note 78 and accompanying text (describing the inefficiency of SOE's).

87. Jia Zhao & Li Qian, *Trading Stocks in China: Development, Regulation, Issues and Prospects*, E. ASIAN EXECUTIVE REP., June 1992, at 8, available in LEXIS, NEXIS Library, EASIAN File. "These early shares of internal stock resembled bonds. The stock was redeemable at specified maturity dates, could be called by the enterprise, and did not provide the holder with any voting rights." Bersani, *supra* note 30, at 307 & n.12; see also Yuen, *Introduction*, *supra* note 67, at vi (noting the early Chinese experiments in establishing companies limited by shares).

88. Conner, *supra* note 8, at 17 (describing early local statutes).

89. See *id.* (writing about the progression of "Zhao Ziyang's call for the enactment of laws and regulations" protecting private enterprise's interests).

90. See Torbert, *supra* note 33, at 3 (noting experimentation in the creation of the Shanghai and Shenzhen stock markets). A draft Company Law had been in the works for at least ten years. Bersani, *supra* note 30, at 307-08.

China's "long-awaited" securities regulatory framework exceeds the scope of this Note. China's State Council has promulgated securities regulatory pro-

China's State Council⁹¹ created the first nationwide company regulation in 1992.⁹² Although this regulatory measure did not have the status of law from the National People's Congress, it set general guidelines for the shareholder and director relationship in stock companies and was the forerunner of the Company Law.⁹³ By enacting the Company Law, Beijing revamped the regulation and strengthened many of its provisions.⁹⁴

visions that attach to the Company Law. For information on these provisions, see *Fears Over H-Share Rules*, S. CHINA MORNING POST, Oct. 23, 1994, at 4, available in WESTLAW, CHINAPOST Database (discussing the additional provisions affecting joint-stock companies) and *Regulations on Overseas Listing of Stocks*, BBC Summary of World Broadcasts, Oct. 26, 1994, available in LEXIS, NEXIS Library, BBCSWB File (reporting numerous provisions that affect stock marketed outside of China).

91. China's State Council is essentially made up of China's cabinet level ministers and is the highest regulatory body in the country, although it is not capable of enacting laws on the level of the National People's Congress.

92. Yuen, *Introduction*, *supra* note 67, at vi. In 1992, the Shanghai and Shenzhen municipalities and Guangdong Province enacted a series of local regulations meant to provide for and oversee the formation of companies. For these regulations, see Shanghai's *Shanghai Gufen Youxian Gongsi Zhanxing Guiding* [Shanghai Municipality, Companies Limited by Shares Tentative Provisions] (1992), translated in 2 CHINA'S NEW COMPANIES, *supra* note 65, at 2; Shenzhen's *Shenzhen Gufen Youxian Gongsi Zhanxing Guiding* [Shenzhen Municipality, Companies Limited by Shares Tentative Provisions] (1992), translated in *id.* at 30; Guangdong's *Guangdong Gufen Zhi Shidian Zhengce Cuoshi* [Guangdong Province, Experimental Share System Policy Measures] (1992), translated in *id.* at 138. These measures were later enhanced through regulatory provisions in the Guangdong's *Guangdongsheng Gongsu Tiaoli* [Guangdong Province Company Regulations] (1993) (repealing Guangdong Province Special Economic Zone Regulations Regarding Foreign Companies, Oct. 20, 1986), translated in *id.* at 145.

At about the same time, Beijing's State Commission for Restructuring the Economic System issued its own tentative collection of regulations. This is the document that was commonly referred to as the "Opinion." *Guafen Youxian Gongsi Guifan Yijian* [Standards for Companies Limited by Shares Opinion] (1992), translated in 1 CHINA'S NEW COMPANIES, *supra* note 65, at 11 [hereinafter *Opinion*]. "In one sense, China has had a company law since 1979, but only one that applied to joint ventures between foreign and Chinese entities" through the Joint Venture Law. Torbert, *supra* note 33, at 2 (providing an introduction to China's company formation).

93. The Opinion provided for the creation of stock companies that were more akin to Hong Kong's company law than to U.S. corporate law. Bersani, *supra* note 30, at 309 (discussing this relationship). Nonetheless, the Opinion, and therefore the Company Law derived from the Opinion, are similar to United States corporate law.

94. See *infra* note 121 (discussing a weakness of the Opinion); see also Nicole Yuen, *Editor's Notes to CHINA'S NEW COMPANIES: THE NEW COMPANY LAW 50* (Philip Rapp & Nicole Yuen eds., 1994) [hereinafter Yuen, *Editor's Notes*] (stating that the Company Law has more specific provisions than does the Opinion).

II. ENTER THE NEW COMPANY LAW

A. THE COMPANY LAW'S UNDERPINNINGS

The Company Law is another sign of China's shift away from the command economy advanced under Mao⁹⁵ toward one driven by market-oriented forces.⁹⁶ The Company Law provides a legal framework for the protection of individual and institutional investors, whether they are foreign or domestic.⁹⁷ Additionally, the Company Law establishes a mechanism for a

95. See *supra* text accompanying notes 19-30 (providing a history of the policy towards private enterprise in China).

96. See, e.g., Lai, *supra* note 11, at 5 (reporting on the impending stock exchange listing of a major Chinese telecommunications enterprise). Through March 1994, there were more than 7 million registered enterprises in China and, according to official Chinese statistics, 1.44 million of those were "corporate companies with State, collective, Sino-foreign or private investment." Ma Zhiping, *State Eases Restrictions on Forming Companies*, CHINA DAILY, July 1, 1994, available in WESTLAW, INT-NEWS Database. By July 31, 1994, an estimated 54,500 of these 1.44 million enterprises were operational shareholding companies. *Figures Show Shareholding Enterprises Prospering*, XINHUA, Nov. 3, 1994, translated in and microformed on F.B.I.S.-CHI 94-213, Nov. 3, 1994, at 46. In a study by the China Enterprise Evaluation Center, Chinese enterprises recorded greater economic efficiency after they adopted the shareholding system. *Id.*

There is significant confusion inside and outside of China as to what makes a company. An example of the mayhem created by the misconceptions is that many of the farm collectives in rural China are converting themselves into "companies" where the shareholders are the local villagers and the farmers. Interview with Tahirih V. Lee, Associate Professor of Law, University of Minnesota Law School, in Minneapolis, Minn. (Apr. 27, 1995). That these "companies" have shareholders might lead a visitor to believe that they are in fact true companies. This is not necessarily the case, however, because a company is merely an entity created by the state—a fiction for the carrying on of business. If an entity fails to comply with regulations designed to provide for that fiction (the structural faculties and registration procedures laid out in the law) then the "company" is not a company at all, but merely an amalgamation of individuals who are doing business together. A problem develops when another entity or individual attempts to bring a suit against the "company" for breach of contract, or other reason, and finds to its embarrassment that the "shareholders" of that "company" are not registered in compliance with any regulation. The individual or entity is thereafter forced into multiple suits against the "shareholders" of the "company." Visitors would do well, therefore, to seek actual registration documentation from the "company," and go one step further by investigating at the local registry whether the document given them is legitimate.

