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The Chinese Independent Director Mechanism Under Changing Macro Political-Economic Settings: Review of Its First Decade and Two Possible Models for the Future

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THE CHINESE INDEPENDENT DIRECTOR MECHANISM UNDER CHANGING MACRO POLITICAL-ECONOMIC SETTINGS: A REVIEW OF ITS FIRST DECADE AND TWO POSSIBLE MODELS FOR THE FUTURE

CHIEN-CHUNG LIN*

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I. INTRODUCTION

Observing the Chinese independent director mechanism—which was imported into corporate architecture in China beginning in 2001—always incurs confusion as well as conflicting opinions.[1] In a legal context, how this newly-introduced mechanism can work within the dual-board structure as an effective addition to Chinese corporate governance has been at the center of debates among academics. At the macro level, whether the general political and economic conditions in China are ripe enough to accept and utilize the idea of an independent director has also inspired much discussion.

From a broader view, the independent director in China—or even corporate governance in China—is a different story compared to what is observed in many other countries. Strictly speaking, China is not really close to many other developing countries in a traditional sense. The strong government, weak constituency and social norms, and less experienced market simultaneously create a unique arena for corporate governance. In this sense, many lessons from modern corporate law and its designs may apply, but only after modification.

Though some might wonder how the independent director mechanism could be successfully transplanted to China, it has, in fact, been part of the law—and mandatory for all listed companies in China since 2001, which is one year earlier than its introduction in neighboring Japan.[2] To look at this

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[1] The confusion mainly arises from the conflict between the independent director mechanism, a product of Anglo-American corporate governance and single board structure, and the default dual board structure in Chinese company law. In addition, the merit of this newly-introduced legal design and how independent directors would perform the anticipated functions in the Chinese political-economic setting are also at the center of many debates. For more detailed discussion, see *infra* Part IV.2.

[2] Japan started introducing independent directors, along with nomination, compensation and audit committees under boards of directors, in its amendment to its Commercial Code in 2002. For more discussion, see generally, Chien-Chung Lin, *The*

issue from a broader angle, it took just three decades for China to transform itself into the world's second largest economy. Many novel governance structures and corporate law concepts have accompanied this shift from a closed, centralized system to a market-oriented economy.[3]

Taking a more careful look at the Chinese independent director mechanism and its implementation yields interesting results. On the one hand, this newly-introduced mechanism is successfully implemented in all listed Chinese companies; and those companies, willingly or not, are starting to gain experience in choosing the right individuals for this position and helping them function in their role as expected. On the other hand, strong voices criticize Chinese independent directors as dormant or ineffective—while leaving explanations largely unattended. At this point, the result of implementation is mixed, if not totally unsatisfactory.

In most legal mechanisms transplanted from one country to another, it is too optimistic to expect that good governance can be easily achieved without necessary support from other institutions and constituencies. As conditions evolve, possible changes in the design of an independent director mechanism, as well as its observations and explanations, must link to changes in relevant socio-economic conditions. From a practical sense, those structural changes may create new dynamics to overcome the seeming mismatch between an independent director and his or her environment, or provide an opportunity to completely re-design this mechanism to fit the whole structure better.

Before a correct course can be concluded, a careful examination and analysis of the current rules and environment are needed. The structure of this article is as follows: Part II will provide a brief history of the Chinese Economic Reform Era and the basic structure of the Chinese Company Law, and then discuss the legal framework about independent directors in Chinese corporate law. Part III will focus on structural issues of Chinese corporate governance and recent changes, including the modernization of state-owned enterprises, the banking sector, and the stock market. It will highlight the difficulties as well as the possibilities that this mechanism faces in a broader context. Part IV will analyze several different surveys on the results of this new legal design. This section will provide a more comprehensive view on the implementation of the independent director mechanism after its first decade in China. Also, the critiques of this new mechanism will be examined and assessed. Part V begins with an analysis

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Japanese Independent Director Mechanism Revisited: The Corporate Law Setting, Current Status, and Its Explanations, 24 TEMP. INT'L & COMP. L.J. 65 (2010).

[3] For more details about the Chinese Economic Reform Era in general and its accompanying reform in corporate law, see *infra* Part II.A.1.

of the core governance issues China is dealing with today and to what extent the current independent director mechanism is helping to solve those issues. After discussing its current ineffectiveness, this section will propose two possible models in which independent directors can play a role as social, economic, and political conditions continue to evolve in China. The purpose of this analysis is to help answer the question of whether the independent director mechanism is a reasonable choice in light of the current conditions in China and to suggest possible strategies to maximize its efficacy. Part VI will briefly conclude this article.

II. CHINESE CORPORATE LAW AND THE LEGAL SETTING OF THE INDEPENDENT DIRECTOR MECHANISM

A. *The Formation of the Modern Corporate Mechanism*

China, at least according to its constitution, has been a socialist country since 1949.[4] As a result of this historical heritage, highly concentrated stock ownership—controlled directly or indirectly—by the government is still a basic feature of the Chinese corporate landscape today.[5] Although most state-owned enterprises have been transforming into modern companies following the "Company Law of the People's Republic of China" promulgated in 1993 ("Company Law of 1993"), the government, central as well as local, still uses, to different extents, its position as the largest shareholder to designate managers and influence companies.[6] Close ties among the government and companies, both economic and political, remains a serious issue for the modern capitalist structure and creates potential hazards and conflicts for both sides.

The fact that the State is the controlling shareholder in many large

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[4] Even based on the current version of the Constitution which was adopted in 1982, it is stipulated clearly in Article 1 of the Constitution that "The People's Republic of China is a socialist state under the people's democratic dictatorship led by the working class and based on the alliance of workers and peasants. The socialist system is the basic system of the People's Republic of China. Disruption of the socialist system by any organization or individual is prohibited." Also, the term "socialist" or "socialism" has been used repeatedly in the preamble of the Constitution more than twenty times. *See* XIANFA pmbl., art. 1 (2004) (China), *available at* http://www.npc.gov.cn/englishnpc/Constitution/2007-11/15/content_1372962.htm.

[5] For detailed numbers, see *infra* Part III.B.

[6] *See generally* LINDA YUEH, ENTERPRISING CHINA: BUSINESS, ECONOMIC, AND LEGAL DEVELOPMENTS SINCE 1979 (2011) (describing the evolution of the market in China under government reforms since 1979, including the development of corporate law in China as a result of government policy and direction); Yingyi Qian, Enterprise Reform in China: Agency Problems and Political Control, 4 ECO. OF TRANSITION 427 (1996) (describing the reforms of state-owned enterprises in China delegated many control rights to managers while maintaining ultimate control rights for the Chinese Communist Party and government.)

companies and actively exerts its power to name or replace management reflects a unique problem for internal governance. In terms of external governance, the Chinese capital market is still in the process of developing. This means both regulatory techniques and local investors' proficiencies are still lagging behind the desirable level of external checks-and-balances for good corporate governance. The fact that the Chinese capital market is still developing is an important aspect to understanding today's Company Law and corporate governance in China.

Tracing the historical roots of economic reform in China (the "Economic Reform Era") can help illuminate today's issues and where they came from. This analysis will provide a basis for further discussion of the independent director mechanism in China today.

1. Historical Roots of the Economic Reform Era

Before the mid-1980s, most of the production of goods and services in China had been controlled and conducted by state-owned enterprises ("SOEs").[7] At that time, there were no private property rights in a strict sense under the highly centralized planned economic system.[8] The government held all property ownership and managerial rights in SOEs, and the State was the only dominant actor in economic activities.[9] Under that regime, the concept of state ownership not only depressed the growth of the private sector in China, but also concurrently deprived state-owned enterprises of economic and legal independence.[10] The SOE executives were required to fulfill the production plans of the government and the terms "corporation" or "legal person" did not exist at all.[11]

China's market-oriented economic reform started in 1978.[12] During the process of economic reform, a major task was to transform the planned economy, which was previously dominated by state-owned enterprises, into market-oriented, privately owned and run productivity units. Based on the

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[7] *See* Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1, 5 (2002).

[8] Before that, the so-called "people's community system" was the main system which was later replaced by the household responsibility system. *See* SHANGQUAN GAO, TWO DECADES OF REFORM IN CHINA 19 (Wang Yuling, ed. & trans., 1999); STANLEY B. LUBMAN, BIRD IN A CAGE: LEGAL REFORM IN CHINA AFTER MAO 19 (1999).

[9] GAO, *supra* note 8, at 21-22.

[10] *Id.*

[11] *See* Schipani & Liu, *supra* note 7, at 7.

[12] It is generally agreed that the Chinese Economic Reform Era started in December 22, 1978 at the Third Plenary Session of the 11th Central Committee of Communist Party of China held in Beijing. *See* GAO, *supra* note 8, at 19; LUBMAN, *supra* note 8, at 103. For a useful summary, see generally 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, 4-7 (1991).

literature discussing Chinese economic reform, on the enterprise level, the reform can be divided into three stages.[13] Each of these stages represents a gradual shift toward a modern concept of the corporation.

a. Stage One: 1979-1983

The first stage of reform began in 1978.[14] In this stage, the State started economic reform by focusing on rural areas to increase agricultural production, as well as setting up special economic zones and fourteen coastal open cities to receive foreign investment.[15] To reform the traditional SOEs, the key move during this stage was to set up a profit retention system that allowed SOEs to retain part of their profits to use at their own disposal.[16] Before that, SOEs needed to hand in all profits to state authorities. SOEs started to be permitted to exert discretion or autonomy and retain part of their profit when they met state-planning targets, which means that enterprises can pay a certain amount of tax instead of handing over all the profit they created. Similarly, local governments can also retain part of the tax revenue they received to give local governments more incentives to encourage local production as well as township and village enterprises in the countryside.[17] The objective of this tax-for-profit reform, generally speaking, was to gradually substitute a uniform idea of egalitarianism so that enterprises would be responsible for their own profits and losses and could compete on an equal footing.[18]

From the SOE standpoint, this represented the first step of departure from the central planning system where enterprises operated under state mandatory planning and were—in nature—just like divisions of the state

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[13] The classification here is based on observations of the emergence of modern western-style companies. The emphasis is on the enterprise level but does not necessarily coincide with the macroeconomic view. Other classifications have been introduced based on different viewpoints. For example, Gao divides the Chinese Economic Reform Era into three stages. The first stage was from December 1978 (the third Plenary Session of the 11th National Congress of the Communist Party of China) to September 1984, which focused on rural areas and established the household responsibility system and township enterprises. The second stage was from October 1984 (the third Plenary Session of the 12th National Congress of Communist Party of China) to December 1991, and expanded from rural areas to urban areas and focused on the reform of state owned enterprises. A system of contracts on enterprise leasing was introduced and management responsibility was set up in this period. The third stage was from January 1992 to the present and aimed at establishing a socialist market economy. Its core purpose was to replace fiscal contract systems with a tax-sharing system, and many other structural adjustments were implemented. GAO, *supra* note 8, at 19-21.

[14] *Id.* at 19.

[15] *Id.*

[16] *Id.*

[17] LUBMAN, *supra* note 8, at 103.

[18] *See* GAO, *supra* note 8, at 22.

administrative apparatus.[19]

b. Stage Two: 1984-1993

The second phase of reform shifted its focus to reform SOEs more extensively. From 1984 to 1993, the SOE reform was shaped by a wish to encourage the expansion of production and profit, which was obviously a reaction to the low productivity of traditional SOEs when compared with vibrant small township and village enterprises. The centerpiece of SOE reform in this stage was the adoption of the "Contract Management Responsibility System."[20] This system abandoned the pursuit of a standardized, generally applicable rate of state-enterprise division-of-enterprise profits.[21] Instead, its aim was to allow the SOEs to keep all of the above-base profits (in which the base was adjustable), and then endow more autonomy to SOEs' managers in setting their specific business goals and strategies.[22] The essence of this stage of reform was to further separate ownership and control but at the same time keep the bargaining process formal rather than ad hoc. In most cases, the State represented all outside interested parties through a unified contract-issuing committee and negotiated a contract with all inside members represented by management.[23] In the bargaining process, quite understandably, serious problems occurred, such as exploitation by informational asymmetry. Moreover, management tended to take more risks and over-expand in good times and ask for re-negotiation when the situation turned in the opposite direction. In short, while trying to conceive a more reasonable division of profit sharing between SOE managers and the State, the State still remained ultimately responsible (legally and economically) for rescuing SOEs—a need which became more frequent after a decade of reform.[24]

In response to the problems created by the Contract Management Responsibility System, policymakers devoted a lot of effort to further separate ownership rights from management rights in SOEs, to allow

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[19] Dic Lo & Russell Smyth, *Industrial Restructuring and Corporate Governance in China's Large-Scale State-Owned Enterprises*, *in* CHINA'S BUSINESS REFORMS: INSTITUTIONAL CHALLENGES IN A GLOBALIZED ECONOMY 11, 19 (Russell Smyth et al. eds., 2005).

[20] Also called "Contract Responsibility System" or "Contract System." For a general discussion of the Contract Management Responsibility System and how it changed SOEs, see generally Chongwoo Choe & Xiangkang Yin, *Contract Management Responsibility System and Profit Incentives in China's State-Owned Enterprises*, 11 CHINA ECON. REV. 98, 98-112 (2000).

[21] *Id.* at 101-02.

[22] *Id.*

[23] *Id.* at 102.

[24] *Id.*

managerial independence and to allow the State to transform itself into a major shareholder while bringing in more private investment domestically and abroad.[25] This effort combined the desire to promote productivity and retain ultimate control over large SOEs. This process was institutionalized by a major piece of legislation.

In 1988, China promulgated the Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People, also known as State-Owned Industrial Enterprises Law of China, or shortened as "SOEs Law."[26] The basic idea of the SOEs Law was that it delegated overall responsibility of managing SOEs to factory managers.[27] In this regard, managers became the legal representatives of the enterprise. Additionally, the law required the establishment of a management committee or other consulting bodies to assist the factory manager in making decisions on important issues.[28] The SOEs Law also provided that the local organization of the Chinese Communist Party should guarantee and supervise the implementation of the guiding principles and policies of the Communist Party and the State.[29] From a broader view, the SOEs Law was the experimental, and primitive, form of the general Company Law of 1993. It represented the first attempt to formalize the relationship among managers, the State, and employees into the framework of legal rules.[30]

However, reform in this stage, along with the SOE Reform, faced several serious challenges. First, as mentioned above, the process of negotiation and re-negotiation of profit-retention implicated both difficulty in predicting the future precisely to decide the amount of profit-sharing in advance and difficulty in avoiding opportunistic behavior ex post. Second, as one commentator points out, the exploitation of SOE assets for personal

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[25] *See* Yueh, *supra* note 6, at 32-36 (discussing the policy shift of the Chinese government in the early 1990s to allow SOEs to become independent legal entities); GAO, *supra* note 8, at 130-31.

[26] Zhong Hua Ren Min Gong He Guo Quanmin Suoyouzhi Gongye Qiye Fa (中华人民共和国全民所有制工业企业法) [Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People] (promulgated by Nat'l People's Cong., April 13, 1988, effective Aug. 1, 1988), http://chinalawinfo.com [hereinafter SOEs Law]. Before the enactment of Company Law of 1993, the SOEs Law of 1988 was the main governing law on the issues of business organization and the operation of state enterprises in China. For an introduction on SOEs Law, see Schipani & Liu, *supra* note 7, at 9-11.

[27] SOEs Law, *supra* note 26, at art. 7.

[28] *Id.* at art. 47.

[29] *Id.* at art. 8.

[30] However, as an interim legislation which covered SOEs only, it was incapable of laying a foundation for future business development in China as there was still much inconsistency and confusion. After the enactment of Company Law of 1993, many SOEs transformed themselves into corporations with legal person status and thus are no longer subject to SOEs Law.

use and the insufficient amount of SOE profits retained for development purposes both represent difficulties for the long term development of SOEs.[31]

2. The Current Regime: Company Law of 1993 and After

The third stage of reform was signaled by the enactment of the Company Law of 1993.[32] This law was enacted to address the problems inherent in the basic conflict of state capital and private ownership structure that could not be completely resolved in the previous stages of reform. The basic idea of this stage of reform was the corporatization of SOEs. By transforming SOEs into different kinds of limited liability companies or shareholding companies, governments, both central and local, would delegate more freedom to managers and continue to enhance productivity. But, on the other hand, it also helped the State retain control through its status as the largest shareholder while shielding the State from the survival or loss of the enterprise. In a more general sense, the Company Law of 1993 retrospectively provided a new legal form through which to consolidate various transitional forms that had emerged during the earlier stages of reform and aimed to bring in small amounts of private capital or foreign investment, which was necessary for further development.[33]

The impact of the introduction of the modern company in China is multifaceted. With the goal of transforming SOEs into companies with a modern organizational form, the Company Law of 1993 established a new relationship between the State, managers, and workers in which the capital owner (at that time, mostly a manager at the same time) has better legal protection. Also from a legal perspective, the status of an independent legal entity provided a foundation for increased managerial freedom. The formation of a separate legal enterprise entity also helped to strengthen the confidence of general investors about state neutrality, which in turn helped to increase the influx of new outside capital.

However, the Company Law of 1993 brought not just better legal protection to investors/managers and an influx of private capital. Under the Constitution, the Socialist State implies an implicit contract in which the State is obliged to guarantee job security and a certain level of social

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[31] Schipani & Liu, *supra* note 7, at 11-12.

[32] Zhong Hua Ren Min Gong He Guo Gong Si Fa (中华人民共和国公司法) [Company Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, effective July 1, 1994) http://chinalawinfo.com [hereinafter Company Law of 1993].