97. See Preston M. Torbert, *China's New Company Law: Foreign Investment Issues*, E. ASIAN EXECUTIVE REP., Aug. 15, 1994, at 7, available in LEXIS, NEXIS Library, EASIAN File. The Law confers "legal person" status on these companies, thereby making them independent legal entities. See *supra* text accompanying notes 37-39 (setting out the rights and obligations of "legal person" status).

shareholding system to transform state-owned enterprises into market-oriented companies.⁹⁸

The heart of the Law's progressivity is Article 102. It provides that shareholders, rather than the state, "shall be the organ of authority of the company."⁹⁹ Article 14 of the Law,¹⁰⁰ however, retains the spirit of the original model of Communism in China that commentators refer to as the "Chinese characteristics"¹⁰¹ of reform. The provision states that the new "companies must . . . strengthen the establishment of a socialist spiritual civilization, and accept the supervision of the government and the public."¹⁰² Although the statement is probably closer to Maoist hyperbole than to enforceable law, it continues a Party-centered dynamic under which China's court system and administrative agencies will likely operate—and a risk of which investors should be aware.

98. Company Law, *supra* note 12, art. 81. Such a mechanism provides ample justification for the Company Law's formation. See *supra* text accompanying notes 78-85 (discussing the status of state-owned enterprises).

On July 20, 1994, China's State Council released company registration procedures for the Company Law. *Regulations of the People's Republic of China for Administering Company Registration*, Xinhua News Agency, translated and available in, LEXIS, WORLD Library, BBCSWB File [hereinafter Registration Regulations]. The Registration Regulations establish that China's State Administration for Industry and Commerce is in charge of company registration work around the country. *Id.* art. 5. Items needed for a company to register include name, address, statutory representative, registered capital (at least 100,000 RMB), enterprise category, scope of operation, period of business operation and names of stockholders or the name of the promoter of the company. *Id.* art. 9. Under article 3 of the Regulations, a company only receives its coveted "enterprise legal-person business license" once it registers "in accordance with the law." *Id.* art. 3.

99. Company Law, *supra* note 12, art. 102.

100. *Id.* art. 14.

101. See, e.g., Solomon M. Karmel, Note, *Emerging Securities Markets in China: Capitalism with Chinese Characteristics*, 140 CHINA Q. 1105, 1105 (1994) (describing the state's purchase of the majority of newly issued securities in a Chinese company as the "defining characteristic of China's emerging 'capitalism with Chinese characteristics'"); Qian, *Why Does Not the Rising Water Lift the Boat?*, *supra* note 47, at 617 (analyzing "the emerging conflict or inconsistency between some of the uniquely Chinese characteristics" of China's securities regulatory regime); Qian, *Riding Two Horses*, *supra* note 2, at 92 (noting that the "Chinese characteristics" relate to public social welfare functions such as provision of hospitals, eating facilities and pre-school child care for enterprise employees);

102. Company Law, *supra* note 12, art. 14. Some commentators consider this provision closer to canonical law than corporate law because it seems almost ecclesiastical with its spiritual language. Rowan Callick, *China: Credibility of Chinese Laws Under Scrutiny*, AUSTRALIAN FIN. REV., Dec. 9, 1994, at 23. They explain that the provision serves to raise questions about the status of companies in China and the Law's legitimacy. *Id.*

B. COMPANY STRUCTURE UNDER THE NEW LAW

The Company Law creates two classes of companies: limited liability companies¹⁰³ and companies limited by shares.¹⁰⁴ Companies limited by shares are commonly referred to as joint-stock companies.¹⁰⁵ This Note focuses on the Company Law's treatment of these joint-stock companies because of their wide investment potential.¹⁰⁶

The Company Law guarantees a joint-stock company limited liability and provides for the division of its registered capital into shares.¹⁰⁷ Like American corporations, shareholders

103. Limited liability companies are sometimes seen as something akin to closely held corporations in the United States. See Vivienne Bath, *Introducing the "Limited Company,"* CHINA BUS. REV., Jan.-Feb. 1993, at 50, 52-53 (comparing new Chinese security regulations to existing regulations in the United States). "The terminology used in this area can be confusing. . . . [T]he term 'limited liability company,' used in Hong Kong and certain states in the United States, also refers to a form of corporate organization that is treated as a partnership for tax purposes." Bersani, *supra* note 30, at 308 n.16. For an illuminating side-by-side comparison of the two classes of new companies see Preston M. Torbert, *Broadening the Scope of Investment,* CHINA BUS. REV., May-June 1994, at 48, 49.

104. Company Law, *supra* note 12, art. 2.

105. Ho, *supra* note 75, at 9.

106. Limited liability companies must have more than two, but less than fifty shareholders. Company Law, *supra* note 12, art. 20. Only joint-stock company promoters can make public offerings for sale of a company's stock. *Id.* art. 74. Shareholders in both forms of companies are liable to the company to the extent of their capital contribution. *Id.* art. 3. In cases where an SOE is reorganized to become a wholly state-owned, limited liability company that produces products determined by the State Council to be of national importance, or is involved in a similarly special industry, the new company is not obligated to establish a shareholder's general meeting. *Id.* arts. 64, 66. These wholly state-owned limited liability companies must have boards of directors, not simply executive directors. *Id.* art. 68.

107. *Id.* arts. 19-36. The national company regulation China issued prior to promulgation of the Company Law provided that shares could be ordinary or preferred and were to be divided into classes according to the nature of the party that held them. Gufen Zhi Qiye Shidian Banfa [Share System Experimental Enterprises Procedures], arts. 3-4 (promulgated May 15, 1992), translated in 1 CHINA'S NEW COMPANIES *supra* note 65, at 7-8. Pursuant to this regulation, the Commission issued on the same day the Opinion. See Opinion, *supra* note 92.

The Company Law changed direction by providing that all prospective shareholders could purchase stock based on the type offered by the company. Company Law, *supra* note 12, art. 130. The promoters of the new joint-stock company, however, must subscribe to at least 35% of the total number of shares offered, and in the case of enterprises other than a restructured SOE, more than half of the five or more promoters must have their domicile in the PRC. *Id.* arts. 75, 83.

The minimum amount of registered capital, unless provided for in other laws and administrative regulations, is ten million renminbi (\$US1.2 million).

exercise control over their contributions and receive a share of profits from the enterprise¹⁰⁸ in proportion to the number of shares they own.¹⁰⁹ Under the Company Law, shareholders elect directors in accordance with the number of voting shares owned by each shareholder.¹¹⁰

The board of directors¹¹¹ in the newly formed company has the responsibility of appointing and removing management at

Id. art. 78. Upon establishment, a joint-stock company is liable to its creditors up to the value of its registered capital. *Id.* art. 3. After the national or locally responsible body carries out an investment certification and the new company issues share certificates, the promoters have thirty days in which to convene an inaugural shareholders' meeting. *Id.* art. 91. The shareholders must then have at least a yearly meeting to carry out their obligations. *Id.* art. 104.

108. *Id.* art. 103. Shareholders can then assign these shares, subject to certain restrictions, and the company, can repurchase the shares in some situation. *Id.* arts. 143-147, 149. Importantly, an SOE or an entity formed under the Company Law can invest up to 50% of its net assets in another company. *Id.* art. 12. In this way, an SOE actually can have the controlling share in a new enterprise formed under the Company Law. *Id.* Because this 50% figure does not include the profit from asset investment the company returns into the new enterprise to provide additional capital for it to operate, i.e., profit capitalization, an investing company's share of the new enterprise could grow over time. *Id.*

109. Shareholders enjoy rights and assume obligations based on the number of shares owned. *Id.* art. 106. They exert a degree of control over the operations of the company through their ability to attend and vote at shareholders' meetings. *Id.* art. 103. Like shareholders of U.S. companies, shareholders in the new Chinese companies have the right to attend meetings in person or by proxy, inspect corporate records, receive dividends, and receive the residual value of the company's assets in the event of liquidation. *Id.* arts. 108, 110, 177, 195. The shareholders may approve matters involving the company's finances and profit distribution plans, including amendment of the company's articles of association and approval of mergers and liquidations. *Id.* art. 103. More than two-thirds of those shareholders in attendance at the general meetings must adopt amendments to the articles. *Id.* art. 107. If subscribers representing more than half of the total number of outstanding shares are present, the shareholders can meet for the first time. *Id.* art. 92. By a simple majority vote of those in attendance, the shareholders at this inaugural meeting can approve the articles and elect board and supervisory board members. *Id.* art. 92(2)-(4). Shareholders owning 10% or more of the company's equity also have the right to convene an extraordinary shareholders' meeting to discuss important issues. *Id.* art. 104(3).

110. *Id.* art. 103(2).

111. *Id.* art. 112(8)-(10). Unlike the U.S. model, a supervisory board, of which the shareholders and the company's workers elect constituent parts, can oversee the board of directors. *Id.* arts. 124, 126; see *infra* note 130 (discussing the difference between the Chinese supervisory board and audit committees in U.S. corporate law).

A company can have from five to nine directors, with the chairperson the "legal representative" of the company. *Id.* arts. 112-113; see *supra* note 39 and accompanying text (discussing the requirements for legal-person status under the Civil Law). A majority of the directors elects the chair and vice-chair. Com-

its highest level.¹¹² Similar to the bylaws of most United States corporations,¹¹³ the company's articles of association set forth management's rules for operation.¹¹⁴ Shareholders¹¹⁵ elect directors, but cannot remove them except for cause.¹¹⁶

Directors and managers ultimately must answer to shareholders under the Company Law. Accordingly, the members of management are supposed to make decisions based on the best interests of shareholders, instead of the members' or third parties' personal concerns. Article 123 of the Company Law states that "[t]he directors and the manager shall . . . faithfully perform their duties and protect the interests of the company."¹¹⁷ Yet, by simultaneously maintaining the company's duty to the "socialist spiritual civilization,"¹¹⁸ the Company Law provides the Party with a justification for upholding a director or manager's decision that the Party deems to be in the best interests of the country, but not necessarily of the company.

The Company Law sets out several provisions, however, that could ultimately work to protect the fiduciary relations inherent in a corporate setting. The Company Law requires directors to execute their official duties and to protect the company's interests without exploiting their position and power in the company.¹¹⁹ Similarly, the law contains duty of loyalty provisions

pany Law, *supra* note 12, art. 113. The articles of association set forth the arrangement for the "composition, functions, powers, term and rules of procedure" of the board in a joint stock company. *Id.* art. 79(7). A director may serve a term of three years, with reelection possible. *Id.* art. 115.

112. Company Law, *supra* note 12, art. 112(9). The management office, under the direction of the board of directors, runs these companies. *Id.* art. 119. The manager attends the directors' meetings as a nonvoting attendee. *Id.* art. 119. Depending on the company's articles, the board or manager can appoint deputy managers. *Id.* art. 119(6). The promoters, through the company's articles, can vest in the manager hiring and firing authority. *Id.* art. 119(8). The manager can in this way have broader powers than his or her SOE counterparts.

113. See, e.g., MINN. STAT. § 302A.181 (1994) ("Bylaws may contain any provision relating to the management of the business or the regulation of the affairs of the corporation not inconsistent with law or the articles.").

114. Company Law, *supra* note 12, art. 79.

115. See *supra* notes 108-110 and accompanying text (discussing the duties of shareholders).

116. Company Law, *supra* note 12, art. 115.

117. *Id.* art. 123. In the United States, a fiduciary obligation exists when someone has a duty to subordinate his or her own personal interests in favor of another's benefit. BLACK'S LAW DICTIONARY 625 (6th ed. 1990). This "is the highest standard of duty implied by law." *Id.*

118. Company Law, *supra* note 12, art. 14.

119. *Id.* arts. 214-215.

like those found in U.S. corporate law.¹²⁰ Commentators practicing under the common law system see these new provisions as "a step further towards the concept of 'fiduciary duties' under common law."¹²¹

Other provisions in the Company Law also work specifically to protect investors from possible breaches of fiduciary duty. The Company Law sets forth a series of prohibitions that, among other things, disqualify government officials from serving concurrently as directors or general managers,¹²² prohibit directors and managers from taking bribes or accepting illegal income,¹²³ and preclude directors and managers from entering contracts with the company except in limited circumstances.¹²⁴ For example, a director may not contract with the company to supply equipment directly to the company from the director's own business without the authorization of the company's articles or its shareholders.¹²⁵ The Company Law also holds directors, supervisors, and general managers liable for violations of the Company Law's duty of care and loyalty provisions.¹²⁶

Finally, the Company Law requires a Chinese joint-stock company to maintain a supervisory board.¹²⁷ Shareholders and the company's staff and workers elect constituent parts of this

120. Under the Company Law, directors or managers may not engage in the same type of business as the company for which they work. *Id.* arts. 61, 123. For similar U.S. provisions, see *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1599 (1978) [hereinafter *Guidebook*] ("When the corporate director has a material personal interest in a contract or transaction to which the corporation is to be a party, . . . the director should disclose the existence of such an interest.").

121. Yuen, *Editor's Notes*, *supra* note 94, at 50 (discussing the differences between the Opinion and the Company Law). Yuen points out that the weaker regulatory Opinion that preceded the Company Law completely failed in this regard and that China is attempting to make strides toward real fiduciary protections with the adoption of these new provisions. *Id.* The Opinion defined the duty of directors as an obligation to fulfill "earnestly and diligently" their roles as management in the company. Opinion, *supra* note 92, art. 62.