[33] For an introduction to the earlier experimental legislations during the prior stage of Chinese economic reform, see Roman Tomasic & Jian Fu, *Company Law in China*, *in* COMPANY LAW IN EAST ASIA 135, 155 (Roman Tomasic ed., 1999).

welfare. With the corporatization of SOEs and the delegation of managing power, the dynamics changed. Especially under the drive for profit, a large number of former SOEs started substantial downsizing and lay-offs.[34] This trend, in turn, reshaped the role of the State and triggered social discontent.[35] Many scandals were reported in the process of corporatization of the SOEs. The selling of state assets cheaply, misuses of funds from the sale of assets, and political corruption presented severe challenges to the Chinese government.[36]

However, a new class of capitalists has been emerging ever since the advent of the Company Law of 1993 and they have begun to gain their own standing free from governmental control. In this light, the interplay between the State—as regulators and at the same time major shareholders in some cases—and companies has started to inevitably move toward a more rule-based legal form, and this leads to further dependence on the development and implementation of the Company Law of 1993 and relevant business regulations.

B. *Chinese Company Law: Basic Structure and Rules*

The current Chinese Company Law was first enacted in December 1993 and came into effect in mid-1994. Along with the Securities Law of the People's Republic of China (promulgated in 1998, hereinafter "Securities Law"),[37] these two statutes constitute the regulatory foundation of modern corporations in China. The Company Law of 1993 contains 11 chapters and 230 articles, and was the first comprehensive piece of legislation on business corporations since the founding of the People's Republic of China in 1949. The purposes of these laws were to set up the basic legal structure for the development of private business, to provide a modern corporate legal system which is more responsive to a market economy, and at the same time to solve the problems left over from the reform of SOEs. As the first piece of national legislation in modern China dealing with the corporate form, the Company Law of 1993 was generally considered to be

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[34] *See* Donald C. Clarke, *Regulation and Its Discontents: Understanding Economic Law in China*, 28 STAN. J. INT'L L. 283, 289-90 (1992).

[35] One of the most famous incidents was the Tiananmen Square protests of 1989. For details, see generally PHILIP CUNNINGHAM, TIANANMEN MOON: INSIDE THE CHINESE STUDENT UPRISING OF 1989 (2010).

[36] *See generally* XIAOBO LÜ, CADRES AND CORRUPTION: THE ORGANIZATIONAL INVOLUTION OF THE CHINESE COMMUNIST PARTY 190-227 (2000) (providing a clear account of the reported corruption involving government/party officials in China in the 1990s).

[37] Zhong Hua Ren Min Gong He Guo Zheng Quan Fa (中华人民共和国证券法) [Securities Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999, amended in 2004 and 2005 respectively) http://chinalawinfo.com [hereinafter Securities Law].

strongly influenced by German and Japanese corporate law, although several other countries' legal systems are also referenced.[38] From the lens of comparative law, China's corporate law has a relatively simple structure and involves many rules similar to Western company laws, but still possesses a socialist tint.[39]

The Company Law of 1993 experienced two minor amendments in 1999 and 2004.[40] On October 27, 2005, after one and one half years' preparation and deliberation, the Eighteenth Session of the Standing Committee of the Tenth National People's Congress promulgated a revised Company Law (hereinafter "Company Law of 2005" or "Company Law") which came into effect on January 1, 2006. In the Company Law of 2005, the general framework and rules of the previous version were preserved, roughly 40 articles were modified, and the total number of articles slightly downsized to 219 articles.[41] These changes mainly include the lower legal capital requirement,[42] improvement of the corporate governance structure (especially strengthening the power of the board of supervisors),[43] a more clearly defined directorial fiduciary duty,[44] and rules concerning shareholder suits.[45] The aim of this revision was to adjust the previous laws to fit current needs. But in general, as mentioned earlier, while the Company Law of 2005 is considered an adjustment or refinement of the Company Law of 1993, it does not present any fundamental change either

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[38] It is often mentioned that the Company Law of 1993 was under certain influence from German corporate law, especially in light of its two-tier board structure. *See* Schipani & Liu, *supra* note 7, at 15; Robert C. Art & Minkang Gu, *China Incorporated: The First Corporation Law of the People's Republic of China*, 20 YALE J. INT'L L. 273, 295 (1995). But if examined more closely, Chinese company law bears more similarity to Japanese as well as Taiwanese corporate law. For a recent general discussion of the Japanese Companies Act, see generally Lin, *supra* note 2, at 78-86.

[39] Art & Gu, *supra* note 38, at 274-75.

[40] The first amendment, which amended two articles, was promulgated on December 25, 1999 and became effective on the same day. The second amendment, which amended only one article, was promulgated on August 28, 2004 and became effective on the same day. As all amendments are incorporated into the original text, all articles are cited according to the latest version unless noted otherwise. Records of amendments can be found in the preamble of the current statute. Details of these amendments, which are available in Chinese only, can be accessed through the links which appear in the preamble of the statute provided by the Chinalawinfo website. *See* Company Law of 1993, *supra* note 32 (click "English" version on the top-right first, then "Basic Law" on the left and then search for "company law").

[41] Zhong Hua Ren Min Gong He Guo Gong Si Fa (中华人民共和国公司法) [Company Law of the People's Republic of China (2005 Revision)] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), art. 3 http://chinalawinfo.com [hereinafter Company Law of 2005].

[42] *Id.* at arts. 26, 81.

[43] *Id.* at arts. 54, 55.

[44] *Id.* at arts. 148-150.

[45] *Id.* at arts. 152-153.

in structure or to the rules themselves.

This section will provide an overview of the Company Law of 2005 and highlight the significant differences between the Company Law of 1993 and the Company Law of 2005.

1. General Feature

The Company Law keeps a high degree of similarity to many modern corporate laws. Fundamental characteristics, such as independent legal entity status, shareholders' limited liability, and shareholders' right to choose managers and central management, are stipulated.[46]

2. Types of Companies

The Company Law recognizes only two types of corporations: the closely held corporation (you xian ze ren gong si) and the publicly held corporation (gu fen you xian gong si).[47] The principal differences between these two types of companies are: (1) the former is limited to fifty members and the latter does not have an upper limit;[48] (2) the former has limitations on transferring shares;[49] and (3) the former is limited in its ability to raise funds from the general public.[50]

On the other hand, governing bodies in closely and publicly held corporations are substantially the same. They are also permitted to convert from one type of company to another once the criteria of the form being converted to are met.[51]

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[46] Many issues surfaced in Chinese corporate law when the Company Law of 1993 was enacted. The reason for this predicament was partly due to the ideological restrictions on the concept of private property in China, which had been a socialist country and was still struggling to transform itself into a market economy at the time when Company Law was enacted. Another reason for this was the existence of extensive state owned capital in China and the difficulty in accommodating it to a market economy. This background led to the unique split-share structure as a compromise. For further discussion, see *infra* Part III.A.1.

[47] Company Law of 2005, *supra* note 41, at art. 2. This categorization varies according to different translators. Some refer to them as a "Limited Liability Company" or a "Joint Stock Limited Company." *See, e.g.*, Tomasic & Fu, *supra* note 33, at 155; LIN FENG ET.AL, COMPANY AND SECURITIES LAW IN CHINA, 11, 31 (2001). According to the official translation provided by National People' Congress, they are referred as "company with limited liability" and "company limited by shares" respectively. For an additional English translation of Company Law, see *Companies Law of the People's Republic of China,* DATABASE OF LAWS AND REGULATIONS, http://www.npc.gov.cn/englishnpc/Law/Frameset-index.html (follow "Civil And Commercial Laws" hyperlink; then follow "Companies Law of the People's Republic of China" hyperlink) (last visited Apr. 18, 2012).

[48] Company Law of 2005, *supra* note 41, at art. 24.

[49] *Id.* at art. 72.

[50] *Id.* at arts. 23, 78.

[51] *Id.* at art. 9. Within each category of the corporation there are special provisions

3. *Basic Corporate Organs*

The Company Law requires three statutory—and indispensable—corporate governing bodies to form corporations: (1) the shareholders, acting as a body at the general meeting; (2) the board of directors; and (3) the board of supervisors.

4. *Shareholder Meeting*

First, Article 4 of the Company Law lays the foundation for corporate governance by stating that the shareholders are empowered to make major decisions and select management personnel.[52] Further, in Articles 38 and 100, the powers endowed to the shareholders in a shareholder meeting mainly include the power to: (1) decide management policy and the investment plan, company elections, and the removal of directors and supervisors;[53] (2) amend corporate charters;[54] (3) approve the annual budget,[55] the directors' and supervisors' reports,[56] and the plan of profit distribution;[57] and (4) make other important decisions such as mergers, divestiture, liquidation, dissolution or other structural changes,[58] increase or

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applicable to subcategories, organized according to the corporation's ownership structure. They include: (1) wholly foreign-invested enterprises; (2) Chinese-foreign equity joint ventures; and (3) Chinese-foreign contractual joint ventures. These types of foreign-invested corporations are governed by three separate laws: the "Wholly Foreign-invested Enterprises Law" of 1986 (also called "Law of the People's Republic of China on Foreign-Capital Enterprises," enacted on April 12, 1986), the "Chinese-foreign Equity Joint Ventures Law" of 1979 (also called the "Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures," enacted by the National People's Congress on July 1, 1979), and the "Chinese-foreign Contractual Joint Ventures Law" of 1988 (also called the "Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures," enacted on April 13, 1988). The relationship between Company Law and these three statutes is still unclear. Generally, it is believed that these three laws will prevail. But as China joined the WTO in 2001, it is now obligated to provide national treatment to foreign investors coming from other WTO member countries. It is also expected that the statutes regulating foreign investments will be repealed and Chinese-invested corporations and foreign-invested corporations will be governed by the same corporate governance norms. Schipani & Liu, *supra* note 7, at 19-21. However, these three laws are still effective up to this date.

[52] In fact, the word used in Article 4—on its face—is to allow shareholders to "participate" in major decisions but not "make" major decisions. The interpretation of "make major decisions" is based on the stipulation of Article 38 (which is also applied to publicly-held companies according to Article 100). However, the difference in the wording between these two articles implies a possible uncertainty in terms of dividing the decision-making power between shareholders and the board of directors. Company Law of 2005, *supra* note 41, at arts. 4, 38, 100.

[53] *Id.* at art. 38, paras. 1-2.

[54] *Id.* at art. 38, para. 10.

[55] *Id.* at art. 38, para. 5.

[56] *Id.* at art. 38, paras. 3-4.

[57] *Id.* at art. 38, para. 6.

[58] *Id.* at art. 38, para. 9.

decrease corporate legal capital,[59] and issue corporate bonds.[60]

In terms of voting, the assignment of voting rights is accorded to the amount of capital invested in a privately-held company,[61] and in a publicly-held company (joint stock company), "one share, one vote" is the default rule.[62] Shareholder meetings should be held annually and are subject to interim meetings if certain conditions are met.[63]

5. *Board of Directors*

The board of directors is responsible to the shareholders in terms of carrying out the company's business and bears ultimate responsibility to the shareholders.[64] In Article 47, the Company Law stipulates that the authority of the board of directors includes the abilities to "carry out the resolution made by shareholder meeting,"[65] to decide on the business management and investment plan,[66] and to choose managers.[67] Also, the board of directors is responsible for preparing proposals for the shareholders during the meeting. The proposal subjects include the company's annual budget,[68] profit distribution,[69] an increase or decrease in the company's capital,[70] issuance of corporate bonds,[71] setting up internal departments[72] and the company's internal management systems and regulations,[73] as well as other major structural changes including mergers, divestitures, and the company's dissolution.[74]

In general, the directors and managers of a company shall abide by the

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[59] *Id.* at art. 38, para. 7.

[60] *Id.* at art. 38, para. 8.

[61] *Id.* at art. 43. However, proportionate voting power in privately-held companies is subject to change by amending the articles of incorporation. *Id.*

[62] Company Law of 2005, *supra* note 41, at art. 104.

[63] *Id.* at art. 40. For privately-held companies, one tenth of the shareholders, one third of directors, or the supervisor/board of supervisors can demand an interim shareholder meeting. *Id.* at art. 101. For publicly-held companies, in addition to the conditions mentioned above, an interim shareholder meeting should be convened if (1) the number of incumbent directors is less than two-thirds of the stipulated number; or (2) accumulated losses reach one-third of the received capital. *Id.*

[64] *Id.* at art. 47.

[65] Company Law of 2005, *supra* note 41, art. 47, para. 2.

[66] *Id.* at art. 47, para. 3.

[67] *Id.* at art. 47, para. 9.

[68] Company Law of 2005, *supra* note 41, at art. 47, para. 4.

[69] *Id.* at art. 47, para. 5.

[70] *Id.* at art. 47, para. 6.

[71] *Id.*

[72] *Id.* at art. 47, para. 8.

[73] *Id.* at art. 47, para. 10.

[74] Company Law of 2005, *supra* note 41, at art. 47, para. 7.

provisions of the articles of association, faithfully perform their duties, protect the interests of the company, and may not exploit their positions or powers to seek personal gain.[75] This is generally interpreted as the source of the "duty of loyalty" and "duty of diligence" in the Company Law. These duties also apply to supervisors and managers and a breach of these duties will incur civil liability.[76]

The number of directors is three to thirteen in a closely held company,[77] and five to nineteen in a publicly held company.[78] The term of a director is up to three years.[79] It is also required by law to have at least two board meetings a year in a publicly-held company.[80] One thing of particular interest concerning the board of directors in Chinese corporate law is the employee representative on the board. According to the current rule, it is encouraged to have an employee representative on the board as a director in both publicly- and privately-held companies.[81] If the privately-held company is formed by more than two SOEs, it becomes required to have an employee representative as a board member.[82] In addition, a smaller privately-held company can have only one executive director, instead of a whole board, to carry out its duty if the corporate charter considers it appropriate.[83]

6. Board of Supervisors

According to Articles 52 and 118 of the Company Law, the board of supervisors is made up of at least three individuals.[84] The board of supervisors should have at least one-third of its members be representatives of employees and workers,[85] and the remaining members are to be elected by the shareholders. The specific proportion of worker representatives shall be provided for in the articles of association.[86] The worker

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[75] *Id.* at art. 148.

[76] *Id.* at art. 150.

[77] *Id.* at art. 45.

[78] *Id.* at art. 109.

[79] *Id.* at arts. 46, 109.

[80] Company Law of 2005, *supra* note 41, at art. 111. The same requirement does not apply to a privately-held company.

[81] *Id.* at arts. 45, 109.

[82] *Id.* at art. 45. Please note that the same requirement does not apply to a publicly-held company.

[83] *Id.* at art. 51.

[84] *Id.* at arts. 52, 118. However, it is permissible for a privately-held company to avoid forming a board of supervisors and have one or two supervisors instead. *Id.* at art. 52, para. 1.

[85] *Id.* at arts. 52, 118.

[86] Company Law of 2005, *supra* note 41, at arts. 52, 118.

representatives shall be elected by workers through an employee meeting or union, or other democratic processes.[87]

The function of supervisors, according to Article 54 and Article 119 of the Company Law, is to supervise the board of the directors. Its powers include: (1) investigating the company's financial affairs;[88] (2) supervising acts undertaken by directors and managers during the performance of their duties and proposing to remove directors or managers when a serious breach occurs;[89] (3) requesting directors or managers to rectify conduct which is harmful to the interests of the company;[90] (4) proposing an interim shareholder meeting;[91] (5) bringing forth a motion in a shareholders' meeting;[92] (6) filing derivative suits against directors when a director breaches his or her duty to abide by the law, administrative rules, or articles of corporate charter;[93] and, (7) carrying out other powers stipulated in the corporate charter.[94] Based on Article 55, supervisors can be present in the board of director' meetings, and make recommendations or challenges to the decisions of the board of directors.[95] Also, the board of supervisors has the right to conduct investigations when an irregularity is spotted.[96]

The term of a supervisor is three years.[97] In convening a meeting for the board of supervisors, in a closely-held company, it is mandatory for supervisors to meet at least once a year.[98] In a publicly-held company, supervisors are bound to meet at least every six months.[99] Supervisors are subject to all the duties and liabilities applicable to directors and managers, such as the duty to abide by the laws and regulations, the duties of good faith and diligence, and restraint on self-dealing.[100]

7. *Divisions of Power Among Corporate Organs*

Despite the seemingly clear-cut nature of the corporate powers of different corporate organs, two somewhat blurred areas are the division of

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[87] *Id.*
[88] *Id.* at art. 54, para. 1.
[89] *Id.* at art. 54, para. 2.
[90] *Id.* at art. 54, para. 3.
[91] *Id.* at art. 54, para. 4.
[92] Company Law of 2005, *supra* note 41, at art. 54, para. 5.
[93] *Id.* at art. 63.
[94] *Id.* at art. 59.
[95] *Id.* at art. 54, para. 5.
[96] *Id.* at art. 55.
[97] *Id.* at arts. 53, 118.
[98] Company Law of 2005, *supra* note 41, at art. 56.
[99] *Id.* at art. 120.
[100] *Id.* at art. 148.

business decision power between shareholders and directors and the reach of supervisory oversight powers. These two issues haunt Chinese corporate law, as they do in many other countries adopting the two-board structure, and the situation has become even worse after independent directors became part of the balancing game inside a company in 2001.

8. Management Power Division Between Shareholder Meeting and Board of Directors

Shareholders are vested with extensive decision rights in Chinese corporate law. Article 4 of the Company Law stipulates that shareholders are empowered to make major decisions and to select management personnel in proportion to the amount of capital that they have invested in the company. In Article 38, paragraph 1, number 1, it also empowers the shareholders to "decide on the [management] policies and investment plans of the company."[101] Based on the language expressed explicitly in these articles, it appears that Chinese corporate law tips the balance of corporate decision-making power toward shareholders and endows a greater range of participation in business decisions for shareholders, weakening the power of the board of directors.

However, Article 47 of the Company Law, which concerns the power of the board of directors, shows a somewhat different picture. Under Article 47, paragraph 1, number 3, the board of directors has the same managing power to "determin[e] the company's business and investment plans."[102] Further in numbers 8 and 10 of the same paragraph, it also stipulates that it is the role of the board of directors to set up internal organs or departments and other management systems and regulations.[103] Simply observing the language used for describing the power of the board of directors, it seems as though Article 47 provides a general and extensive managing power to the board of directors.