122. Company Law, *supra* note 12, arts. 58, 123. In addition, directors cannot lend or misappropriate company funds, open their own accounts for deposit of company funds, or use company equity as security for debts of shareholders or other persons. *Id.* arts. 60, 123. The Company Law also prevents directors from disclosing company secrets unless allowed to do so by law or according to the shareholders' wishes. *Id.* arts. 62, 123.

123. *Id.* arts. 59, 123.

124. *Id.* arts. 61, 123.

125. Torbert, *supra* note 33, at 7.

126. Company Law, *supra* note 12, art. 63. Under the current state of the court system in China, it is hard to determine the exact loss to the company. See *supra* part I.B.3 (discussing the problems with China's court system).

127. Company Law, *supra* note 12, art. 124.

board.¹²⁸ The board's functions are to supervise staff and ensure that the actions of the directors and management are in compliance with other PRC laws and the company's articles.¹²⁹ The supervisory board has the authority to require a director or manager to "correct" an illegal act or one that violates the joint-stock company's articles.¹³⁰ Overall, the Company Law represents a good foundation for the beginnings of corporate activity in China despite provisions favoring the central government.¹³¹

C. ESTABLISHING FIDUCIARY DUTY: A BASIC RUN-THROUGH OF THE U.S. CORPORATE LAW DUTY OF CARE DOCTRINE

As a point of comparison, U.S. corporate law ensures at least a minimal level of fiduciary protection to minority shareholders through the duty of care doctrine, as limited by the business judgment rule.¹³² The fundamental principle underlying

128. *Id.* Although the promoters set out the general composition of the supervisory board in the company's articles of association, the Company Law requires that the staff and workers elect an "appropriate proportion" of the members of the board. *Id.* In addition, the supervisory board must have at least three members, who serve three years with the possibility of reelection. *Id.* art. 125.

129. *Id.* art. 126(2).

130. *Id.* art. 126(3). In doing so, the supervisory board has the right to examine the company's books and propose interim shareholders' meetings. *Id.* art. 126(1), (4). Like a company manager, supervisory board members must attend meetings of the board of directors as nonvoting attendees. *Id.* art. 126. What effect the supervisory board will have on the amelioration of a breach of fiduciary responsibility in a new company is uncertain.

Although some writers compare these supervisory boards to audit committees in U.S. corporate law, Anthony Tyen & Hong Ying, *Financial Management of China's New Limited Companies*, in 1 CHINA'S NEW COMPANIES, *supra* note 65, at 46, 47, the supervisory boards are very different in their composition. Unlike the composition of supervisory boards, outside directors typically compose entire audit committees. Under the June 30, 1978 New York Stock Exchange listing requirements, for example, employees and officers of the company cannot qualify for committee membership. See *Guidebook*, *supra* note 120, at 1624 n.1. An audit committee's purpose is also much different than that of supervisory boards laid out in the Company Law. Audit committees have four purposes: to recommend an independent auditor; to consult with that auditor; to review the audit; and to consult with internal auditors in conjunction with independent auditor work. *Id.* at 1626-27.

131. Although joint-stock companies have been operating in China for some time now, the government has only recently promulgated measures regulating their establishment and operation. Vivienne Bath, *Introducing the "Limited Company"*, CHINA BUS. REV., Jan.-Feb. 1993, at 50, 50-51; see also *supra* text accompanying notes 69-71 (discussing the limited privatization of domestically traded companies).

132. See *Lutz v. Boas*, 171 A.2d 381, 395-96 (Del. Ch. 1961) (holding that complete abdication of directorial responsibilities breaches the duty of care).

the corporation is that a board of directors as fiduciaries or trustees of the company manage the corporation's affairs.¹³³ In the early case of *Litwin v. Allen*,¹³⁴ a New York court stated that a director is "required to use his independent judgment. . . . He must also exercise some degree of skill and prudence and diligence. . . . In other words, directors are liable for negligence in the performance of their duties."¹³⁵ A director must, therefore, use that degree of care that a reasonable person would exercise in a similar circumstance.¹³⁶

The business judgment rule later qualified this proposition. Stated broadly, the rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."¹³⁷ Applying this rule, courts in the United States generally will not disturb business decisions or "second-guess the board's judgment or find liability for honest mistakes of business judgment."¹³⁸ Shareholders questioning a decision of the board in a derivative action must, furthermore, comply with the "demand" requirement of the board spelled out in *Aronson v. Lewis*¹³⁹ and thereby use their intra-corporate remedies first, before bringing the case to court.

133. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (holding that a board had breached its fiduciary duties to the shareholders when it approved a proposed merger without information regarding the intrinsic value of the company).

134. 25 N.Y.S.2d 667 (N.Y. App. Div. 1940).

135. *Id.* at 677-78.

136. Section 8.30 of the Revised Model Business Corporation Act (RMBCA) contains the Act's standard for directors. Its duty of care provisions state that:

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner he reasonably believes to be in the best interests of the corporation.

REVISED MODEL BUSINESS CORP. ACT § 8.30 (1984).

137. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Therefore, in order to gain the benefit of the business judgment rule, the directors must have had no conflict of interest, gathered prior to the decision a reasonable amount of information, and made the decision in a deliberate and not wholly irrational manner. See *Smith*, 488 A.2d at 872-73.

138. E. Norman Veasey, *New Insights into Judicial Deference to Directors' Business Decisions: Should We Trust the Courts?*, 39 BUS. LAW. 1461, 1464 (1984).

139. 473 A.2d at 811-12. *Aronson* held that a derivative shareholder need not make a demand on the board if "a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Id.* at 814.

The business judgment rule provides directors with great flexibility in making business decisions and makes derivative actions increasingly difficult to maintain in the United States unless there is a gross breach of duty on the part of the directors.¹⁴⁰

III. FIDUCIARY DUTY IN THE OWNERSHIP AND CONTROL OF CHINA'S COMPANIES

Still unclear under China's system of corporate governance is whether the steps taken by the new Company Law will provide sufficient protection to investors, especially minority shareholders in majority state-held joint-stock companies. The Company Law must protect the "lawful rights and interests of companies, shareholders and creditors" if China hopes to use effectively the fiduciary relationship that exists in company settings.¹⁴¹ The Company Law must ensure that minority shareholders in majority state-held companies have a right of recourse to directors or managers who breach their fiduciary duty to the company.

A. AN EXAMPLE AMPLIFYING THE SHAREHOLDER PROTECTION ENIGMA IN CHINA

Recall the inconsistency of Articles 14 and 102. While the Company Law provides that shareholders "shall be the organ of authority of the company,"¹⁴² the Law also mandates that new companies should build the "socialist spiritual civilization, and accept the supervision of the government and the public."¹⁴³ The following scenario illustrates the contradiction this creates.

In August 1995, Ford Motor Company announced plans to purchase a twenty percent equity stake in the Chinese company Jiangling Motors Corporation to produce minivans for the Chinese market.¹⁴⁴ Jiangling is a light-truck manufacturer located in Nanchang, the capital of Jiangxi province in southern China. Ford paid \$40 million for a twenty percent stake in Jiangling when Jiangling issued new shares on Shenzhen's B-share mar-

140. Veasey, *supra* note 138, at 1474-75 (stating that directors do not have to worry when making most business decisions).