But this interpretation might bump against Article 47, paragraph 1, numbers 1 and 2. As Article 47, paragraph 1, numbers 1 and 2 indicate, it is clear that the primary tasks of the board of directors are to "convene[] the shareholders' meetings and present reports thereto" and to "[i]mplement[] the resolutions made at the shareholders' meetings."[104] Following this line and pulling all pieces together, it appears that Chinese corporate law has adopted an approach that provides less managerial discretion to directors and requires the board of directors to defer to the extensive decision-

[101] Company Law of 1993, *supra* note 32, at art. 38 (emphasis added).
[102] Company Law of 2005, *supra* note 41, at art. 47, para. 3 (emphasis added).
[103] *Id.* at art. 47, paras. 8, 10.
[104] *Id.* at art. 47, paras. 1, 2.

making power of shareholders if the shareholders explicitly use it. In this sense, the managerial power that the board of directors has is more supplementary and restricted in Chinese corporate law, and it can be fairly said that management power is, at best, divided. However, the exact dividing line in real life is more complicated and is still unclear under the current rule. Noticeably, this debate is largely limited to a theoretical level now, as the unique capital structure in many Chinese public companies effectively reduces the possibility of disagreement between the board of directors and the shareholders. But this issue is likely to come back with severity when the current capital structure is no longer stable or gradually changes over time.

9. *The Oversight Power of Supervisors and Its Limitations*

The line between the directors' managing power and supervisors' oversight power is another issue that is not clearly answered in Chinese law. This is an issue commonly encountered by countries who adopt a two-board structure.

To begin, the Chinese Company Law stipulates that a supervisor cannot be a manager and a director at the same time.[105] This rule is aimed at increasing the segregation between management and the body responsible for oversight of the company at the same time. This is a common assertion, which can be found in many countries using a dual board structure.[106] However, this stipulation has left much uncertainty. In Article 54, paragraph 2, which is the main article about the board of supervisors' authority, it only says that a supervisor's powers include the power to "supervise the duty-related acts of the directors and senior managers, [and] to put forward proposals on the removal of any director or senior manager who violates any law, administrative regulation, the bylaw, or any resolution of the shareholders' meeting."[107] However, Article 54, paragraph 2 does not provide a clear delineation about the range of the items that are subject to supervisors' oversight. According to the text, the plain interpretation is that the range of the supervisors' oversight power covers everything related to "acts of the directors and senior managers" in

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[105] *Id.* at arts. 58, 118.

[106] For example, the Japanese Companies Act article 335, paragraph 2 stipulates that supervisor positions ("Kansa-yaku," also often translated as "corporate auditors") cannot be held by directors or employees of the same company (including its subsidiaries). SHŌHŌ (Comm. C.) art. 335, para. 2 (2005) (Japan), *available at* http://www.japaneselawtranslation.go.jp/law/detail/?id=1961&vm=04&re=02. For a general introduction to the Japanese supervisors system, see generally, Lin, *supra* note 2, at 84-85.

[107] Company Law of 2005, *supra* note 41, at art. 54, para. 2.

respect of the performance of their duties.[108] If this text works as its plain language indicates, the oversight power of supervisors in China is, in fact, almost unlimited, and will, in turn, decrease the breadth of directors' discretion, blur the line between directors and supervisors, and make supervisors the ultimate decision makers in a company.

This confusion is exacerbated by another unusual rule in the Company Law. Article 55 provides supervisors the right to attend the board of directors' meetings and to make a direct inquiry or recommendation on anything concerning board resolutions.[109] But there is no further detail provided in the Company Law or relevant regulations about what will happen if disagreements between directors and supervisors occur, or what the effect or applicable procedure would be to solve it. From a comparative perspective, this rule is noticeable as both directors and supervisors are directly elected by shareholders, and further compounds the already blurred line of power allocation between directors and supervisors.

Some clues might be found by looking back at the legislative history for these rules. The right to attend a meeting of the board of directors and the power to file a motion to a shareholder meeting to remove directors are both new rules added in the 2005 amendment. Based on the Introduction to the Amendment on Company Law of People's Republic of China, an introductory document provided by State Council to National People Congress, the reason for these two rules is to "strengthen the function of supervisors," and "provide some concrete rules for the supervisors to perform their duties." [110] This statement can be interpreted as a strong sign of the distrust towards directors and a corresponding endowment of an uncertain degree to supervisors of corporate decision-making powers.

The aforementioned discussion suggests that Chinese corporate law collectively reveals a mentality in China that includes a strong sense of caution and distrust toward corporate directors and managers—as directors and managers (or more precisely, controlling private shareholders) have successfully accumulated great wealth and power over past economic reforms and privatization.[111] Partly due to historically socialist roots and

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[108] *Id.*

[109] *Id.* at art. 55, para. 1, art. 119.

[110] STATE COUNCIL, INTRODUCTION TO THE AMENDMENT ON COMPANY LAW OF PEOPLE'S REPUBLIC OF CHINA, Part II, § 2(3) (Feb. 25, 2005) *available at* http://www.npc.gov.cn/wxzl/gongbao/2005-10/27/content_5343120.htm (last visited February 24, 2012) (personal translation).

[111] The distrust toward corporate major shareholder and managers can be read from the emphasis placed on the roles that supervisors should play in the *Introduction to the Amendment on Company Law* by the State Council. *Id.* at Part II, § 2(3); *see also* Mingyi Hung, T.J. Wong & Fang Zhang, *The Value of Relationship-based and Market-based Contracting: Evidence from Corporate Scandals in China* (May 2011), *available*

social problems triggered in the course of transferring state capital under private control, this perception effectively changed the formation of the Company Law. However, the issue of how to divide different powers among corporate organs is an unsolved issue and might need to be decided on a case-by-case basis. This, in turn, will beg for more court decisions to substantiate this field in the future.

10. Shareholder Suits

Shareholder suits under the Company Law are decided, arguably, under a dual-track design. There are only two articles about shareholder suits, and both were newly added in the 2005 Amendment. However, the language used in these two articles about shareholder suits does not provide a clear picture to understand how a shareholder suit mechanism can or should work. Company Law Article 152 is about derivative suits. According to Article 152, any shareholder in a closely-held company—or shareholder who holds more than one percent of the outstanding stock in a publicly-held company—can demand the board of supervisors to file a suit against directors or managers if they breach their duty, as described in Article 150.[112] Qualified shareholders can only bring a suit directly if the board of supervisors refuses to file suit, fails to file suit within thirty days, or when an emergency situation or irreparable damage exists.[113] Shareholders can use the same rule to bring a suit against a supervisor, as shareholders should demand the board of directors to bring the suit instead.[114]

As to the cause of action, Article 150 is a rather simple rule itself and stipulates that directors, supervisors, and managers are subject to civil liability when they violate a law, relevant administrative rules, or corporate charter and thereby incur damages to the company.[115] Articles 148 and 149 of the Company Law provide a rather detailed list of the legal obligations that directors, supervisors, and managers should observe. Article 148 provides that directors, supervisors, and managers should assume a duty to

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at http://server1.tepper.cmu.edu/Seminars/docs/HWZ%20May%202011%20v6_clean.pdf (Table 1 listed a categorized investigation of over 200 corporate scandals sanctioned by CSRC in 1997-2005). Also, frequent reports in newspapers about various business scandals echo and confirm this general perception. For a recent sample of business scandals in China, see Qiang Xiaoji, *Top 10 Business Scandals*, CHINADAILY (Nov 22, 2010), *available at* http://www.chinadaily.com.cn/business/2010-11/22/content_11580396.htm.

[112] Company Law of 2005, *supra* note 41, at art. 152, para. 1.

[113] *Id.* at art. 152, para. 2.

[114] *Id.* at art. 152, para. 1.

[115] *Id.* at art. 150.

obey the law and regulations, a duty of loyalty (good faith), and a duty of diligence (care).[116] It also prohibits them from taking bribes and misappropriating company property.[117] In Article 149, the Company Law proscribes directors and managers from conducting any of the following: (1) misappropriating corporate funds;[118] (2) placing corporate funds in private accounts;[119] (3) lending corporate funds or providing corporate assets as collateral to any third party without a provision from the articles of incorporation, prior consent from board of directors, or consent from shareholders;[120] (4) conducting any transaction involving self-dealing without the provision of the articles of incorporation or prior consent from shareholders;[121] (5) exploiting corporate opportunity or assuming any positions in other similar business without the prior consent from the shareholders;[122] (6) taking a commission from another company which transacts business with the company;[123] (7) leaking confidential business information;[124] or (8) performing any other breach of loyalty to the company.[125] In short, Article 148 is about a duty to abide the law and a duty of diligence, and Article 149 is a general provision about a duty of loyalty.

Article 153 is about shareholder direct suits. Unfortunately, this is an article that causes more confusion than clarity. Article 153 says: "If any director or senior manager damages the shareholders' interest by violating any law, administrative regulation, or the bylaw, the shareholders may lodge a lawsuit in the people's court."[126] On its face, Article 153 talks about exactly the same cause of action as mentioned in Article 152 but applies a different procedure. Due to the limited amount of time since the implementation of the 2005 amendment of the Company Law, there is not much academic discussion available concerning a direct shareholder suit and its application.[127]

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[116] *Id.* at art. 148, para. 1.
[117] *Id.* at art. 148, para. 2.
[118] Company Law of 2005, *supra* note 41, at art. 149, para. 1.
[119] *Id.* at art. 149.
[120] *Id.*
[121] *Id.*
[122] *Id.*
[123] *Id.*
[124] Company Law of 2005, *supra* note 41, at art. 149, para. 1.
[125] *Id.*
[126] *Id.* at art. 153.
[127] Shareholder suits in China in the last decade mostly arose from misrepresentation in stock market cases based on Article 69 of the Securities Law (formerly Article 63 before the 2005 amendment). In fact, in addition to the limited occasions for shareholder suits provided in the Company Law, the Securities Law permits two causes

11. Supplementary Note

The main limitation of the Company Law, which can be also found in many other bodies of legislation in China, is the laxity of its language. A relatively small body of legislation inevitably leads to a certain degree of ambiguity in practical use. This in turn leads to an extensive reliance on rules or "explanations" promulgated by various relevant administrative and judicial authorities, including the Chinese Supreme Court. Those explanatory regulations impose a lot of influence on how lower courts interpret the statute in concrete cases, even though some of the explanatory regulations are without clear legislative authorization and sometimes even contradict the law. Extensive reliance on these rules, along with the fact that much of the judicial branch in China is appointed by the political branch, makes the court opinions vulnerable to political influence and less predictable.

However, the problems created by an inadequate statute are not solved simply by relying on administrative supplements of explanatory rules.

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of action for shareholders to institute suits, Article 47 (the rule about short-swing and speculative share trading) and Article 69. Securities Law Article 69 prohibits misrepresentation in the prospectus, financial and accounting reports, and annual report. It reads: "Where any of the prospectus, measures for financing through the issuance of corporate bonds, financial statements, listing reports, annual reports, midterm reports, temporary records or any disclosed information that has been announced by an issuer or listed company has any false record, misleading statement or major omission, and thus incurs losses to investors in the process of securities trading, the issuer or the listed company shall bear the liability of compensation. Any director, supervisor, senior manager or any other person of the issuer or the listed company as held to be directly responsible shall take several and joint liabilities of compensation, unless he is able to prove that he has no fault therein. Where any shareholder or actual controller of an issuer or a listed company has any fault, he or it shall bear several and joint liabilities of compensation together with the relevant issuer or listed company." *Id.*

One study conducted by the Royal Institute of International Affairs (now Chatham House) in 2003 compiles a list of twelve companies involved as defendants in the first wave of private securities litigation in China, which includes ST Shandong Bohai, ST Shanghai Tongda Innovation Investment, ST Yantai Dongfang Electronic Information, ST Shanghai Jiabao Shiye, ST Fujian Jiuzhou Group, Xian Shengfang Keji, ST Yi An Technology, Shenzhen Sanjiu Medical, ST Guangxia (Yinchuan) Industry, Hubei Tianyi Science and Technology, Daqing Lianyi, and ST Chengdu Boxun Shuma Technology. Eleven of the twelve are about account falsification and misrepresentation, and the remaining one is about tax evasion and other breaches of law. Stephen Green, *Better Than a Casino: Some Good News From the Frontline of China's Capital Market Reforms* 13-15 (Asia Programme, Royal Inst. of Int'l Affairs, Working Paper No. 6), *available at* http://www.chathamhouse.org/sites/default/files/public/Research/Asia/better_than_a_casino.pdf. Interestingly, no damages have been awarded by the courts, and settlements have ranged from $97 to $27,000 (for eleven investors). Furthermore, courts are rumored to be forcing larger group suits to be split up into smaller group suits to bolster court fee incomes. *See id.* at 13-15. For some case studies in the 1990s and early 2000s, see Donald C. Clarke, *Law Without Order in Chinese Corporate Governance Institutions*, 30 NW. J. INT'L L. & BUS. 131, 192-95 (2010).

Lack of experience among legislators in conceiving the kinds of situations the law needs to deal with—along with a lack of techniques for drafting its formulation with precision—has created a huge barrier among practitioners towards understanding how the Company Law applies in certain cases. Further, academic work in China, although having experienced a period of impressive progress, is still developing and not yet capable of providing the help needed in borderline cases. A lack of judicial precedents to fill the holes left by the relatively unclear language in statutes is another difficulty. Sometimes there is concern about applying extreme cases more generally especially in light of the somewhat doubtful decision quality in some lower courts. In sum, both judicial decisions and academic work in China are not very helpful in filling in the gaps created by the Company Law.

C. The Introduction of Independent Directors

The introduction of the independent director mechanism to China was mainly a unilateral decision of the administrative branch, rather than a result of natural evolution of corporate governance or legislative action. In 2001, the China Securities Regulatory Commission promulgated Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies and the independent director became a mandatory internal organ for all listed companies.[128]

1. Legal Sources of Independent Directors

The term "independent director" appeared for the first time in Chinese corporate law in the Guiding Opinion for Listed Corporations' Articles of Incorporation issued by the China Securities Regulatory Commission ("CSRC") on December 26, 1997.[129] In Article 112 of this regulation, listed companies were advised to retain an independent director at their option. In terms of defining "independent director," it provided that an independent director cannot be a current employee of the company, an employee of a shareholder, or a relative of an interested person or management. Article 112 also encouraged the listed company to stipulate

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[128] Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu De Zhidao Yijian (关于在上市公司建立独立董事制度的指导意见) [Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies] (promulgated by the China Sec. Regulatory Comm'n, Aug. 16, 2001), http://www.sse.com.cn/cs/zhs/xxfw/flgz/html/t0078.htm [hereinafter 2001 Guideline].

[129] Shangshi Gongsi Zhangcheng Zhiyin (上市公司章程指引) [Guidelines for the Articles of Association of Listed Company] (promulgated by the China Sec. Regulatory Comm'n., Dec. 16, 1997), http://www.sse.com.cn/cs/zhs/xxfw/flgz/html/t0091.htm. This regulation was succeeded by Shangshi Gongsi Zhangcheng Zhiyin (上市公司章程指引) [Guidelines for the Articles of Association of Listed Company] (promulgated by the China Sec. Regulatory Comm'n, Mar. 16, 2006), http://www.asianlii.org/cn/legis/cen/laws/tgftaolci2006489/.

the duty and authority of its independent directors in its own charter.[130]

In 2001, the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies ("2001 Guideline") were introduced.[131] In fact, it marked an important move by the CSRC to carry out this new mechanism. In this new regulation, a basic framework was spelled out for the extensive implementation of the Chinese independent director mechanism. It contained various rules about the qualification and authority of independent directors for all listed companies. Basically, the 2001 Guideline required each listed company to have at least two independent directors by June 30, 2002 and have one third of its board comprised of independent directors by June 30, 2003.[132] By these means, the independent director became a mandatory corporate organ for all listed companies in China as the 2001 Guideline took its full effect in 2002.[133]

Following the introduction of the 2001 Guideline, several regulations repeatedly emphasized the determination to carry out the independent director mechanism by the CSRC. In the Notice on Matters Regarding Further Regulations of Initial Public Offers and Listing of Shares of September 19, 2003, it is reiterated that issuers shall set up the independent director system following the 2001 Guideline.[134] In this notice, it is stipulated that when a company applies for the initial public offering of shares and listing, at least one-third of the members of the board of directors shall be independent directors, and among them there shall be at least one accounting professional (the accounting professional must carry the senior title of a professional accounting post or the qualification of certified public accountant).[135] Also in January 31, 2004, the State Council of China issued Several Opinions on Promoting the Reform and Opening-

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[130] Guidelines for the Articles of Association of Listed Company of 1997, at art. 112.

[131] 2001 Guideline, *supra* note 128.

[132] *Id.* at art. 1, para. 3.

[133] For a detailed discussion about the rules in the 2001 Guideline, *see* discussion *infra* Part II.C.3.c.

[134] Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Guanyu Jinyibu Guifan Gupiao Shouci Faxing Shangshi Youguan Gongzuo De Tongzhi (中国证券监督管理委员会关于进一步规范股票首次发行上市有关工作的通知) [Notice of the China Securities Regulatory Commission on the Relevant Work of Further Regulation of Initial Public Offering] (promulgated by the China Sec. Regulatory Comm'n., Sept. 19, 2003, effective Oct. 1, 2003), http://chinalawinfo.com.

[135] *Id.* Subsequently, this order was replaced by *Measures on Administration of Initial Public Offering of Shares and Listing* in 2006. The new order repeated the requirement of establishing independent directors pursuant to relevant current rule, which includes the 2001 Guideline. *See* Shou Ci Gong Kai Fa Xing Gu Piao Bing Shang Shi Guan Li Ban Fa (首次公开发行股票并上市管理办法) [Measures for the Administration of Initial Public Offering and Listing of Stocks] (promulgated by the China Sec. Regulatory Comm'n., May 17, 2006, effective May 18, 2006), art. 21, http://chinalawinfo.com.

up and Stable Development of Capital Market.[136] This document underscores the importance of independent directors in the reform and development of China's capital market.[137]

Article 123 of the Company Law of 2005 provides a new legal basis for the independent director in the Chinese corporate law. According to the text, this new article simply states that a listed company shall have independent directors and delegates the power to stipulate detailed rules concerning independent directors to the State Council.[138] The empty language in this new article does not mandate a broader application of the independent director mechanism in China in the future. This new article, however, officially provides the independent director a better legal basis in the Company Law, and elevates it from administrative regulation to law. In addition, the rule-making power delegated to State Council is still meaningful if utilized.

2. Reason for the Introduction of the Independent Director Mechanism in China

Like most of the laws and regulations in China, the purported purpose of introducing the independent director mechanism in China is not explicitly spelled out. However, some hints can be found in several pieces of legislation.

According to the preface of the 2001 Guideline, the purpose of having an independent director is to "further improve the governance structure of listed companies and standardize their operation[. The] China Securities Regulatory Commission (CSRC) formulates the Guidelines for Introducing Independent Directors to the Board of Directors in Listed Companies. All listed companies are required to act in accordance with the Guideline."[139] In Article 1, paragraph 2, it states that "[t]he independent directors shall ... protect the overall interests of the company, and shall be especially concerned with protecting the interests of minority shareholders from being infringed. Independent directors shall carry out their duties independently

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[136] Guo Wu Yuan Guan Yu Tui Jin Zi Ben Shi Chang Gai Ge Kai Fang He Wen Ding Fa Zhan De Ruo Gan Yi Jian (国务院关于推进资本市场改革开放和稳定发展的若干意见) [Some Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets] (State Council Opinions) (promulgated by the China State Council, Jan. 31, 2004, effective Jan. 31, 2004), http:// www.lawinfochina.com/display.aspx?id=3366&lib=law&SearchKeyword=&SearchCKeyword=#.

[137] *Id.*

[138] Company Law of 2005, *supra* note 41, at art. 123. The language itself only says: "Listed companies shall institute independent directors. Further detail is subject to the rules promulgated by the State Council."

[139] 2001 Guideline, *supra* note 128, at preface.

and shall not subject themselves to the influence of the company's major shareholders, actual controllers, or other entities or persons who are interested parties of the listed company." [140]

Based on the language used in the 2001 Guideline, the purpose of introducing the independent director mechanism in China can generally be interpreted as providing more protection to minority shareholders, while at the same time protecting the company itself from looting by its managers (referred to "actual controllers").[141] The major reason the independent director mechanism was imported seems to be to alleviate the problems that controlling shareholders bring, which usually harm minority shareholders. To put it in a different way, the controlling/non-controlling shareholder agency problem seems to be the core issue which the 2001 Guideline attempts to address.

However, several facts compound this reasoning. In theory, the traditional agency problem (the manager/shareholder agency problem) should have been limited in the Chinese context because a controlling shareholder effectively controls the management as well as the board of a company. But in reality, managerial stripping emerged as—and remains a serious problem in—China.[142] Further, if the government is the controlling shareholder, as many SOEs appear to be in China, there will be potential looting by high-ranking governmental officers (who are appointed as managers in companies themselves, or collaborate with company managers as government officials).[143] Controlled transactions, such as self-dealing, become an issue despite the highly concentrated capital structure. In this sense, the goal of protecting minority shareholders bumps up against both types of agency problems (manager/shareholder and controlling shareholder/non-controlling shareholder). Thus, introducing the independent director mechanism in China seems to be a wished-for cure for the two mixed corporate issues that differ fundamentally from each other.

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[140] *Id.* at art. 1, para. 2.

[141] *Id.*

[142] As Mingyi Hung et al. show in their research, manager embezzlement, taking kickbacks, abusing power for private gains, forgery, tunneling, and executing related party loans and guarantees were prevalent in China and took up more than fifty percent of more than two hundred CSRC sanctions during the period of 1997-2005. The remaining are more about bribing government officials, accounting manipulations, false or incomplete disclosure, and tax evasion. *See* Hung, et al., *supra* note 111, at Table 1.

[143] *See id.* (totaling the results of an investigation of corporate scandals and outlining the prevalence of various offenses, including instances of company managers stealing firm assets and manipulating accounting numbers).

3. *Substantive Rules*

a. *Definition and General Requirement*

First, an independent director of the listed company means a director who does not assume any other office except director in the company, and has no relationship, either between him and his company or between him and the main shareholders of this company, that may hinder his independent and objective judgment.[144]

Second, the independent director shall fulfill his duties independently; shall not be influenced by the main shareholders, the actual controllers of the company, or other units or individuals with interest relationships with the listed company; and, shall prevent the legal rights and interests of small to medium shareholders from being damaged.[145]

Independent directors should also have five years or more of working experience in the law, economics, finance, or other relevant fields.[146] Companies must have at least one accounting professional among its independent directors.[147] Independent directors should also meet the general qualification requirements for ordinary directors, which are stipulated in Company Law Article 147[148] and an independent director can

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[144] 2001 Guideline, *supra* note 128, at art. 1, para. 1.

[145] *Id.* at art. 1, para. 2.

[146] *Id.* at art. 2, para. 4.

[147] *Id.* at art. 1, para. 3.

[148] *Id.* at art. 2, para. 1. Company Law of 2005, at art. 147 reads:

Anyone who is under any of the following circumstances shall not assume the post of a director, supervisor or senior manager of a company:

1) Being without civil capacity or with only limited civil capacity;
2) Having been sentenced to any criminal penalty due to an offence of corruption, bribery, encroachment of property, misappropriation of property or disrupting the economic order of the socialist market and 5 years have not elapsed since the completion date of the execution of the penalty; or he has ever been deprived of his political rights due to any crime and 3 years have not elapsed since the completion date of the execution of the penalty
3) He was a former director, factory director or manager of a company or enterprise which has bankrupt and liquidated, whereby he was personally liable for the bankruptcy of such company or enterprise, and three years have not elapsed since the date of completion of the bankruptcy and liquidation of the company or enterprises;
4) He was the legal representative of a company or enterprise, but the business license of this company or enterprise was revoked and this company or enterprise was ordered to close due to a violation of the law, whereby he is personally liable for the revocation, and three years have not elapsed since the date of the revocation of the business license thereof;
5) He has a relatively large amount of debt which is due but has not been paid.

Where a company elects or appoints any director or supervisor, or hires any senior

work as an independent director for, at most, five listed companies.[149] In addition, articles of incorporation may impose additional requirements for independent directors, both in terms of qualifications and code of conduct.[150]

b. Exclusions to the Independent Director Mechanism

Article 3 of the 2001 Guideline clearly provides a list of situations disqualifying the candidacy of an independent director. The list includes:

1) Those who hold posts in a listed company or its subsidiary enterprises, the lineal relatives (spouse, parents, and children, etc.) of those aforementioned persons, and those with significant social relations (sisters and brothers, parents-in-law, daughters-in-law and sons-in-law, spouses of sisters and brothers, sisters and brothers of spouse);[151]
2) In the situation of a natural person shareholder, any shareholder who directly or indirectly holds more than one percent of the shares issued by the listed company or is ranked as one of the top ten shareholders of this company, he or she and his or her lineal relatives cannot be an independent director;[152]
3) In the situation of a corporate shareholder, if it directly or indirectly controls more than five percent of the shares issued by a listed company or is ranked as one of the top five shareholders of a listed company, employees and their lineal relatives of those corporate shareholders cannot assume the position of independent director,[153]
4) Those who fell into the previous three categories within the last year;[154]
5) Persons who provide financial, legal, consulting, or similar services for the listed company or its subsidiary enterprises;[155]
6) Other personnel as stipulated by the articles of association;[156]

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manager by violating the provisions in the preceding paragraph, such elections, appointments, or hiring shall be invalid. Where any director, supervisor or senior manager, during his term of office, is under any of the circumstances as mentioned in the preceding paragraph, the company shall remove him from his post.

[149] 2001 Guideline, *supra* note 128, at art. I, para. 2.

[150] *Id.* at art. II, para. 5.

[151] *Id.* at art. III, para. 1.

[152] *Id.* at art. III, para. 2.

[153] *Id.* at art. III, para. 3.

[154] *Id.* at art. III, para. 4.

[155] 2001 Guideline, *supra* note 128, at art. III, para. 5.

[156] *Id.* at art. III, para. 6.

and

7) Other personnel as determined by CSRC.[157]

c. Procedure for Selecting Independent Directors

It is generally understood that the nomination process is crucial to the impartiality that independent directors are expected to maintain. However, the design of the nomination process of independent directors in the 2001 Guideline seems to provide plenty of room for majority shareholder or inside directors to intervene, though final approval from the shareholder meeting is still required. The process is designed as followed:

1) Independent directors are to be nominated by any of the following: (a) incumbent members of the board of directors; (b) the board of supervisors; or (c) a shareholder who owns more than one percent equity interest.[158]
2) The listed company must pre-file the nomination information with the CSRC and the CSRC maintains the right to dissent within fifteen days after filing.[159]
3) Approval will be made by the resolution of the shareholders meeting.[160]

In reality, independent directors are often selected by controlling shareholders, not self-elected or through the board. Controlling shareholders and management more often select those with either personal or financial connection to them, and do so in the hope those independent directors will side with them in any needed situation.[161]

d. Term of Office

The term of an independent director is the same as that of an ordinary director (which means it is subject to stipulation in the articles of incorporation and has a maximum three-year term).[162] Also, the maximum term cap of six years applies.[163]

e. Powers and Obligations of Independent Directors

The powers that independent directors have are provided in Articles 5

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[157] *Id.* at art. III, para. 7.
[158] *Id.* at art. IV, para. 1.
[159] *Id.* at art. IV, para. 3.
[160] *Id.* at art. IV, para. 1.
[161] *See* 2001 Guideline, *supra* note 128. at art. IV, para. 1 (naming the parties with the authority to nominate independent directors). For further discussion about the nomination and selection process and related problems, see *infra* Part IV.A.1.
[162] Company Law of 1993, *supra* note 32, at art. 47.
[163] 2001 Guideline, *supra* note 128, at art. IV, para. 4.

and 6 of the 2001 Guideline. Among them, the most important ones are the right to approve related party transactions and to issue independent opinions to a shareholder meeting.

1) Major related transactions ratification: major transactions (referring to those of an amount of more than RMB 3,000,000 [roughly $461,538 by the exchange rate 6.5/1] or exceeding 5% of net assets of the listed company) have to obtain ratification from the independent directors before being submitting to the board of directors for discussion.[164]
2) Power to request or convene a meeting with the board of directors.[165]
3) Power to request the board of directors to convene in an interim shareholder meeting.[166]
4) Power to propose an appointment or removal of the accounting firm to the board of directors.[167]
5) Power to retain independent counsel[168]
6) Power to solicit proxies.[169]
7) If the board of directors of the listed company establishes the committees of salary and remuneration, auditing, nomination, the independent directors shall make up more than one half of the members of these committees.[170]
8) Obligations to deliver independent opinions: an independent director has the obligation to deliver independent opinions at the shareholder meeting or to the board of directors concerning the nomination and replacement of directors,[171] the appointment and dismissal of important managing positions,[172] compensations of directors and high-ranking managers,[173] major loans to "parties related to the listed company,"[174] and other occurrences that

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[164] *Id.* at art. V, para. 1.

[165] *Id.* at art. V, para. 1.

[166] *Id.* at art. V, para. 1.

[167] *Id.* at art. V, para. 1.

[168] *Id.* at art. V, para. 1 (granting the ability of independent directors to appoint an "outside auditing or consulting organization" independent of other directors' wishes).

[169] 2001 Guideline, *supra* note 128, at art. V, para. 1.

[170] *Id.* at art. V, para. 4.

[171] *Id.* at art. VI, para. 1.

[172] *Id.* at art. VI, para. 1.

[173] *Id.* at art. VI, para. 1.

[174] *Id.* at art. VI, para. 1. A Loan over RMB 3,000,000 or 5% of net assets of the listed company is considered a "major loan" here. *Id.*

could damage the interests of minority shareholders.[175]

9) Equal right to corporate information: when two or more independent directors determine that the materials presented at a meeting of the board of directors are not sufficient, they have the right to request a deferment of the related discussion or the meeting as a whole.[176]
10) Enhanced power in ratifying a management buyout: Measures for the Administration of the Takeover of Listed Companies,[177] prescribes that in the case of a management buyout, the company should have no less than half of its directors as an independent director.[178] In terms of resolution, first the takeover plan shall be carried out upon the resolution of the non-affiliated directors only. The resolution has to obtain approval from two thirds or above of the independent directors, and then it must be submitted to the shareholders meeting for majority consent.[179]
11) A company needs to disclose the relevant information when the requests or proposition of independent directors are denied, including when independent directors propose to call an interim shareholders meeting and are rejected.[180] It should be disclosed when independent director cannot exercise their mandatory power listed above.[181]
12) When exercising their tasks as independent directors, the independent directors shall obtain consent of at least one half of the independent directors.[182] However, if the opinions among the independent directors differ, the board of directors shall separately disclose the opinions of each independent director.[183]

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[175] 2001 Guideline, *supra* note 128, at art. VI, para. 1.

[176] *Id.* at art. VII, para. 1.

[177] Measures for the Administration of the Takeover of Listed Companies (上市公司收购管理办法) (promulgated by the China Sec. Regulatory Comm., July 31, 2006, effective Sept. 1, 2006) ch. VI, arts. 62, 63, http://www.gov.cn/flfg/2006-08/02/content_352370.htm *translated in* http://www.fdi.gov.cn/pub/FDI_EN/Laws/Securities/P020070720592424062457.pdf.

[178] *Id.* at art. 51.

[179] *Id.*

[180] 2001 Guideline, *supra* note 128, at art. V, para. 3; Measures for the Administration of the Takeover of Listed Companies, *supra* note 177, at ch. I, art. 5.

[181] 2001 Guideline, *supra* note 128, at art. V, para. 3; Measures for the Administration of the Takeover of Listed Companies, *supra* note 177, at ch. I, art. 5.

[182] 2001 Guideline, *supra* note 128, at art. V, para. 2; Measures for the Administration of the Takeover of Listed Companies, *supra* note 177, at ch. I, art. 5.

[183] 2001 Guideline, *supra* note 128, at art. VI, para. 3; Measures for the Administration of the Takeover of Listed Companies, *supra* note 177, at ch. I, art. 6.

On its face, much is entrusted to the Chinese independent directors. However, simply looking at these rules is not enough to provide a clear picture of how the independent director mechanism in China is implemented, what it means, and what changes it brings to corporate China. Before moving toward the discussion of its implementation and what it impacts, however, it is necessary to start with the landscape of the Chinese economy and its structural background. By doing so, the rules and their effects can be more clearly understood and assessed.

III. THE STRUCTURAL CHALLENGES OF CORPORATE GOVERNANCE IN CHINA

Corporate governance in China cannot be adequately observed only through the analysis of the Company Law. Political, social, institutional, and ideological factors all play a role in changing and shaping today's Chinese corporate governance. As a result, a larger view, which includes the banking system, capital market, state control via shares as well as regulatory means, the interest of corporate stakeholders, and the public perception of corporate social responsibility, is needed. This approach provides a better understanding on how corporate law affects institutions, the limit of this influence, and the possible direction for the future.

A. The State Ownership and Its Unfinished Transformation

The extensive existence of Chinese SOEs and state/collective controlled shares, as a relic of the Socialist State, still has profound effects on the Chinese corporate environment. SOEs themselves are still part of the government, but also part of the private market economy. State ownership, on the one hand, provides a powerful weapon to control the macro-economy and maintain direct access to the allocation of corporate assets which the State cannot reach as a traditional regulator. But, on the other hand, there are costs to this powerful presence. Inefficiency in management and corruption caused by state ownership are both difficult nightmares that have haunted this socialist country's system from the day it was born in 1949.[184] In a practical sense, how the government played the role of shareholder defined China's past economic miracle and, similarly, it will shape the future direction of its corporate governance and its corporate law.

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[184] The history of the People's Republic of China started on October 1, 1949, when, after a near complete victory by the Communist Party of China (CPC) in the Chinese Civil War, Mao Zedong proclaimed the People's Republic of China (PRC) from atop Tiananmen, Beijing. For general information, see *China*, BRITANNICA ONLINE ENCYCLOPEDIA, http://www.britannica.com/EBchecked/topic/111803/China (last visited Apr. 19, 2012).

1. Incorporation of SOEs

Back in the early 1990s, the enactment of the Law on Industrial Enterprises Owned by the Whole People ("SOEs Law") and the Company Law of 1993 marked the first step toward solving the problem of state ownership by means of legal reform. Generally speaking, the SOEs Law only provides a legal basis for the separation of management and state ownership, and it played a role in balancing the practical need to promote more efficient management techniques on one hand and the demand for collective ownership under the socialist Constitution on the other. The later implementation of the Company Law of 1993 further pushed for corporatization—and even privatization in some cases—of SOEs. In some successful cases, SOEs were transformed into independent legal entities and started to be financially responsible. Some SOEs were even successfully transformed into listed corporations or parent corporations of listed subsidiaries, raising large funds from overseas securities markets in the years following the implementation of the Company Law of 1993. But not all aspects of this transformation are positive. In most cases, SOEs were simply reorganized as wholly state-owned corporations with various subsidiaries.[185]

As a result of several decades of China's highly centralized economy, SOEs and transformed SOEs created many complicated social, cultural, and economic implications for Chinese society.[186] Politically, despite some successful cases, many large SOEs were generally regarded as government branches—even after acquiring an independent legal entity status.[187] This confusing situation was further compounded by the fact that government agencies exerted various influences over those former SOEs. For this reason, many former large SOEs did not really enjoy legal independence

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[185] Schipani & Liu, *supra* note 7, at 24-25. This explains that under the Chinese government's pilot plan, one hundred SOEs were selected for corporatization beginning in 1992. By 1998, ninety-eight of those companies had been successfully transformed, with sixteen becoming publicly held companies, sixteen becoming closely held corporations, and sixty-two transforming into SOEs with subsidiaries.