141. Company Law, *supra* note 12, art. 1 ("This Law is formulated in accordance with the Constitution in order to suit the requirements of establishing a modern enterprise system.")

142. *Id.* art. 102.

143. *Id.* art. 14.

144. Angelo B. Henderson & Craig S. Smith, *Ford to Purchase 20% Equity Stake in Jiangling Motors*, WALL ST. J., Aug. 23, 1995, at A5.

ket—the only shares that foreigners may purchase.¹⁴⁵ The Jiangling Motors Corporation Group (JMCG) retains a fifty-one percent controlling interest in the corporation with another seventeen percent owned by local investors through Shenzhen's A-share market—shares that only Chinese may purchase.¹⁴⁶ The agreement to purchase the equity stake entitles Ford to three directors on Jiangling's nine-member board and five senior management positions.¹⁴⁷ A Ford spokesperson said that the company could have purchased a greater stake in Jiangling, "but we saw no real advantage in that. We can't get a controlling interest in any case."¹⁴⁸ That interest, of course, stays with JMCG, a state-controlled entity.¹⁴⁹ Jiangling remains a majority state-owned joint-stock company publicly listed on the Shenzhen stock exchange.

Assume that all goes well for Ford in its new venture and that the new minivans become quite popular for domestic Chinese consumers.¹⁵⁰ Jiangling begins to make a profit. In fact, it is so profitable that by the end of the partnership's first year of business, Jiangling has money to spare. Assume that at that point, local Jiangxi officials ask Jiangling's board to make a loan to one of Jiangxi's failing SOEs. In keeping with China's tight money policy of the past few years,¹⁵¹ the SOE has been unable to secure enough credit through its usual channel, the central government. The local officials sell the loan as a way to "strengthen the establishment of a socialist spiritual civilization" and diversify Jiangling's investments.¹⁵² In addition, the officials promise the JMCG majority directors that the SOE will

145. *Id.*

146. Tony Walker, *Ford Skates Around Chinese Freeze—Share-buying Avoids the Joint Ventures Ban*, FIN. TIMES, Sept. 7, 1995, at 34, available in LEXIS, WORLD Library, ALLWLD File.

147. *Id.*

148. *Id.*

149. Christine Chan, *Ford Stake Puts Brakes on Jiangling*, S. CHINA MORNING POST, Aug. 24, 1995, at 4, available in LEXIS, WORLD Library, ALLWLD File.

150. Apparently, at the time of the Ford announcement, Jiangling was not the healthiest of companies. The company had debts of over 2.5 billion yuan, including a 1.9 billion yuan foreign currency loan. Renee Lai, *Jiangling B Shares Raise \$352m*, S. CHINA MORNING POST, Sept. 15, 1995, at 3, available in LEXIS, WORLD Library, ALLWLD File. In addition, its operating profit was down from a year before and the Shenzhen exchange rules did not require the company to make a profit forecast for the subsequent year. *Id.*

151. See Chen & Kahn, *supra* note 7, at A10 (describing China's moves to reign in inflation by cutting off government credit).

152. See Company Law, *supra* note 12, art. 14.

make every effort to pay back the credit. The Jiangxi officials convince the JMCG directors that an operating loan to the SOE, full of would-be unemployed, is the "right" thing to do. Jiangling's board, including the three Ford directors, performs the usual due diligence as to the SOE's credit-worthiness and determines that a loan to the SOE is not in Jiangling's best interests. But because of the symbiotic relationship that exists between the Jiangxi officials and the JMCG directors—and much to the chagrin of the Ford directors—the JMCG directors approve the loan.

As expected, the SOE defaults on the loan and Jiangling is out the money it could have used for development purposes. The Ford directors strenuously objected to the loan, but, in an effort not to waste the good *guanxi*¹⁵³ they have built with local Jiangxi officials, they decide against bringing an action for breach of duty. They realize that "[i]t's going to take time and money [because] [t]he transition is still occurring from a socialist economy to a socialist market economy, and that has its difficulties."¹⁵⁴

Assume further that Jiangling, in spite of the bad loan, continues to be profitable.¹⁵⁵ Other local SOE managers notice, and soon the JMCG directors have approved three more similar loans that are all outstanding and in various stages of default. Tired of what they see as an abuse of discretion by the JMCG directors,¹⁵⁶ and clearly wanting to return to the business of manufacturing minivans, the Ford directors decide to test the Company Law's fiduciary duty provisions in court. They bring a case for breach of Article 123's duty to "protect the interests of the company."¹⁵⁷

153. "In short, Ford is entering traditional joint ventures with key Chinese companies—thereby pleasing a demanding Chinese government and building *guanxi*, or connections—while working hard to modernize and expand those companies." Keith Naughton et al., *Ford Opens the Throttle: It's Challenging Toyota's Dominance in the Far East*, Bus. Wk., Sept. 18, 1995, at 66, 68.

154. Keith Naughton et al., *Ford Opens the Throttle*, Bus. Wk. (Int'l ed.), Sept. 18, 1995, at 24, available in LEXIS, WORLD Library, ALLWLD File.

155. "Amazingly, no listed company has admitted that their [sic] decline in profits could be the result of . . . misguided operating decisions." Shuang Mu, *Seven Listed Companies Report Losses in First Half*, Bus. Wk. (China Daily Supp.), Sept. 10, 1995, available in LEXIS, WORLD Library, ALLWLD File.

156. A similar occurrence is quite likely to happen in more and more situations as Chinese "companies [use] their funds in high-risk stock and futures trading." *Id.*

157. See Company Law, *supra* note 12, art. 123.

This sets up the dilemma for the Company Law. The JMCG directors must decide whether to work toward the company's profitability or answer the requests of the Jiangxi officials. A joint-stock company's business decisions do not "reflect fully those of a shareholding company in the developed countries"¹⁵⁸ because of the Chinese government's presence in the management of Jiangling, and, arguably, in all aspects of the economy.¹⁵⁹

B. THE ILL-EFFECTS OF LIMITED PRIVATIZATION ON CHINA'S CORPORATE SECTOR

The long-term viability and legitimacy of companies in China depends on the ability of shareholders to make the new companies respond to market forces. Unfortunately, the Chinese government, whether on the local or national level, has an overriding influence in economic decisions made by majority state-owned companies.¹⁶⁰ The influence emanates from "Chinese characteristics"¹⁶¹ of reform and the conception of management and control of joint-stock companies that pervades business in China.¹⁶²

Management accountability is viewed in a different light than in fully market-based economies, and management in majority state-owned companies sometimes overlooks the interests

158. Qian, *supra* note 11, at 92.

159. Mr. Jiang Zemin, Communist Party chief, president, military leader, and heir-apparent to senior leader Deng Xiaoping, continues to take a conservative approach to governing China. His speeches have focused on the theme of protecting state enterprise's role as the core to the Chinese economy and building discipline in the Communist Party. Kathy Chen & Joseph Kahn, *Mr. Weather Vane: A Pliant Technocrat is in Line to Become Next Leader of China*, WALL ST. J., Feb. 3, 1995, at A1, A8.

160. According to an interview with Hong Hu, China's Vice Minister of the State Commission for Restructuring the Economy, China is now concentrating on improving the state-owned sector to insure that the "public sector—including the State-owned sector and collectively-owned sector—holds a dominant position in China's economy." *Privatization Not 'Orientation' for Restructuring*, Xinhua, June 20, 1995, translated in and microformed on F.B.I.S.-CHI 95-118, June 20, 1995, at 31 [hereinafter Hong Hu]. Consequently, the state-owned sector plays a leading role in China's economic growth. *Id.*; see also *supra* note 74 (noting that state-owned enterprises continue to take up the largest part of the Chinese economy).

161. See *supra* note 101 and accompanying text (explaining "Chinese Characteristics").

162. See *supra* note 71 and accompanying text (explaining the theory that the government must retain majority shares in joint-stock companies to keep them in the "people's" hands).

of minority shareholders they are supposed to protect.¹⁶³ Concepts such as public disclosure of financial records,¹⁶⁴ accountability to shareholders, and equal shares/equal votes are alien in China.¹⁶⁵ Former SOE managers-turned-joint-stock company directors in companies where the state has a controlling interest too often continue to answer the requests of the state or the Party.¹⁶⁶

China's continuing state control ideology¹⁶⁷ pervades decisions made by the courts and government in China.¹⁶⁸ Government officials within China believe the "joint-stock system is just a property organization form and does not mean private ownership."¹⁶⁹ A possible effect of the relationship between state control and actual private ownership is that the profits in state controlled joint-stock companies have begun to falter, while joint ventures and privately owned companies in China are prospering.¹⁷⁰ A far more deleterious effect, however, is that the state's

163. See *supra* notes 69-71 and accompanying text (discussing the ideological underpinnings of enterprise activity in China).

164. One commentator has stated:

Although Chinese stocks that are listed abroad have to meet local standards on releasing information, 'the level of disclosure is still very poor. . . . [T]here are still massive problems in understanding what is going on with these companies. . . . [D]omestic accounting varies from the international accounting systems, so most companies have two sets of books. Once a year, in theory, you should get accounts that have been audited by international auditors, but there are gaps in those accounts, and it is still a struggle.'

Harvey D. Shapiro, *The Tao of Investing*, HEMISPHERES, Jan. 1995, at 50. Andrew Xuefeng Qian cites modernization of accounting and corporate systems in China as possibly the most important item for China to deal with in internationalizing its securities regulatory regime. Qian, *Why Does Not the Rising Water Lift the Boat?*, *supra* note 47, at 617.

165. Yuen, *Introduction*, *supra* note 67, at v (providing an introduction to possible difficulties China will experience with implementation of company regulation).

166. See *id.* (noting that managers of state enterprises have never had to answer to anyone other than the State or Communist Party).

167. See Hong Hu, *supra* note 160, at 31 ("The State-owned sector controls the lifeline of the national economy and plays a leading role in China's economic growth.").

168. See *supra* part I.B.2-3 (discussing the State's power to influence decisions made by local governments and courts).

169. Hong Hu, *supra* note 160, at 31.

170. See Craig S. Smith, *Profits at China's State-Run Firms Sank in First Half, Reflecting Credit Squeeze*, WALL ST. J., Sept. 5, 1995, at A12 (noting that profits of state companies have plummeted); see also Shuang Mu, *supra* note 155 ("Among 177 Shanghai-listed companies, 89 earned fewer profits compared with the same period of last year. And 30% of companies suffered a 30% slide in profits. Of the 122 Shenzhen-listed companies, only 20% saw a rise in their per share yields.").

overwhelming presence as a company shareholder might render the new Company Law's fiduciary provisions meaningless.

1. Protection of Fiduciary Interests Through Shareholder Meetings?

The Company Law provides a good basis on which to build China's corporate structure.¹⁷¹ When events similar to those in the Jiangling example occur, however, protection for investors is inadequate. Under the Company Law, as in the United States, the shareholders' first line of control and financial protection emerges from their right to vote at company shareholder meetings.¹⁷² Unfortunately, in those companies where a majority of the shares are controlled by a government entity, the meetings are often a rubber stamp for previously decided state actions.¹⁷³

The Company Law, like Western corporate law, effectively excludes minority shareholders from determining the business policies and plans of the company.¹⁷⁴ Although minority shareholders have a right under the Company Law to call an extraordinary board meeting to consider an issue,¹⁷⁵ the shareholders cannot change the course of business decisions made by the board or dismiss a director without cause.¹⁷⁶ Thus, the shareholder's minority status, like that of the Ford directors in the hypothetical, eliminates an important means of recourse against the management of the company through the shareholding system itself.

171. See Ho, *supra* note 75, at 9 (noting that the Company Law gives foreign investors "something more concrete to go by than mere opinions and unpublished rules vaguely quoted by state officials").

172. See *supra* text accompanying notes 73-74 (discussing a shareholder's voting power).

173. "Theoretically investors are supposed to be able to select top officers and managers in a company, influence the annual report, discuss future investment, and so forth. . . . [Y]et a Huadong University Professor of Politics and Law, described a shareholders' meeting he had attended as a 'joke,' followed by a banquet." Karmel, *supra* note 101, at 1113 n.35.

174. Directors are elected by the shareholders; thus, the same situation occurs when minority shareholders attempt to replace certain directors. Company Law, *supra* note 12, art. 103(2).

175. See *id.* art. 104(3) (requiring an extraordinary shareholders' meeting if requested by shareholders owning 10% or more of the company's shares).

176. See *id.* art. 39 (requiring that resolutions be adopted by two-thirds or more of voting shareholders).

2. Protection of Fiduciary Interests Through Supervisory Boards?

A second possible avenue for minority shareholders might come through notifying the company's supervisory board about the situation so that the supervisory board can "correct" the decision.¹⁷⁷

Unfortunately, under the Law a "proportion"¹⁷⁸ of the supervisory board are also shareholders, and most likely majority shareholders. If, as in the Jiangling example, the majority is representative of a state entity that controls the board of directors, the supervisory board's own willingness to remedy a minority shareholder's complaint proves problematic. This is especially true where the head of the supervisory board is a Party member.¹⁷⁹ It is unlikely that the supervisory board will provide recourse for a minority stock owner because the supervisory board in a majority state-controlled company almost always will be made up of Party members.