[186] One of the most conspicuous examples is the burden of social welfare and retirement payments to former state-owned enterprise employees. *See, e.g.*, Vivian Y. Chen, *A Macro Analysis of China Pension Pooling System Incentive Issues and Financial Problem*, Part III.2.2 *in* PENSIONS IN ASIA: INCENTIVES, COMPLIANCE AND THEIR ROLE IN RETIREMENT 16-18 (2004), *available at* http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN030983.pdf (discussing the heavy burden of social benefits faced by SOEs in China).

[187] Wenkui Zhang, an economist at the Development Research Center of the State Council of China, provides an account of the "privatization" after corporatization in the 1990s and states that the privatization was much more successfully carried out in small and medium size SOEs. Wenkui Zhang, *The "China Model" of SOE Reform and Its Challenges*, 4 CHINA ECONOMIST 7 (2009), *available at* http://ssrn.com/abstract=1544336.

even after incorporation as companies.[188]

2. *Remaining Problems of State Ownership*

Financially speaking, the Chinese government still acts as a majority shareholder for many listed corporations even after almost a decade since the enactment of the Company Law of 1993.[189] At the end of 1995, state shares made up fifty-four percent of the total shares of listed Chinese companies; this number declined to slightly less than forty-eight percent by the end of 2001.[190] Many state shares appear in the form of share interests in the listed public companies held by their parent SOEs.[191] This situation occurred often as SOEs first partitioned better quality assets to the subsidiary and received shares of these subsidiaries in return. Such a tactic allows those subsidiaries to be more easily listed on the stock market and raise more money than their parent companies. However, parent SOEs still remain in control over those publicly-traded subsidiaries, and sometimes demand excessive interest from their controlling position at the expense of other shareholders.[192] The dominance of the State as a shareholder in most

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[188] *See id.* at 14 (explaining that almost all of the large SOEs overseen by the State Assets Administration and Supervision Commission have chosen to maintain whole state ownership); *see also Central Enterprises Directory*, STATE-OWNED ASSETS SUPERVISION & ADMIN. COMM'N, http://www.sasac.gov.cn/n1180/n1226/n2425/index.html (last visited April 12, 2012) (listing the 117 extra-large SOEs currently under SASAC's direct management) and *Local SASAC*, STATE-OWNED ASSETS SUPERVISION & ADMIN. COMM'N, http://www.sasac.gov.cn/n1180/n1271/n1286/7206979.html (listing the local state-owned assets supervision and administration commissions that oversee the management of local SOEs).

[189] *See* Schipani & Liu, *supra* note 7, at 56 n.215 (asserting that although "there were 999 A or B Share listed companies, with a total market capitalization of 4069 billion Chinese Yuan (about 500 billion USD)" and "negotiable market capitalization of 1322.909 billion Chinese Yuan (about 160 billion USD)," most non-negotiable shares were held by other SOEs and the central and local government). Indeed, approximately "90% of the non-negotiable shares were State-owned shares and State-owned legal persons' shares." *Id.* at 64.

[190] Alice De Jonge, *Solving Agency Problems in a Cross-Border Environment: Ten Years of Chinese Company Listings in Hong Kong*, *in* CHINA'S BUSINESS REFORMS: INSTITUTIONAL CHALLENGES IN A GLOBALISED ECONOMY 46, 48 (Russell Smyth et al. eds., 2005). However, there is a voice criticizing the traditional understanding about the classifications of shares in China and positing that those numbers underestimate the state's real influence as an equity owner. *But see* Guy S. Liu & Pei Sun, *Identifying Ultimate Controlling Shareholders in Chinese Public Corporations: An Empirical Survey* 8 (Asia Programme, Working Paper No. 2, 2003), *available at* http://www.chathamhouse.org/sites/default/files/public/Research/Asia/stateshareholding.pdf (criticizing the traditional understanding about classifications of shares in China and positing that those numbers underestimate the State's real influence as an equity owner, with the conclusion that, in 2001, the Chinese government controlled about eighty-four percent of listed companies in China).

[191] Schipani & Liu, *supra* note 7, at 25.

[192] *See id.* at 60-62 (noting that the parent SOE's controlling relationship with its subsidiary has been criticized for various reasons, particularly from a governance

of the listed firms remains more than large enough to seriously compromise the independence of company management.

According to a study conducted by a Japanese think-tank, in the mid-2000s Chinese SOEs still accounted for over thirty-four percent of the national capital in China.[193] The remaining state capital power and its impact on corporate law and economic development are still extensive. As could be expected, their dominance creates a dilemma. For example, the government may be concerned with whether the State is sufficiently protected as a shareholder from the managers' discretion. But minority shareholders and potential investors may be similarly concerned about the potential misuse of corporate assets or priority-setting by the State as a controlling shareholder.[194] To solve this dilemma, a more aggressive move toward privatization and further dissolution of state ownership, through the establishment of a soundly functioning capital market, are necessary.

3. An Attempt to Address the Insufficient Monitoring Mechanism

According to the basic structural setting in Chinese corporate law, the supervisor or board of supervisors possesses the authority, as well as the duty, to monitor acts of managers and directors.[195] The supervisor also possesses the authority to demand corrections if any of their actions are found to have damaged the interests of the company.[196] It is believed that the governing corporate bodies would assert claims whenever the corporate interests are damaged or threatened by directors' or executives' breach of their duties. But this type of monitoring is only theoretically possible. In reality, the board of directors may refuse to assert claims against offenders due to the amicable relationship between the culpable directors or managers and the remaining directors. The same situation may also occur with respect to the board of supervisors when supervisors are close to the culpable director, or when both are under control of the same controlling shareholder.

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perspective).

[193] Ken Imai, *Explaining the Persistence of State-Ownership in China* 7 (Inst. of Developing Economies, Discussion Paper No. 64, 2006), *available at* http://ir.ide.go.jp/dspace/bitstream/2344/130/3/ARRIDE_Discussion_No.064_imai.pdf. In fact, however, determining the exact number of either state capital or state-controlled companies is both difficult and controversial. That is the reason numbers sometimes come out with very different results. For statistics about state-controlled companies in general and different methods of calculations, compare De Jonge, *supra* note 190, at 48 (averring that the state owned 47.7% of the total shares of listed Chinese companies in 2001) with Liu & Sun, *supra* note 190, at 7 (calculating that figure to be 44.6 percent).

[194] Schipani & Liu, *supra* note 7, at 56.

[195] Company Law of 1993, *supra* note 32, at art. 126, paras. 1-3.

[196] *Id.*

The dominance of SOEs and state capital in China makes the already seriously insufficient governance mechanism even weaker. Although the situation has been improving gradually as private investor participation and business competition develop, the fact that control of most Chinese companies (especially those with larger capitalization) remains in the hands of the Chinese government continues to be a great challenge to corporate governance. In this light, the monitoring issue in China's corporate world is interwoven in the capital structure.

The fact that having a controlling shareholder over the past few decades has caused different types of problems for Chinese corporate governance clearly indicates that the transformation of state ownership to private ownership is the linchpin of understanding today's governance issues in China. Surely directorial accountability cannot be achieved only by policy or government actions. Rather, it is co-determined by the market, business actors and legal/judiciary mechanisms. The question of how to improve the board of directors' role and increase its accountability is inevitably linked to a more political question: whether or how to transform single state ownership into dispersive, private ownership. If the move toward more dispersive ownership continues in the future, independent directors in China may play a more important role than they have in the past ten years.[197]

4. *Stock Market Establishment and Reform in 2005*

a. *Establishing Stock Market*

Along with the march toward the enactment of the Company Law of 1993, the establishment of a Chinese stock market also began in the late 1980s. Since the early period of the Economic Reform Era, several attempts were made to implement a share-holding system within certain types of companies.[198] The effort to establish a stock market was understandable since a market in which investors can trade their

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[197] Political control, or monitoring by a governmental agency, rather than any other intra-corporation monitoring mechanisms conceived by Company Law, is another means to control managers in China. In other words, administrative power plays a determining role in Chinese corporate governance. For a detailed discussion on the role of the Chinese Securities Regulatory Commission and its tools in disciplining corporate governance, see, for example, Clarke, *supra* note 127, at 169-80.

[198] China promulgated its first Securities Law in 1998, which remains the main source of law on securities regulation, though as of mid-2011, the Securities Law has been amended twice, in 2004 and 2005. Zheng quan fa [Securities Law], (adopted by the Standing Comm. of the Nat'l People's Cong., Dec. 29, 1998, effective July 1, 1999, amended Oct. 27, 2005, effective Jan. 1, 2006), http://chinalawinfo.com (China) [hereinafter Securities Law].

investments is pivotal to a continuing willingness to invest.[199]

In November and December 1990, China set up two stock exchanges, the Shanghai Stock Exchange and Shenzhen Stock Exchange, respectively.[200] In the first several years after the establishment of these exchanges, stock trading was limited. The main reason for this was the small number of companies that had successfully completed their transformation as shareholding companies.[201] This was attributed to the fact that the full implementation of the corporatization of former SOEs, as well as the legislation of the Company Law, which provided a basic modern corporate structure, were still absent.[202]

In its early stage, one key purpose to develop the securities market was to raise more funding to meet the needs of modernizing and restructuring traditional SOEs.[203] As this strategy rolled out slowly and regulatory agencies gained more experience, the growing securities market started to face its problem, which was inseparable from the prolonged privatization and SOE reform and eventually led to the reform of the split-share system in 2005.

b. Share Ownership Reform in 2005

The split-share system was a unique product from the very early stage of the Chinese stock market. By its very nature, it was the result of a compromise between the need to privatize SOEs and the healthy, gradual development of the stock market.[204]

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[199] *Id.* at art. 1

[200] *Brief Introduction*, SHANGHAI STOCK EXCHANGE, http://www.sse.com.cn/sseportal/en/c01/p996/c1501_p996.shtml (last visited Feb. 27, 2012); *SZSE Overview*, SHENZHEN STOCK EXCHANGE, http://www.szse.cn/main/en/aboutsse/sseoverview/ (last visited Feb. 27, 2012).

[201] *See* 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, 617-18 (1995) (discussing the low trading volume of B shares in Chinese securities market in its early years).

[202] *See generally* Andrew Xuefeng Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 UCLA PAC. BASIN L.J. 62, 66-67, 71 (1993) (providing a general account of the early development of the Chinese stock market); Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 COLUM. L. REV. 929 (2008) (offering a recent useful discussion of the latest developments surrounding the Chinese securities market).

[203] Liebman & Milhaupt, *supra* note 202, at 935.

[204] For a general discussion about the split-share reform, see Wallace Wen-Yeu Wang & Jian-Lin Chen, *Bargaining for Compensation in the Shadow of Regulatory Giving: The Case of Stock Trading Rights Reform in China*, 20 COLUM. J. ASIAN L. 298, 312-18 (2006); Sandra P. Kister, Note, *China's Share-Structure Reform: An Opportunity to Move Beyond Practical Solutions to Practical Problems*, 45 COLUM. J. TRANSNAT'L L. 312 (2006).

In the beginning, the split-share structure was the result of the transition from the socialist economy to capitalism, which required transforming the ownership of collectively-owned enterprises (along with all its assets) into segmented structure. What the split-share system created was basically a lock-in system which prohibited most shares from being traded but allowed a portion of ownership to be freely-transferable.[205] The idea of this design was, in the early stage of SOEs reform, to set up a modern stock market with an appropriate amount of equity in the market, attract both domestic and foreign investors to invest, and help transform SOEs into partially private companies.[206] For this reason, most SOEs only issued a small portion of their shares to the public market. Meanwhile, a great portion of the total shares were retained by state or other legal entities (such as local governments and other related SOEs), and those shares were required to be non-tradable.

The rationale behind this design, at the time when it was first conceived, was two-fold. First, the Chinese authorities worried there might not be enough willing capital available to invest in the Chinese market and the possible dilutive effect if all shares were later allowed to be dumped in the market all at the same time. The fact that only limited shares were available in the market was targeted to maintain the price of shares and avoid a price crash.[207] Second, the Chinese government was still somewhat bounded by socialist ideology, which remains embedded in the Chinese constitution.[208] The retention of the majority of SOEs shares was intended to maintain governmental control over large enterprises. Additionally, the desire to create a stock market gradually and at a steady pace, as well as concern over the possibility of serious market speculation and price volatility, were also important reasons for this mechanism.[209]

A compromise was reached with limited issuance. For those who invested money in stocks in the beginning phase, the maintenance of the distinction of tradable and non-tradable shares meant an indispensable premise for them to enter the Chinese stock market.[210] In general, this

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[205] *See* Kister, *supra* note 204, at 312.

[206] *See id.* at 320-21 (identifying that the government's interests in retaining control over large SOEs and the economic sector as a whole were another important reason to have non-tradable shares).

[207] *See id.* at 320 (noting that the CSRC was concerned that the entry of new shares onto the market would dilute the value of existing shares).

[208] *See* Wang & Chen, *supra* note 204, at 305 (recognizing that the Chinese government "had to confront a difficult ideological conflict between socialist and capitalist economies").

[209] Kister, *supra* note 204, at 319-20.

[210] The legal attributes of this non-trading feature have been hotly debated among Chinese legal scholars. Some maintain that this feature is a part of the (implicit) contract implied in the prospectus when new shares were first introduced to the stock

approach was mostly successful in the second half of 1990s because the government, as the largest shareholder—due to its inability to run too many corporations efficiently at the same time—silently forwent some of the most important rights that shareholders in a similar position in the western world would have exercised.

However, the distinction of tradable and non-tradable shares also created several serious issues. One key problem was the economic distortion. For example, limiting the tradability of shares controlled by the State meant that the State was locked into many enterprises. The State still was responsible for their management and financial performance but could not enjoy the fruit of a company's better performance.[211] But from the viewpoint of private investors, the split-share structure also created great uncertainty since their minority position was always subject to majority's mistreatment and prevented them from obtaining larger control or further influence in their company.[212] To both sides, this system created serious problems of alignment of ownership, economic benefit, and control. Furthermore, the limited number of tradable shares also helped to create a perfect environment for market speculation and manipulation.[213]

As a result, the split-share system, as a transitional design, started to face challenges from the outside as well as from within. In the summer of 2005, Chinese security authorities started an initiative to repeal the split-share system.[214]

Basically, repealing the split-share structure is a method to pacify (or compensate) the current transferable shareholders for their loss—caused by the increase in outstanding shares.[215] This repeal was achieved through a private negotiation among non-tradable shareholders and tradable share owners.[216] By providing certain forms of compensation to tradable share owners by non-transferable share holders (generally a certain number of shares previously owned by non-tradable share owners), non-tradable share owners can reach an agreement with tradable share owners, and based on this agreement, securities authorities may lift the non-trading restriction of the non-tradable shares and allow those shares to be traded on the stock

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market. But other scholars deny the very existence of this implicit contract. *See* Wang & Chen, *supra* note 204, at 312-18.

[211] *Id.* at 306.

[212] *Id.*

[213] *See id.* at 307-09.

[214] *See id.* at 309-12 (discussing the implementation of the "Guidance Opinions on the Split-share Structure Reform of Listed Companies" and "Administrative Measures on the Split-share Structure Reform of Listed Companies" in September 2005)

[215] Kister, *supra* note 204, at 332-33.

[216] *Id.* at 332.

exchange.[217] In terms of the agreement among tradable and non-tradable shareholders, shareholders representing both two-thirds of tradable and non-tradable shares must consent.[218] Also, some agreements contain a time or amount restriction on the trading of the previously non-tradable shares.[219]

Generally speaking, the split-share reform was a tremendous success—a conclusion derived from the booming stock market both in China and globally from 2006 to 2007. As of December 25, 2006, more than ninety-four percent of listed companies on the Shanghai and Shenzhen stock exchanges had completed their negotiation and successfully repealed the non-trading restriction of non-tradable shares, while seventy-four companies remain in the process of doing so.[220] With reforms implemented and a stronger private economy formed, the Chinese stock market is gradually moving closer to a normal structure that can better handle the difficult governance and alignment problem. However, problems still remain in the Chinese stock markets. For example, although the legal restriction of non-trading was repealed, the capital structure of many of the publicly traded Chinese companies is still concentrated in the hands of the State, local governments, and rising wealthy entrepreneurs.[221] Also, some other historical relics such as the distinction of A shares and B shares remains to this day, despite the fact that the distinction is generally expected to be abandoned eventually.[222]

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[217] *See id.* at 339 (noting that frequently mentioned forms of compensations include "shares . . . cash, call or put warrants, stock distributions, and redemptions").

[218] *Id.* at 341.

[219] *Id.* at 342.

[220] Huang Jintao, *Wei Gu Gai Gong Si Jiang Bei Cha Yi Hua, Zhang Die Fu Xian Zhi Jiang Bei Xian Zhi Wei Bai Fen Zhi Wu* [If Nor Completing Share Reform, Companies Will Need To Face Additional Restriction in Trading, Including Price Trading Range Will Be Set To 5% Each Day], Shang hai zheng quan bao [Shanghai Securities News], Dec. 25, 2006, http://news.xinhuanet.com/stock/2006-12/25/content_5527569.htm. For a complete list of companies that have finished transformation, see *List of Companies, List of Trading Reform*, CHINA SEC. REGULATORY COMM'N, http://www.csrc.gov.cn/pub/newsite/flb/lfzl/jnlfssyzn/xzzf/200612/t20061230_77097.htm (last visited Feb. 23, 2012).