3. Other Avenues of Possible Fiduciary Protection

Likewise, unless the directors simultaneously serve as government officials or in some other way violate the Company Law's explicit prohibitions,¹⁸⁰ those stipulations do not provide any recourse either. Minority shareholders inevitably have little or no recourse to the management of a majority state-owned company through the channels explicitly provided in the Law.¹⁸¹

The "limited privatization"¹⁸² of companies saps the vitality of a market that could protect minority rights. If a large number of share subscriptions existed such that a majority of the shareholders in the Jiangling example were private individuals or

177. *Id.* art. 126(3). If some minority shareholders are employees of the company, they can be elected by their coworkers to serve on the supervisory board and thereby take up the issue. *Id.* art. 124.

178. *Id.*

179. The Party Committee Secretary, Chairman and General Manager of the Shenyang Materials Development Corporation wrote that in joint-stock companies "party organizations [must] play their role as the political nucleus; and for the party organizations to play this role they must, based on the characteristics of a joint-stock enterprise, carry out and implement the party's line, principles, and policies in the enterprise." Linhua, *supra* note 85, at 34.

180. See *supra* text accompanying notes 119-131 (discussing the provisions of the Company Law).

181. See *supra* notes 108-110 and accompanying text (referring to the power of shareholders to manage the company through their voting power).

182. See *supra* notes 70-71 and accompanying text (discussing China's cautious approach to privatization).

non-state-controlled institutions, the situation could change because private shareholders would theoretically demand profitability in cases where the state would balk.¹⁸³ Because the Party is still prone to serve its own interests when the situation demands, rather than the interests of profitability,¹⁸⁴ minority shareholders in a majority state-owned joint-stock company must turn to China's judicial system or *guanxi* to resolve business disputes.¹⁸⁵

C. JUSTICE THROUGH THE CHINESE JUDICIARY?

Although the decision in the Jiangling example may remain standard in China, it would not be considered "business as usual" in developed countries.¹⁸⁶ Assume that the loan to the fictional Jiangxi SOE would be considered a gross abuse of discretion by U.S. courts. Under the "legal person" status provided for in the Company Law,¹⁸⁷ and guaranteed under China's Civil Law,¹⁸⁸ Ford's minority directors should be able to bring a deriv-

183. For a different view, see Lincoln Y. Rathnam & Viswanath Khaitan, *Privatization: An Investor's Perspective*, PUB. UTIL. FOR., Jan. 1, 1994, at 17 (outlining the benefits of state, as opposed to private ownership). "Investors are generally better off with offerings where 1) the government continues to own a majority of the shares . . . [and] 2) new management runs the business as a business." *Id.*

184. See *supra* notes 86-87 and accompanying text (discussing SOE productivity).

185. See *supra* note 63 (discussing the use of *guanxi* in the everyday business dealings of foreign business persons).

186. Qian, *supra* note 2, at 92.

187. Company Law, *supra* note 12, art. 3; see *supra* text accompanying notes 36-39 (describing the legal person fiction).

188. Included in the Civil Law is a description of the rights and obligations of an agent to their principal, the enterprise legal person. Civil Law, *supra* note 32, ch. IV, § II. Unlike agency principles in the United States, see, e.g., RESTATEMENT (SECOND) OF AGENCY §§ 160-161, 194 (1958), the Chinese principal has the power to repudiate the agent's acts committed outside the scope of the agency relationship:

With respect to acts committed without the power of agency, beyond the power of agency or after the termination of the power of agency, the principal shall bear civil liability therefor only after such acts have been ratified by the principal. The actor shall bear civil liability for any act that has not been ratified. Any principal who is aware that another person is implementing civil acts in the name of the principal and does not make a declaration of repudiation shall be deemed to have consented thereto.

Any agent who fails to perform his duties causing losses to the principal as a result thereof should bear civil liabilities.

Civil Law, *supra* note 31, ch. VI, § II, art. 66. "[A]n agent's acts that are *ultra vires* are, seemingly, not binding on the principal unless the principal ratified or acquiesced to the agent's acts." Gary J. Dernelle, *Direct Foreign Investment*

ative suit as agents on the company's behalf against the JMCG directors.¹⁸⁹ While it appears Ford may have a valid claim against the JMCG directors, that may not be the case in China.

The conflicting language of the Company Law¹⁹⁰ and the subordinate position of the judiciary in China's governmental hierarchy¹⁹¹ hampers a shareholder's legal recourse. Article 123 of the Company Law requires directors and managers to protect the company's interests.¹⁹² This requirement is offset by Article 14's duty to "strengthen the establishment of a socialist spiritual civilization, and accept the supervision of the government and the public."¹⁹³ Due to the difference between the Chinese concept of fiduciary responsibility and that of their Western counterparts,¹⁹⁴ it is doubtful that a Chinese People's Court would find a loan to a failing SOE sufficient to penalize the directors.¹⁹⁵ Moreover, the conflicting language of the Law adds to the difficulty by allowing directors a great deal of flexibility when making business decisions. Chinese courts, especially lo-

and Contractual Relations in the People's Republic of China, 6 DEPAUL BUS. L.J. 331, 344-45 (1994). If such an act occurs, the Civil Law provides that the agent assumes civil liabilities. Civil Law, *supra* note 31, ch. VI, § I, art. 106. These civil liabilities can take several forms and can include compensation for losses. *Id.* ch. VI, § IV, art. 134.

189. Although the Company Law does not set out an explicit provision guaranteeing the right to bring a suit derivatively by a shareholder, especially a foreign minority shareholder, Article 111 of the Law appears to grant that right. Article 111 provides that "[w]here a resolution of the . . . board of directors . . . infringes the lawful rights and interests of the shareholders, the shareholders concerned shall be entitled to apply for an injunction in a People's court to terminate the violation or infringement." Company Law, *supra* note 12, art. 111. When read together with the Civil Law and the Company Law's mandate on directors to "faithfully perform their duties and protect the interests of the company" under Article 123, it appears that minority shareholders can at least bring an injunction against the board for a breach of fiduciary duty and then seek damages on behalf of the company for that infringement.

190. See *supra* text accompanying notes 99-102 (discussing the inconsistencies found in the Company Law).

191. See *supra* part I.B.3 (discussing the status of the court system).

192. Company Law, *supra* note 12, art. 123.

193. *Id.*

194. See *supra* notes 78-85 and accompanying text (detailing the influence the Party exerts on management and how that influence affects management's ability to make independent decisions).

195. See *supra* notes 69-71 and accompanying text (explaining the concept of limited privatization that allows the Chinese government to remain in control of enterprises).

cal ones,¹⁹⁶ likely would uphold the decision of the directors based on the directors' responsibility to the state.¹⁹⁷

Alternatively, in the event that a judge decides to interpret the Company Law to actually create director liability to shareholders for a board of directors' poor business judgment, local Party officials could step in and override the ruling.¹⁹⁸ The Party has ultimate control over court decisions because the Party remains at the top of the Chinese hierarchy. Using the Ford fiction, if the Party believes that the JMCG directors' decision to loan money to the failing SOE was good for the Jiangxi community, Ford is probably not assured of adequate recourse through the Chinese court system. Thus, China's laws "do not adequately protect shareholders, especially the minority shareholders."¹⁹⁹

IV. COMPANIES FOR THE FUTURE

Although the Company Law is Western in form,²⁰⁰ it lacks the substance needed to protect shareholder property rights from fiduciary breaches found in other corporate codes. Unfortunately, there is little possibility that the Chinese legal and regulatory system in its current state will provide that substance.²⁰¹ Judicial and administrative bodies could do so, however, by clarifying the inconsistencies in the Company Law to make management accountable to shareholders through a preferential reading of Article 123's duty of interest to the company over Article 14's duty to the country. Minority shareholders could bring claims to clarify the rights and duties stemming from the language of the law.²⁰² The judicial and administra-

196. For example, local exchange officials in Shanghai were able to protect "big local traders during a bond-futures scandal last February that nearly toppled the city's leading broker." Bruce Einhorn & Dexter Roberts, *China's Other Exchange Reaches for the Spotlight*, Bus. Wk., Sept. 25, 1995, at 106.