[221] *See* Imai, *supra* note 193, at 8-9. It is noteworthy that under the reform to repeal the split-share system, many holders of non-tradable shares agreed, due to economic reasons or political ones, not to sell their shares in the market for a different period of years to protect the share price and holders of tradable shares.

[222] Traditionally, the Chinese government has dealt with the problem by classifying shares into several classes. Different shares are under different restrictive covenants, such as limitations on resale, holding period, voting right, profit-sharing, or to whom these shares can be sold. Shares are classified according to who owns those particular shares. In this way, the government successfully attracted the first group of foreign and local private investors and started on its way to a modern securities market. The A share is owned by domestic investors, and the B share is owned by foreign investors, and they are traded on different boards of the stock exchange with different prices. In

c. Current Situation

As of January 2007, according to the statistics provided by the CSRC, the total number of listed companies is 1,445, the total market capitalization of companies in China is nearly RMB 105.64 billion, and negotiable market capitalization is almost RMB 30.41 billion.[223] Total capital is 15.24 billion shares (9.44 billion shares are non-negotiable and 5.81 billion are negotiable).[224]

In light of the April 2011 data,[225] the numbers indicate how the split-share reform has transformed the Chinese stock market.

	Total Market Capitalization (Bn, in RMB)		Total Listed Companies	Total Capital (Bn, Shares)	
	Negotiable Shares	Total Shares		Negotiable Shares	Total Shares
Jan. 2007	30.41	105.64	1445	5.81	15.24
Apr. 2011	207.51	274.64	2175	26.67	33.90

Table 1: Market Capitalization and Shares in China: Comparison between 2007 and 2011[226]

Despite the fact that privatization in China has been continuing and the government has been selling its stock in SOEs through various channels after repealing the ban on non-tradable state shares, the Chinese government is still the biggest shareholder in many large enterprises through direct or indirect holdings.[227] But undeniably, the repeal of the

addition to this A and B share distinction, there are H shares, which are issued for and traded on the Hong Kong Stock Exchange. For more discussion about the historical development of B shares and H shares, *see* Qian, *supra* note 201, at 617-18.

[223] Special attention should be paid to the above statistics since the market capitalization went up 3,493 billion January 2006, which amounts to a 202 percent increase. MKTG. DEP'T, CHINA SEC. REGULATORY COMM'N, JAN. 2007 STATISTICS, *available at* http://www.csrc.gov.cn/pub/zjhpublic/G00306204/zqscyb/200808/t20080815_108682.htm.

[224] *Id.*

[225] SFC, CHINA SEC. REGULATORY COMM'N, APR. 2011 STATISTICS, *available at* http://www.csrc.gov.cn/pub/zjhpublic/G00306204/zqscyb/201106/t20110602_196073.htm (last visited on Mar. 1, 2012).

[226] CHINA SEC. REGULATORY COMM'N, STATISTICAL INFORMATION: SECURITIES MARKET MONTHLY DATA, *available at* http://www.csrc.gov.cn/pub/newsite/sjtj/zqscyb/index.htm.

[227] Currently all shares owned by the State are administered by State-owned Assets Supervision and Administration Commission ("SASAC"), which is under the direct command of the State Council. SASAC is the product of "The Law on the State-Owned Assets of Enterprises," which was promulgated on Oct. 28, 2008 (effective Jan.

split-share system represents a successful removal of legal barriers to the further release of government-owned stock and a move toward further normalization of the Chinese stock market and related corporate governance. To say the least, it is only when state-owned shares are privatized—or at least reduced to a relatively low number—and the differential treatment among shares and shareholders are eliminated, will more meaningful corporate governance or an independent director mechanism function in China.

B. *Banking System: Policy Lending, Non-performing Loans, and Its Symbiosis*

Instead of direct finance provided by the equity market, the role of financial intermediaries, mostly in the form of bank loans, has proved to be another determining factor in shaping the landscape of corporate governance at a national level.[228] However, compared to the relatively liquid equity market, the banking system is dominated by fewer players, and often has a stronger tint of governmental involvement or intervention.

Generally speaking, the Chinese banking system has been dominated by several features: concentration, large-size, and state influence. Prior to the Economic Reform Era and until the 1980s, the banking system was either wholly state-owned or heavily controlled by state bureaucrats.[229] Before the Economic Reform Era, money was more like "units of accounting."[230] The major function of the banking system then was much like a clearing house—to move money between accounts to meet the financial obligations of enterprises.[231]

Until the mid-1980s, more than ninety percent of total financial assets

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1, 2009). By creating a unified, centralized organization, SASAC's main purpose is to supervise and manage the State-owned assets of enterprises and enhance the management of state-owned assets. *Main Functions and Responsibilities*, STATE-OWNED ASSETS SUPERVISION & ADMIN. COMM'N, http://www.sasac.gov.cn/n2963340/n2963393/2965120.html (last visited Feb. 23, 2012). Interestingly, Article 1 of *The Law on the State-Owned Assets of Enterprises* specifically stipulates that to "enhance the protection of state asset[s]" is one of the main reasons for this new law. The latter expression exemplifies the problem of asset tunneling in China. Qi ye guo you zi chan fa [THE LAW ON THE STATE-OWNED ASSETS OF ENTERPRISES] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2008, effective May 1, 2009) art. 1, http://chinalawinfo.com.

[228] For how financing method shapes corporate governance from a comparative perspective, see e.g., Mark J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 51-102, 169-87 (1994) (discussing the history of American corporate finance).

[229] SATYANANDA J. GABRIEL, CHINESE CAPITALISM AND THE MODERNIST VISION 133-34 (2006).

[230] *Id.* at 134.

[231] *Id.*

were concentrated in the Chinese central bank ("People's Bank of China") and the objective of financial institutions was to move money from one account to another to meet the financial obligations of the enterprises.[232] However, as the Economic Reform Era was being carried out in the 1980s and the 1990s, four major state banks—Agricultural Bank of China, Bank of China, People's Construction Bank of China, and Industrial and Commercial Bank of China, customarily known as "the Big Four"—were established.[233] The People's Bank of China started to shift all commercial accounts to those special purpose banks based on the types of accounts and began to perform as a central bank, acting as other central banks in the world do with functions such as issuing currency, implementing monetary policy, and regulating and supervising financial institutions.[234]

As those special purpose banks (generally referred to as state-owned commercial banks) started taking over the commercial accounts formerly owned by the People's Bank of China, their roles in the field of commercial banking were still obscured. To a large extent, those commercial banks in China were still owned and controlled by the State and their operations were hence heavily influenced by state policy. For example, policy-lending often forced Chinese state-owned banks to accumulate a large amount of non-performing loans that are directed to other SOEs for political reasons.[235] Until the early to mid-2000s, state-owned commercial banks still greatly extended policy-directed credits to special clients, which were mostly SOEs or former SOEs.[236] As a result, policy lending, which still persists today, has caused a heavy and unnecessary loss on those state-owned commercial banks.[237]

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[232] RAPHAEL SHEN, CHINA'S ECONOMIC REFORM: AN EXPERIMENT IN PRAGMATIC SOCIALISM 170 (2000).

[233] *Id.* at 178; *see also*, Andrew Xuefeng Qian, *Transforming China's Traditional Banking Systems Under the New National Banking Laws*, 25 GA. J. INT'L & COMP. L. 479, 482-83 (1996).

[234] SHEN, *supra* note 232, at 177.

[235] According to *The Economist* (which cites a report by Ernst & Young from May 2006, a company that does a large amount of work on the mainland), "China's stock of non-performing loans (NPLs) added up to $911 billion" and is "more than five-and-a-half times the latest government estimate of $164 billion, published in March." Also, "[t]he report deemed the country's big four state-owned banks, which are trying to attract international investors, to be carrying $358 billion of bad loans, almost three times the official tally." *Chinese Banks: A Muffled Report*, ECONOMIST, May 18, 2006, *available at* http://www.economist.com/node/6955515. Another estimate of China's non-performing loans estimates the amount between $350 and $550 billion. U.S.-CHINA ECON. AND SEC. REVIEW COMM'N, 109TH CONG., 2005 REPORT TO CONGRESS 53 (Comm. Print 2005), http://www.uscc.gov/annual_report/2005/annual_report_full_05.pdf.

[236] *See* Weitseng Chen, *WTO: Time's Up for Chinese Banks--China's Banking Reform and Non-Performing Loan Disposal*, 7 CHI. J. INT'L L. 239, 242-43 (2006).

[237] *Id.* at 253 (documenting that from 1999 to 2000, the Big Four transferred

Additionally, these practices limit the availability of loans for healthy private enterprises, further hindering the development of the banks. Despite the gradual easing of the problem of bad loans, which has lessened due to China's economic success over the past decade,[238] the problem of market concentration is still unsolved. For example, the so-called Big Four dominate more than fifty percent of the total assets of banking institutions according to statistics published in late 2006 by the China Banking Regulatory Commission.[239] Three of these four (Bank of China, China Construction Bank, and Industrial and Commercial Bank) are publicly traded and listed in Shanghai and Hong Kong separately.[240]

Parallel to the dominant position of the Big Four, another group of important banking institutions are Joint Stock Commercial Banks (JSCBs),

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approximately $168.2 billion to Chinese AMCs to take responsibility for bank losses from policy lending that predated 1996).

[238] Due to the growing strength of China's economy since 2002, non-performing loans in Chinese state-owned banks have been significantly reduced in recent years. According to the statistics published in 2007, the NPL ratio for the "Big Four" is 9.22%, which equals RMB 105 billion and is 1.26%, or RMB 18.83 billion, lower than early 2006. On the other hand, the same ratio for twelve major stock Commercial Banks in early 2007 is 2.81%. Yan Sun, *Corporate News Brief—Banks: Chinese Lenders See Drop in Nonperforming Loans*, WALL ST. J. ASIA, Jan. 22, 2007, at 4. A different statistic published by Chinese Banking Regulatory Commission shows that in 2007, the aggregate NPLs ratio of Chinese banking industry is moving between 6.63% to 6.17%. *NPLs of Commercial Banks as of End-2007*, CHINA BANKING REGULATORY COMM'N, 2007 NONPERFORMING LOANS OF COMMERCIAL BANKS (2008), http://www.cbrc.gov.cn/chinese/home/docView/20070516A4DD51DB0062F0CBFF88 3AB8A21E4800.html.

[239] CHINA BANKING REGULATORY COMM'N, TOTAL ASSETS & TOTAL LIABILITIES AS OF END-2006 (2006), http://www.cbrc.gov.cn/EngdocView.do?docID= 20070212AEEE115DF551BD83FF530487A9E07B00 [hereinafter 2006 ASSETS & LIABILITIES REPORT]. One phenomenon needing particular attention is the dramatic drop from roughly ninety percent in 2001 to roughly fifty percent since middle of the 2000s. *See infra* Table 2.

[240] Three among the "Big Four" have conducted their IPOs in 2005 and 2006. China Construction Bank Corp., the third-largest lender by assets in China, raised $9.2 billion in its IPO in the fall of 2005. Bank of China Ltd., the second-largest bank by assets in China, raised $11.2 billion in its IPO in mid-2006. The Industrial Commercial Bank of China Ltd., the largest commercial bank by total assets, loans and deposits in China, raised $21.9 billion, in late 2006. *Great China Bank Sale*, WALL ST. J., Oct. 18, 2006, at A20; Laura Santini, *Year-End Review of Markets & Finance 2006: Investors Place Bets Globally -- and Reap the Rewards; India and China Lead Asia Higher; Japan Rally Fizzles*, WALL ST. J., Jan. 2, 2007, at R6. However, these IPOs are only possible with significant help from the government. "Since 1998, Beijing has injected $95 billion into the 'big four banks,' and carved out $305 billion of bad loans." *Great China Bank Sale*, *supra* note 240. The *Wall Street Journal* also reports that the "ICBC itself received a $15 billion state capital injection last year, plus a government-financed nonperforming-loan carve-out of $85 billion. Foreign banks added an additional $20 billion; Goldman Sachs, Allianz Capital and American Express own 10% of ICBC's equity." *Id.*

which are comprised of twelve commercial banks.[241] In general, JSCBs are smaller commercial banks and take up to sixteen percent of total banking institutions assets.[242] Although JSCBs have larger private ownership, the State still enjoys substantial influence over JSCBs. If including postal saving and rural cooperatives, credit unions, and banks in the calculation, the percentage of banking assets under Chinese government control would be even higher. This degree of concentration has not yet showed any substantial sign of easing.

	Asset, by amount, BN (RMB)		
Year (end of)	State-Owned Commercial Banks (The Big Four)	All Banks	Ratio
2007	28,007.1	52,598.2	53.2%
2010	46,894.3	95,305.3	49.2%
	Liability, by amount, BN (RMB)		
2007	26,433.0	46,567.5	53.3%
2010	44,033.2	89,473.1	49.2%

Table 2: Market Concentration Comparison Between 2007 and 2010: State-Owned Commercial Banks to All Banking Institutions[243]

	NPLs Owed by State-Owned Commercial Banks		NPLs Owed by All Banking Institutions		Ratio of Major Commercial Banks to All Banking Institutions, by amount, BN (RMB)
Year (end of)	Percentage of Total Loans	Amount, BN (RMB)	Percentage of Total Loans	Percentage of Total Loans	
2007	8.05%	1268.4	6.17%	8.05%	1268.4
2010	1.31%	429.3	1.14%	1.31%	429.3

Table 3: NPLs Status Ratio Comparison Between 2007 and 2010: State-Owned Commercial Banks to All Banking Institutions[244]

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[241] 2006 ASSETS & LIABILITIES REPORT, *supra* note 239 (listing the twelve referenced banks as the Bank of Communications, CITIC Industrial Bank, Everbright Bank of China, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Co., Evergrowing Bank, and China Zheshang Bank).

[242] By end of 2006, JSCBs owned RMB 7141.9 billion in assets. Compared to the total assets of RMB 43,950 billion owned by all banks, JSCBs account for roughly 16.25% of total assets owned by all banks. *Id.*

[243] CHINA BANKING REGULATORY COMM'N, TOTAL ASSETS & TOTAL LIABILITIES OF THE BANKING INSTITUTIONS AS OF END-2007, (2007) http://www.cbrc.gov.cn/EngdocView.do?docID=20071112169537BCC40F1A95FF169F0FB9383B00; China Banking Regulatory Comm'n, Annual Report 2010, at 152 (2011), *available at* http://zhuanti.cbrc.gov.cn/subject/subject/nianbao2010/english/zwqb.pdf (last visited Apr. 10, 2012).

[244] For 2007 data, see NPLS OF COMMERCIAL BANKS AS OF END-2007, CHINA BANKING REGULATORY COMM'N, http://www.cbrc.gov.cn/EngdocView.do?docID=20070517748300DBD1F20010BFFD7F4A6791F6F00 (last visited Apr. 10,

Due to the State's control over the banks and the limited market competition, the range of innovation and the services provided still lag behind the need. From an investment perspective, the conservative attitude poses a threat to the adequate and stable supply of funds needed by companies as banks choose whom they want to lend money to. Consequently, the banking system in China performs a relatively weak role in corporate financing today, and some Chinese companies have to bypass major banks and obtain needed capital through other channels (such as the securities market or private lenders).

In conclusion, banking is the main mechanism for financing the country's high levels of investment.[245] Despite the pressure caused by the need to provide funds to inefficient SOEs, the growing economy and the high savings rate have helped keep the banking system in China liquid enough.[246] Also, China currently has more than $3 trillion foreign exchange reserves on hand, which provide the government powerful weapon to improve its banks' health, boost investment and fight possible consequences of a financial crisis if downturn happens.[247]

The problems facing Chinese banks, however, are governance problems experienced by most state-owned enterprises in China—namely strong governmental intervention and insufficient involvement from other shareholders or even stakeholders. In this sense, even though banks provide a large portion of Chinese company funding, the expectation that those financial relationships will result in greater participation or an effective governance relationship may still be immature.

C. *The Dual Role of State in Corporate Governance*

Understanding the current Chinese corporate environment highlights the need for the institution of independent directors and the implementation of more careful observation and evaluation. One main distinction in the

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2012). For 2010 data, see NPLS OF COMMERCIAL BANKS AS OF END-2010, CHINA BANKING REGULATORY COMM'N, http://www.cbrc.gov.cn/chinese/home/docView/201004217094BE544F34FB48FF5D5DB53962FB00.html (only available in Chinese) (last visited Apr. 10, 2012).

[245] Harry Harding, *Think Again: China*, FOREIGN POL'Y, Mar.–Apr. 2007, at 26, 28.

[246] *Id.* For the change of saving rate in China from 1983 to 2008, see also Guonan Ma & Wang Yi, *China's High Saving Rate: Myth and Reality* 3 (Bank for Int'l Settlement, Working Paper No. 312), *available at* http://www.bis.org/publ/work312.pdf (graphing China's gross national savings).

[247] Harding, *supra* note 245, at 28 (indicating that "with $1 trillion in foreign exchange reserves . . . China is hardy dependent on foreign capital."). By the end of 2011, China's foreign exchange reserves reached $3,181.1 billion. *See* NAT'L BUREAU OF STATISTICS OF CHINA, STATISTICAL COMMUNIQUÉ ON THE 2011 NATIONAL ECONOMIC AND SOCIAL DEVELOPMENT, fig. 5 (2011), *available at* http://www.stats.gov.cn/english/newsandcomingevents/t20120222_402786587.htm.

Chinese corporate world is the large portion of state-owned shares in equity. This peculiarity, a product of a former socialist idea, still presents strong barriers to the adoption of a standard design of corporate governance. Moreover, the Chinese government's heavy use of its regulatory power to influence various actors in the Chinese securities market creates problems. These competing roles of the State produce mixed results in many aspects.

Based on the discussions above, the following section will discuss the implementation of the Chinese independent director and the general response from the community. Combining the general background of corporate governance and the implementation of an independent director mechanism, we may be in a better position to understand and assess the future prospects of this imported legal mechanism.

IV. THE IMPLEMENTATION OF THE INDEPENDENT DIRECTOR AND ITS CRITICS

A. *Implementations*

1. 1999

A survey covering the newly listed companies from the June 1997 to May 1999 contained several statistics providing a basic picture of public companies in China.[248] About seventy-nine percent of the companies surveyed have between seven and eleven directors on their board of directors in compliance with the mandatory five to nineteen stipulated in the Company Law.[249] In terms of ownership, more than seventy-four percent of the companies participating in this survey have the directors owning over fifty percent of the outstanding shares of their companies, and in about forty-four percent of companies, directors own more than two-thirds of the outstanding shares.[250] In contrast to the strong alignment of ownership and directorship in those companies, however, there is another group of companies at the opposite end of the spectrum in which directors own nominal or even no shares. Most companies in this second group are owned by the government or under indirect governmental control and their directors are either professional managers or people with strong

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[248] Li Dongming & Deng Shiqiang, *Shang shi Gong si Dong shi hui Jie gou Zhi neng de Shi zheng Yan jiu* [*An Empirical Study on the Structure and Power of Board of Directors in Listed Companies*], 10 ZHENG QUAN SHI CHANG DAO BAO (SEC. MKT. REP.) 25-30 (1999), *available at* http://www.witsee.com/article/cwss/60588.html.

[249] *Id.*; *see* Company Law of 2005, *supra* note 41, at art. 109, para. 1.

[250] Dongming & Shiqiang, *supra* note 248.

government ties, so-called "insiders."[251]

In terms of board composition, about forty percent of the surveyed companies have a majority of insiders or managers as directors.[252] Another thirty-six percent of the companies have a majority of directors appointed by substantial shareholders.[253] This creates a polarized situation where over three quarters of the companies' boards are either controlled by insiders/managers or controlling shareholders.

In terms of ownership concentration, about fifty-four percent of surveyed companies have substantial shareholders controlling over half of the total shares, and another thirty percent of companies have substantial shareholders controlling two-thirds of total shares. In contrast, only fourteen percent of companies report that substantial shareholders control less than thirty percent of the total shares.[254]

Among the surveyed companies, eighteen percent already have an independent director or outside director.[255] Half of the surveyed companies have a majority of supervisors who are elected by employees.[256] The law only requires that one third of supervisors be elected by employees, so this number is higher than what the law requires.[257] Despite this apparent achievement, the general perception is that, whether elected by shareholders or employees, the supervisors are not functioning effectively.[258]

2. 2001

Another survey[259] conducted in 2001 covering 1,135 listed companies in China provides several interesting findings—especially about the constitution of the board of directors.

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[251] *Id.*

[252] *Id.*

[253] *Id.*; *see also* HONG KONG EXCHS. & CLEARING LTD., RULES GOVERNING THE LISTING OF SECURITIES ON THE STOCK EXCHANGE OF HONG KONG LIMITED 1-13 (2010) (defining that a substantial shareholder "means a person who is entitled to exercise, or control the exercise of, ten percent or more of the voting power at any general meeting of the company").

[254] HONG KONG EXCHS. & CLEARING LTD., MAIN BOARD LISTING RULES § 1.01: RULES GOVERNING THE LISTING OF STOCK EXCHANGE OF HONG KONG LIMITED (2010), *available at* http://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_1.pdf.

[255] *Id.*

[256] *Id.*

[257] Company law of 2005, *supra* note 41, at art. 118.

[258] *Id.*

[259] 2002 NIAN SHANG SHI GONG SI DONG SHI HUI ZHI LI LAN PI SHU [THE BLUE BOOK OF 2002 LISTED COMPANIES DIRECTORATE GOVERNANCE] (Wang Zhong Jie ed., 2002) [hereinafter THE BLUE BOOK OF 2002].

In terms of state ownership, about sixty-six percent of listed companies have more than thirty percent of their shares owned by the State or government controlled entities; around forty percent of companies have more than fifty percent of their shares owned by the State or government controlled entities; and a little more than nine percent of surveyed companies have more than seventy percent of their shares owned by state or government controlled entities.[260]

In addition, almost sixty percent of the directors are appointed by the State or other government controlled entities. Or to put in a different way, 730 of the surveyed companies have half of their directors appointed by the State or government controlled entities, which is about sixty-five percent of the total surveyed companies. Furthermore, 226 companies (equaling 19.91% of the surveyed companies) have all their directors appointed by the State or government controlled entities.[261]

In terms of the number of directors, seventy-seven percent (878 companies) of the surveyed companies have between seven and eleven directors. The average number of directors equals 9.42 for all surveyed companies.[262]

The survey shows 348 companies (30.66%) have installed independent directors. Independent directors take almost seven percent of total directorship for all surveyed companies. The survey also shows that 248 companies have more than two independent directors, and in fifty-three companies, independent directors make up more than one third of the board.[263]

About eighty-nine of independent directors have backgrounds in technology, finance, or management. It is common to see academics, technological experts, or government officials (incumbent and retired) acting as independent directors in China, as the survey shows.[264]

The survey found almost twenty-nine percent of directors who are not independent are also managers in the same company. In addition, more than forty-four percent of directors are appointed by shareholder companies. In most of cases, they serve also as employees or managers in those shareholder companies.[265] These numbers reflect the intensive network among companies and corporate groups in China, which were built on inter-company equity investment and mutual monitoring.

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[260] *Id.* at 29.
[261] *Id.* at 30.
[262] *Id.* at 37-38.
[263] *Id.* at 60.
[264] *Id.* at 63-64.
[265] *Id.* at 147.

3. 2002

Another survey conducted in 2002 provides details of independent directors in China. In 500 randomly-picked Chinese listed companies, there are 1,044 independent directors in total and thirty-nine percent of these directors are professors at universities or colleges.[266] Additionally, twenty-eight percent of them are from business circles; fourteen percent of them are professionals, such as lawyers and accountants; thirteen percent are retirees who are former Communist party or governmental officials; and six percent of them are from other research institutions.[267]

About eighty-six percent of independent directors in this survey work on a part-time basis.[268] Only fourteen percent of them are retirees, which is substantially lower than was generally perceived.[269] Most independent directors work for only one company as an independent director.[270] Only six percent of them serve as independent directors in two or more companies at the same time.[271]

4. 2010

The 2001 Guidelines made independent directors mandatory. Most listed companies in China are expected to maintain one third of their directors as independent after 2002.[272] To observe whether this implementation is actually occurring and the actual functioning of this newly-transplanted design, it must be viewed in light of its relationship to the whole board and supervisors. The following tables summarize the number of independent directors, the ratio to the whole board, and the number of supervisors in top financial companies listed on the Shanghai and Shenzhen stock exchanges and top twenty-five companies in China.

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[266] Yue Qing Tang, *Dui Wu Bai Jia Shang Shi Gong Si Du Li Dong Shi Nian Ling Zhuan Ye Deng Gou Cheng De Shi Zheng Yan Jiu* [*Empirical Survey on The Age, Professional and Other Characteristics of The Independent Directors in Five Hundred Listed Companies*], JING JI JIE [ECON. AFFAIR], Feb. 2003, at 86, 89.

[267] *Id.*

[268] *Id.*

[269] *Id.*

[270] *Id.*

[271] *Id.*

[272] *2001 Guideline*, *supra* note 128, at art. 1, para. 3.

Top 10 Financial Companies (Shanghai Stock Exchange)							
Name	Contributed Capital (thousand)	Board of Directors	Number of Independent Directors	Term (year)	Ratio of ID to the Board	Number on Commit-tee	Number of Supervisors
Industrial and Commercial Bank of China	334,019,000	16	6	3	37.50%	6	6
Agricultural Bank of China	270,000,000	14	3	3	28.60%	5	6
Bank of China	253,839,000	16	6	3	37.50%	5	8
China Construction Bank	233,689,000	15	5	3	33.33%	5	9
Bank of Communications	48,994,000	17	6	3	35.29%	5	13
China Citic Bank	39,033,000	15	5	3	33.33%	4	8
China Everbright Bank	33,434,790	15	5	3	33.33%	6	11
China Life	28,265,000	12	5	3	41.7%	5	5
China MinSheng Bank	22,262,000	18	6	3	33.33%	6	8
China Merchants Bank	19,119,000	17	6	3	35.29%	6	9

Table 4: Board Composition in Top 10 Financial Companies (Data from Shanghai Stock Exchange, compiled by author)[273]

Top 8 Financial Companies (Shenzhen Stock Exchange)							
Name	Contributed Capital (thousand)	Board of Directors	Number of Independent Directors	Term (year)	Ratio of Independent Directors to the Board	No. on Committee	Number of Super-visors
ShenZhen Dev. Bank	3,105,434	20	8	3	40.00%	2	7

[273] Information personally gathered by author from Shanghai Stock Exchange (Oct. 2010) (on file with author); *see also Corporate Governance Overview*, ICBC, http://www.icbc-ltd.com/ICBCLtd/Corporate%20Governance/Overview/ (last visited Apr. 25, 2012); *Investor Relations*, AGRICULTURAL BANK OF CHINA, http://www.abchina.com/en/investor-relations/ (last visited Apr. 25, 2012); *Investor Relations: Corporate Governance*, BANK OF CHINA, http://www.boc.cn/en/investor/ir6/ (last visited Apr. 25, 2012); *Corporate Governance Overview*, CHINA CONSTRUCTION BANK, http://www.ccb.com/en/newinvestor/governance.html (last visited Apr. 25, 2012); *Governance Structure*, BANK OF COMMUNICATIONS, http://www.bankcomm.com/BankCommSite/en/invest_relation/company_develop.jsp?type=company_develop&categoryPath=ROOT%3E%D3%A2%CE%C4%CD%F8%D5%BE%3EInvestor+Relations%3ECorporate+Governance (last visited Apr. 25, 2012); *Corporate Governance Policy*, BANK OF CHINA (HONG KONG), http://www.bochk.com/web/common/multi_section.xml?section=about&level_2=corporate_governance&fldr_id=31584 (last visited Apr. 25, 2012); *About CMBC*, CHINA MINGSHENG BANKING CORP., INC., http://www.cmbc.com.cn/en/about/dongshihui.shtml (last visited Apr. 25, 2012); *Corporate Governance*, CHINA MERCHANTS BANK, http://english.cmbchina.com/cmbir/en/ProductInfo.aspx?type=info&id=CG (last visited Apr. 25, 2012).

Top 8 Financial Companies (Shenzhen Stock Exchange)							
Name	Contributed Capital (thousand)	Board of Directors	Number of Independent Directors	Term (year)	Ratio of Independent Directors to the Board	No. on Committee	Number of Supervisors
Bank of Ningbo	2,500,000	7	1	3	14.29%	5	8
Chang Jiang Securities	2,171,234	12	4	3	33.33%	4	6
GF Securities	2,057,045	7	3	3	42.86%	4	3
GuoYuan Securities	1,964,100	15	5	3	33.33%	4	5
HongYuan Securities	1,461,204	10	4	3	40.00%	4	7
North East Securities	639,312	13	5	3	38.46%	4	9
ShaanXi International Trust	358,413	11	3	3	27.27%	4	3

Table 5: Board Composition in Top 10 Financial Companies (Data from Shenzhen Stock Exchange, compiled by author)[274]

Top 25 Public Companies (All sectors, Shanghai and Shenzhen Stock Exchange combined)							
Name	Contributed Capital (ten thousand shares)	Board of Directors	Number of Independent Directors	Term (year)	Ratio of Independent Directors to the Board	No. on Committee	Number of Supervisors
Industrial and Commercial Bank of China	33,401,885	16	6	3	37.50%	6	6
Agricultural Bank of China	32,479,412	12	3	3	28.60%	5	6
Bank of China	25,383,916	16	6	3	37.50%	5	8
China Constr. Bank	23,368,908	15	5	3	33.33%	5	9
China National Petroleum Corporation	18,302,098	14	5	3	35.71%	4	9
China Petrochemical Corporation	8,670,253	15	5	3	33.33%	3	9
Bank of Communications	5,625,964	17	6	3	35.29%	5	13
China Everbright Bank	4,943,479	15	5	3	33.33%	6	11
China Citic Bank	3,903,334	15	5	3	33.33%	4	8

[274] Information personally gathered by author from Shenzen Stock Exchange (Oct. 2010) (on file with author); *see also Corporate Governance*, SHENZEN DEV. BANK (2012), http://www.sdb.com.cn/website/page/files/wcms/SDB/primary/en/PersonalFinancing; *Corporate Governance*, BANK INT'L NINGBO (2012), http://www.binbank.com/e-profile6.htm.

Top 25 Public Companies (All sectors, Shanghai and Shenzhen Stock Exchange combined)							
Name	Contributed Capital (ten thousand shares)	Board of Directors	Number of Independent Directors	Term (year)	Ratio of Independent Directors to the Board	No. on Committee	Number of Supervisors
China State Construction Engineering Corporation	3,000,000	7	4	3	57.14%	3	5
China Life	2,826,471	12	5	Unclear	41.7%	5	5
China MinSheng Bank	2,671,473	18	6	3	33.33%	6	8
China Merchants Bank	2,157,661	17	6	3	35.29%	6	9
China Railway	2,129,990	9	5	3	55.56%	5	6
China United Network Communications Group	2,119,660	10	4	3	40.00%	3	3
Shanghai International Port Group	2,099,080	9	3	3	33.33%	4	5
China Shenhua	1,988,962	9	3	3	33.33%	5	3
China Metallurgical Corporation	1,911,000	10	5	3	50.00%	4	3
Baoshan Iron & Steel Co.	1,751,205	10	6	3	60.00%	3	5
China Yangtze Power Co.	1,650,000	11	5	3	45.45%	3	6
Zijin Mining Group Co.	1,454,131	11	5	3	36.36%	3	5
Aluminum Corporation of China Limited	1,352,449	10	4	3	40.00%	4	3
China National Coal Group Corp.	1,325,866	7	5	3	71.43%	5	3
Daqin Railway Co.	1,297,676	11	4	3	36.36%	4	7

Table 6: Board Composition in Top 25 Companies of China, Data from Shanghai Stock Exchange, and Shenzhen Stock Exchange, compiled by author[275]

Based on the survey above, several observations can be tentatively drawn. First, it seems that the independent director mechanism has taken root in China. As major listed companies successfully meet the compulsory one-third threshold, the persistent presence of independent directors on boards of listed companies creates a possible—even

[275] Information personally gathered by author from Shanghai Stock Exchange and Shenzen Stock Exchange (Oct. 2010) (on file with author).

favorable—environment for them to perform intended functions. Second, the committee within the board of directors has been utilized extensively in many large Chinese listed companies. The non-required nature of the committee structure and its acceptance provides an interesting topic for future study. Third, a similar degree of acceptance towards the independent director mechanism has been shown across different sections of industry. However, whether different types of companies or businesses adopt this new mechanism differently is another topic requiring more in-depth research, and it may be too early to jump to any conclusion at this point.

As a legal transplant with a clear aim, the survival of this mechanism in China after a decade of experimentation is a fact rather than mere myth. But similarly understandable, to have an independent director on board, in many cases, is not good corporate governance. The role of Chinese independent directors and the actual difference they make are still subjects of further observation and discussion. One thing is certain: the future of independent directors in China will be a function of political, economic, and social environments as well as public opinion.

B. Critiques and Phenomena

1. Question about Effectiveness

Although transplanted in the name of enhancing corporate governance, there is much uncertainty, even suspicion, about independent directors in China. The common critique of independent directors is that they do not really function as a monitoring mechanism in Chinese corporations.

However, academics show a positive attitude toward the introduction of an independent director mechanism and believe it will help alleviate the problem of concentrated ownership structure (i.e., the mistreatment of minority shareholders from a controlling shareholder) and the prevailing "insider-dominance"[276] by providing a better check-and-balance mechanism within the board, and facilitating a board of directors' monitoring function.[277] Also, independent directors are considered to be helpful in improving the quality of the board of directors and broadening its perspectives.

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[276] XIN ZHONG HUA REN MIN GONG HE GUO GONG SI FA XIU DING YAN JIU BAO GAO SHANG CE [REPORT ON THE REVISION OF NEW COMPANY LAW] Vol. 1, 132 (Cao Kang tai, et al. eds., 2005); Zhu Ci Yun, *Xin de Li nian yu Xin de Shi jiao: Ping Da lu Zhong Hua Ren Min Gong He Guo Gong Si Fa de Xiu gai* [*New Ideas and New Perspectives: Comments on the Revision on Chinese Company Law*], YUE DAN MIN SHANG FA ZA ZHI [CORSS-STRAIT L. REV.], Oct. 2005, at 40, 53.

[277] Zhu, *supra* note 276, at 53.

On the contrary, reservations about independent directors are easily found in Chinese academic circles.[278] One common critique is the issue of false independence and its effectiveness. The concentration of ownership in China often results in a strong tie between ownership and management. The existence of a sole owner, either the State or a private one, makes desired independence difficult to attain. Because independent directors are most likely friends of incumbent management, many critics consider independent directors to be either not independent enough in reality or unable to make any difference, let alone effective monitoring.[279]

2. Question about Power Division with Supervisor

The unclear division of power between independent directors and the supervisory board is a legal issue which has been heavily debated and criticized. In the Chinese context, this issue is slightly different from other two-board systems in other countries such as Japan.[280] Contrary to Japan's case, supervisors in China do not have deep historical roots with powerful cross-industry institutions. The short history of corporate law in China makes this institution less resistant to other competing institutions that might share authority or reset the power structure. Also, supervisors in China face similar challenges to their ability to perform their function adequately.[281]

In discussing this issue, some Chinese academics consider these two institutions to be serving different purposes and can successfully co-exist

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[278] Gu Gong yun and Luo Pei xin characterize independent directors in China in the following manner: "In reality, most of the independent directors in China become independent directors as the result of the leading managers' invitation. They accept simply due to the personal relationship with these managers. In fact, their responsibility and power are both obscure and the only purpose is to enhance the public image of that company or for advertisement, or even to meet the requirement for foreign stock exchanges. In short, these invitations or relationships surely compromise their independence." Gu Gong Yun & Luo Pei Xin, *Lun Wo guo Jian li Du li Dong shi Zhi du de Ji ge Fa lu Wen ti [On Several Legal Issues of the Establishment of Independent Director in China]*, Zhong Guo Fa Xue [CHINA LEGAL SCIENCE], June 2001, at 67.