197. See Company Law, *supra* note 12, art. 14 (explaining the responsibilities companies have to the state).

198. See *supra* notes 48-62 (referring to the problems created by the Communist Party's influence on the Chinese courts).

199. Qian, *supra* note 2, at 92.

200. See *supra* part II. B (discussing the structure of the Company Law).

201. See *supra* part III.B.2 (noting the Party's influence on companies' supervisory boards).

202. See *supra* notes 58-62 (arguing that it would be beneficial for the judicial system of China if plaintiffs brought their actions to court, rather than try to work through the processes associated with using *guanxi* to resolve disputes).

tive bodies' actual ability to protect shareholders, however, continues to be a matter for the future.

A more timely solution would be for the National People's Congress to ameliorate the problem by striking the inconsistent provisions in Article 14.²⁰³ This would prevent a court or political official from falling back on the language of that article to override the director's duty to the company's interests. The Chinese leadership should simultaneously add a duty of care provision similar to those found in United States corporate law. The Company Law should demand that directors perform their duties "in good faith"²⁰⁴ . . . with the care an ordinarily prudent person in a like position would exercise under similar circumstances[] and . . . in a manner [they] reasonably believe[] to be in the *best interests of the corporation*.²⁰⁵

A Chinese court or administrative agency deciding a duty of care dispute might then use as a model the textbook New York Supreme Court case, *Litwin v. Allen*.²⁰⁶ In that litigation, the owners of thirty-six shares of stock of the Guaranty Trust Company brought a derivative suit against the directors of the Guaranty Trust Company.²⁰⁷ They sought to impose liability on the directors of the Trust Company for losses incurred as a result of a securities purchase the directors made that amounted to a no-risk, low interest loan.²⁰⁸ The plaintiffs asserted that the Trust Company lost \$2.25 million because the loan was unsecured.²⁰⁹ The *Litwin* court held that "the entire arrangement was so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practice."²¹⁰ The court concluded that "[u]nless we are to do away entirely with the doctrine that directors of a bank are lia-

203. See Company Law, *supra* note 12.

204. "This phrase means honestly or in an honest manner. A director purporting to rely upon information which he knows to be untrue will not be considered to be acting in good faith." *Guidebook*, *supra* note 120, at 1601.

205. REVISED MODEL BUSINESS CORP. ACT § 8.30 (1984) (emphasis added). "[B]est interests of the corporation . . . This phrase is an expression of that component of the duty of loyalty involving the corporate director's primary allegiance." *Guidebook*, *supra* note 120, at 1601. This standard is different than that provided by Article 132 of the Company Law because there is no common law negligence type of standard provided in Article 123. See Company Law, *supra* note 12, art. 123.

206. 25 N.Y.S.2d 667 (Sup. Ct. 1940).

207. *Id.* at 675-76.

208. *Id.* at 676-77.

209. *Id.* at 676.

210. *Id.* at 699.

ble for negligence in administering its affairs liability should be imposed in connection with this transaction.²¹¹

Finally, China's reasonable person standard should be viewed not as a reasonable person in China influenced by the effect of political pressure, but by a reasonable person that takes into account what that person as a board member or manager should be responsible for—making the joint-stock company profitable. The Jiangling hypothetical illustrates a situation where minority shareholders could base a claim on the new provisions if they are added by the National People's Congress. Presumably, the financial records and projections of the failing SOE show that the enterprise was not a profitable undertaking for Jiangling.²¹² The directors, therefore, are unable to rely on the business judgment rule to exculpate them from liability because the records clearly show that the SOE would likely default on its repayment obligation.²¹³ If directors are required to "act in good faith," even minority shareholders will be guaranteed a certain amount of protection from dubious director decisions in majority state-owned joint-stock companies. Adding stronger fiduciary provisions to the Company Law will improve the position of all shareholders in the new companies and help to solve the problems associated with the Chinese legal system. This will add legitimacy to the Chinese court system and China's business environment. Directors who breach their duty to shareholders will have to compensate the shareholders, whether foreign or domestic, for losses caused by their negligent or fraudulent decisions.²¹⁴

211. *Id.*

212. The JMCG directors would not meet the standard required by the business judgment rule. That rule provides:

A director exercising his good faith judgment may be protected from liability to his corporation under the Business Judgment Rule. . . . For the Business Judgment Rule to apply, a director must have acted in good faith and with a reasonable basis for believing that the action authorized was in the lawful and legitimate furtherance of the corporation's purposes, and must have exercised his honest business judgment after due consideration of what he reasonably believed to be the relevant factors. The Business Judgment Rule will not apply in situations where conflict of interest or other breaches of the duty of loyalty are present.

Guidebook, supra note 120, at 1604.

213. *See supra* notes 137-140 (discussing the U.S. business judgment rule).

214. *See Company Law, supra* note 12, art. 118 (discussing director liability).

CONCLUSION

China has pursued a revolutionary pace of reform since Deng Xiaoping's assumption of power in 1978. An important part of the reform movement has been the evolution of a corporate form of enterprise common to free-market Western countries. For Beijing to regulate these new creatures and provide a way for the state to deal with bloated SOEs, China promulgated a national framework in the form of the Company Law.

Absent from the new Company Law, however, are provisions ensuring real protection for shareholders who are not associated with the government. Because complete privatization of stock ownership in China is not likely for the foreseeable future,²¹⁵ foreign and domestic Chinese investors in new companies will need enhanced guarantees of fiduciary accountability so that enterprises in which they choose to invest will continue toward profitability and investment growth. Such protection can come about through amendments to the Company Law and the establishment of a legal system that is independent of Party functionaries.

215. As an example of how far China has yet to go, a member of the Chinese People's Political Consultative Conference National Committee said in an interview "that the ongoing reform of state enterprises in China should separate distinct property rights from ownership because enterprise reform has nothing to do with ownership." Wang Yuxia, *Enterprise Reform Separate Issue From Ownership Rights*, *Zhongguo Xinwen She* [China News Agency], Mar. 5, 1995, translated in and microformed on, F.B.I.S.-CHI 95-044, Mar. 7, 1995, at 48 (interview with Rui Xingwen).