[279] *See, e.g.,*Yi Xian Rong, *Du li Dong shi Xu yao Du li [Independent Director need to be Independent]*, 99 XIN WEN ZHOU KAN [CHINA NEWSWEEK], 45, (2002); Su Xiang Hui, *Du li Dong shi Zhi du Ying gail; Huan xing [Independent Directors Mechanism Should be Postponed]*, ZHONG GUO SI FA (JUDICATURE OF CHINA) 36, (2003).

[280] *See* Lin, *supra* note 2, at 105-06 (describing how Japanese corporate auditors and supervisors resist the implementation of independent directors and use strong cross-industry lobbying associations to defend the position of corporate auditors and supervisors in corporate law).

[281] *See* Gan Pei Zhong, *Lun Wan shan Wo guo Shang shi Gong si Zhi li Jie gou zhong de Jian shi Zhi du [Comment on Improving Supervisors Mechanism in the Governance Structure in Chinese Listed Companies)*, ZHONG GUO FA XUE (CHINA LEGAL SCIENCE), May 2001, at 79.

while functioning in a supplementary fashion.[282] In opposition to this opinion, some attack independent directors for being redundant and believe corporate law should go back to the supervisory board and enhance its monitoring authority.[283] Other than these two opinions, there are also opinions positing that the independent director mechanism needs more time to fit itself into the Chinese corporate environment, and probably some revisions are needed for it to perform its function.[284] In any event, the uncertainty created by the power overlap between the supervisor and independent directors in China may develop new gridlock or create an obstacle for furthering the implementation of independent directors in China. Final settlement of this disagreement may require a detailed analysis and comparison of how both institutions function.[285]

3. Insufficient Support

Another usual critique is that the independent director in China is insufficiently equipped. The law requires companies to provide necessary assistance to help independent directors perform their jobs.[286] But in reality, in most cases, independent directors do not have enough resources to conduct effective monitoring in their companies.[287]

4. Scarcity of Eligible Personnel

One frequent problem with the current implementation of the independent director mechanism in China is the scarcity of eligible personnel. As mentioned above, academics in relevant disciplines are often

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[282] *Id.* at 84. In this view, it is generally proposed that supervisors should be in charge of financial auditing, representing employees' interests, and have the right to file derivative suits against directors. Independent directors should focus on strategic decisions and enhancing the quality of the board's decisions, especially participating actively in situations such as self-dealing and protecting the interest of minority shareholders. *See also* LI JIAN WEI, GONG SI ZHI DU, GONG SI ZHI LI YU GONG SI GUAN LI [CORPORATE SYSTEM, CORPORATE GOVERNANCE AND CORPORATE MANAGEMENT], 162-65, (2005).

[283] *See, e.g.*, Su Xiang Hui, *supra* note 279.

[284] *See, e.g.*, Gu & Luo, *supra* note 278, at 75.

[285] The opinion of this article, similar to the opinion held in another article by the author discussing Japanese independent directors, is that the independent director is a better choice in terms of monitoring power allocation. Since independent directors on a single board structure possess more organizational design simplicity, this simplicity will lead to a clearer sense of command/follow relationship. Lin, *supra* note 2, at 109-12. This position is strengthened by the fact that there is no workable guidance on how to perform the function of a supervisor under the current Company Law in China.

[286] *See* Yu Hua Jun, et al., Zhong guo Shang shi Gong si Du li Dong shi Gong neng Que shi Yan jiu [The Study of the Insufficient Function of Independent Directors in Chinese Listed Companies], Shi chang Zhou kan Cai jing Lun tan [Market Weekly: Economic Forum], Sept. 2003, at 27-28.

[287] *Id.*

invited to serve as independent directors in China.[288] Professionals such as accountants, financial advisors, lawyers, or former government officers are also usual candidates.[289] However, many observers have expressed their reservation on the effectiveness of academics serving as independent directors in modern companies. The lack of experienced executives from other companies or industries is also a legitimate concern in China.[290] Even when qualified personnel are found, concerns about double roles and conflict-of-interest arise.

5. Resignations as Protests

All the difficulties mentioned above explain the high rate of resignation among independent directors in China. Resignations of independent directors are frequently observed and—especially in smaller companies—act as the means for independent directors to protest. It is also an important sign that serious corporate corruption was spotted. Several anecdotal incidents suggest that many outside directors in China chose to resign when they spotted illegal activity or other highly suspicious behavior by the board.[291] One possible reason for this phenomenon is that most independent directors in China are minorities in their board, which is still comprised of insiders at most time. Independent directors often encounter a situation where the rest of the board (most are managers/inside directors) have made decisions without consulting them before board meetings. Sometimes those inside directors even colluded in inappropriate decisions without ever bringing those decisions to the board's attention during a meeting or otherwise. As a result, out of fear of being charged with personal liability, many independent directors choose to resign when they sense that there might be something wrong. This phenomenon reflects the vulnerability of the independent director as a minority on boards and the prevalent lack of respect they receive in the practice of Chinese corporate governance.[292]

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[288] *Supra* note 264 and accompanying text.

[289] *See* Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 208, 220 fig.2b, 221 fig.2c (2006) (providing two surveys on the educational level of independent directors in China); Sibao Shen & Jing Jia, *Will the Independent Director Institution Work in China*? 27 LOY. L.A. INT'L & COMP. L. REV. 223, 242 (2005); Chao Xi, *In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China*, 22 CONN. J. INT'L L. 1, 20 (2006).

[290] This dearth can be attributed to the relatively short modern business development history as many successful businessmen focus only on their own companies. The fast-changing business environment in China and "manager as owner" structure also contribute to the scarcity of eligible personnel.

[291] THE BLUE BOOK OF 2002, *supra* note 259.

[292] In his article *Du li Dong shi Xu yao Du li* (Independent Director need to be

6. *Variables for Further Observations*

a. *The Increasing Importance of Institutional Investors*

The increasing number of institutional investors, in theory, can play a role in reshaping the corporate governance landscape in China.[293] In theory, the emergence of institutional investors should support the implementation of the independent director mechanism. As part of the current trend, however, institutional investors in China have mainly taken extreme approaches that allow them either to control a company directly or become a passive minority. Especially in recent times, the former approach is particularly popular among foreign institutional investors in China. This partly reflects the fact that foreign investors prefer to institute their own managers to co-manage companies with domestic shareholders. If this tendency continues, it is difficult to determine whether the situation would be improved by more foreign institutional investors. Based on current observations, the appointment of independent directors by institutional investors is still rare.

b. *The Trend of Foreign Listing*

Foreign listing is an important feature providing impetus for some Chinese companies to embrace the idea of independent directors more willingly. Due to various reasons, there has been a trend since the late 1990s of Chinese companies issuing their stocks and listing them on foreign stock exchanges.[294] Some companies went to the Hong Kong Stock

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Independent), a researcher in the Chinese Academy of Social Science Yi Xian rong cited more than ten independent director resignations occurring between 2001 and 2002 and attributed these resignations to an inability to detect corporate misconduct and fear of bearing liability for these misconducts in the future. Yi, *supra* note 279, at 45.

[293] There has been a substantial increase in institutional investors in the Chinese securities market in the last decade. The China Securities Regulatory Commission noted that there were only five securities investment funds in 1998, and the number grew to 218 by the end of 2005, and 557 by the end of 2009. Also, by the end of 2009, the total net asset value under management by investment funds was RMB 2.68 trillion. That equals to 17.69% of the market capitalization of the Shanghai and Shenzhen Stock Exchanges combined. *China's Securities and Futures Markets 2005*, CHINA SECS. REGULATORY COMM'N, 27 (2006), *available at* http://www.csrc.gov.cn/pub/csrc_en/Informations/publication/200812/P020090225568825932596.pdf; *Annual Report 2009*, CHINA BANKING REGULATORY COMM'N, 22 (2010), *available at* http://www.csrc.gov.cn/pub/csrc_en/about/annual/201011/P020101105493830315968.pdf.

[294] Conceivably, the most important reason was the limited funds available domestically—especially during the early part of the decade when the Chinese stock market started to develop. However, a recently emerging—and possibly more important reason—is that being able to meet stricter listing rules also increases domestic investors' confidence, which in turn increases a company's value when it later sells its stock to domestic investors. For a discussion of this phenomenon, see, for example, John C. Coffee, *Racing Towards the Top?: The Impact of Cross-Listings and*

Exchange and others to the New York Stock Exchange (NYSE) or NASDAQ.[295] When they list on U.S. stock exchanges like the NYSE, companies must meet the requirements of independent directors. This trend of foreign listing helped the implementation of independent directors in China even before the mandatory rule in 2001. Lately, more and more companies have chosen to go public on both the domestic and foreign exchanges. It is still unclear how these newly-instituted independent directors work or are making changes due to operations within boards generally not being disclosed to the public. However, greater acceptance seems to provide some chance for Chinese companies to accept the idea of independent directors more openly, and enhance the level of internal monitoring while simultaneously cultivating a sense of respect for shareholders, which is conceived as the foundational principle of modern corporate governance.[296]

c. *Corporate Misconduct*

As history shows, corporate misconduct is always an important driving force for creating a higher standard of internal governance and triggers supplementary monitoring mechanisms like the independent director mechanism.[297] Corporate misconduct observed in China today has been

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Stock Market Competition on International Corporate Governance, 102 COLUM. L. REV. 1757 (2002). *Cf. infra* note 303.

[295] As of the end of 2008, there were over eight hundred Chinese companies incorporated overseas and listed outside mainland China. Of these, 465 were listed on the Hong Kong Stock Exchange, 44 on the New York Exchange, 76 on NASDAQ, 64 on the London Stock Exchange, and 150 on the Singapore Stock Exchange. *Annual Report 2009*, CHINA BANKING REGULATORY COMM'N, *supra* note 293, at 17 n.1.

[296] However, the contrary argument—that a foreign listing does not in fact enhance internal control or compliance of Chinese companies—can be made since a series of allegedly suspicious behaviors were spotted in U.S.-listed Chinese companies in 2010 and 2011. *See, e.g.*, Bill Alpert, *SEC Reports on China Reverse-Mergers*, BARRON'S (May 5, 2011), http://online.barrons.com/article/SB50001424052970203390704576305100837510830.html; David Barboza & Azam Ahmed, *A Thorn for Chinese Companies*, N.Y. TIMES, June 10, 2011, at B1, B5; Owen Fletcher, *Bubble Worries Hit Tech Firms Based in China*, WALL ST. J. (June 15, 2011, 3:14 PM), http://online.wsj.com/article/SB10001424052702304665904576383332824651962.html; Joshua Gallu, *'Reverse-Merger' Stocks May Be Prone to Fraud, Abuse, SEC Says in Warning*, BLOOMBERG (June 9, 2011, 2:26 PM), http://www.bloomberg.com/news/2011-06-09/-reverse-merger-stocks-may-be-prone-to-fraud-abuse-sec-says-in-warning.html; Michael Rapoport, *SEC Investigation Auditors Facing 'Reverse' Inquiry*, WALL ST. J., June 3, 2011, at C1, C.2. This reported that Chinese companies gain listings on U.S. exchanges through reverse mergers. Some of them hire small audit firms which are unable to verify the company's financial statements, and therefore may be prone to fraud and other abuses. After a series of scandals involving U.S.-listed Chinese firms, trading was halted for more than a dozen U.S.-listed stocks, and the Securities and Exchange Commission investigated the accounting and disclosure issues for some of the companies.

[297] Similar situations can be observed in the Great Depression in 1929 and the

often solved and disciplined through the government directly issuing an order and relieving a high-ranking manager of his posts in the company and then delivering him to criminal court.[298] In this way, managers are mainly disciplined by government intervention and criminal prosecution rather than internal governance mechanisms such as replacement by election or a derivative suit.[299] This is a rather different approach to solving corporate misconduct. Conceivably, this method represents an inclination to prefer public enforcement mechanisms and inadequate private enforcement. However, the government—as the largest shareholder—can, at least in theory, pursue similar results via private litigation if the relevant mechanisms were installed.[300]

d. Employees as Stakeholders

As a developing mechanism in China, independent directors have the potential to develop themselves as guardians of the stakeholders, especially employees. A relevant issue is the placement of employee union representatives as independent directors on the board.[301] From the demand

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enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, the collapse of Enron in 2001 and the enactment of the Sarbanes-Oxley Act, and the financial crisis in 2008 and the enactment of the Dodd-Frank Act. For criticism, see, for example, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521(2005) (arguing that the corporate governance provisions in SOX are ill conceived and challenging why Congress would enact legislation that in all likelihood will not fulfill its objectives); Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011) (arguing legislation after crisis tends to be adopted in a hurry and often over-penalizing risk-taking).

[298] *See, e.g.*, Alexa Olesen, *China Ex-Food and Drug Chief Executed*, WASHINGTON POST (Jul. 10, 2007) (demonstrating an extreme example of high-ranking managers being subject to criminal laws and suffering the consequences).

[299] There are not many documented corporate law cases that have gone to trial in China. Based on an academic survey, from the period 1992 to 1998, there were only nine cases that could be considered corporate cases involving disputes between company/directors and shareholders. Based on a different judicial decision bulletin and its digest, the number of corporate law cases in the period 1992 to 1999 was thirteen. The reason for the low numbers is that the most common type of misconduct is false representation and these cases are generally handled through administrative proceedings or criminal proceedings, and rarely as civil cases. Those considered civil corporate law cases generally involve a transfer of shares among shareholders or between the shareholder and the company. *See* REPORT ON THE REVISION OF NEW COMPANY LAW, *supra* note 276, at 187, 208.

[300] For a discussion of the interactive dynamics between private enforcement and public enforcement in the corporate law arena in the United States, see, e.g., Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1619-22 (2005).

[301] The current rule imposes a mandatory representation of employees on the board of supervisors, instead of on the board of directors. Company law of 2005 Article 118, Section 2 says: "The board of supervisors shall include representatives of shareholders and an appropriate percentage of representatives of the company's employees. The

side, employees are particularly vulnerable in today's Chinese society as new capitalists gain more strength in the economic booms. Independent directors in China may play a more active role in protecting labor if they take this growing gap between managers and general employees into consideration. In this sense, the future development of Chinese independent directors can be linked to more participation in corporate decisions by employees and, at the same time, can ease the anger that results from job-endangering profit-seeking. However, this trend is still developing and is a mere possibility at this time. If, looking from a longer time-horizon, using the institution of independent directors to mitigate the tension between managers and employees is a feasible and desirable strategy, then attention must be given to the voice of employees since their concerns might well affect the attitude of central government, and in turn, the corporate governance structure and its structural design through the political process.[302]

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percentage of the representatives of employees shall account for no less than [one-third] of all the supervisors, but the concrete percentage shall be specified in the bylaw. The representatives of employees who serve as members of the board of supervisors shall be democratically elected through the assembly of representatives of the company's employees, the shareholders' assembly, or other means." As noted earlier, however, the role of supervisors is obscure in the language and fails to provide enough accountability in practice. What further compounds this issue is the insufficient disclosure of the inside operation of the board of supervisors in China. Therefore, whether the mandatory representation of employees on the board of supervisors brings real change is still doubtful. *See* Li-Wen Lin, *Corporate Social Responsibility in China: Window Dressing or Structural Change*, 28 BERKELEY J. INT'L L. 64, 71-72 (2010) (arguing that the legislative history stressed the "improvement of employee participation" and the "importance of labor protection").

[302] Employees tend to prefer more highly controlled and monitored governance models and ally with other employees (sometimes even through the political decision process). Also, due to the lower ability to diversify their individual input in a specific company, they are usually against excessive risk-taking activities, similar to creditors. These features create a possibility of allying with banks and altogether seeking a higher participation of decision-making within companies, which in turn leads to a possible request over the right to nominate and veto independent directors to protect their interest. *See* EMPLOYEES AND CORPORATE GOVERNANCE (Margaret M. Blair & Mark J. Roe eds., 1999) (especially part I); MARGARET M. BLAIR, WEALTH CREATION AND WEALTH SHARING: A COLLOQUIUM ON CORPORATE GOVERNANCE AND INVESTMENTS IN HUMAN CAPITAL (1996).

However, it is still not clear how—or whether—such a request will be carried out in a Chinese context. Employee participation is generally even farther away than from the paradigm of "shareholder primacy" than creditor participation. Its populist flavor may not easily accommodate the idea of profit maximization and the quest for economic development. These concerns inevitably cast doubts about using the independent director mechanism to solve employee issues. However, as social welfare becomes a growing problem in China, how to incorporate the needs of employees will become a pressing issue which cannot be avoided, and it may well affect the political decision-making process as well as corporate governance, though when and to what extent these are still issues is open for further discussion.

e. The Potential Hostile Takeover Wave and the Rise of Private Sector

A takeover, hostile or not, theoretically can be an important event that may trigger a more significant role for independent directors. This could be an over-simplified estimation. First, as mentioned earlier, the derivative suit in China was not available until the 2006 amendment of the Company Law. Due to the vacant language of the article, it is difficult to bring a suit because many of the details about the relevant procedure, such as disclosure, have not yet been provided. In fact, at present there are no leading reported cases about shareholder suits in China. Under these circumstances, it is not quite clear how courts will handle a case involving a breach of directorial fiduciary duty. If a case is brought, whether involving the independent director in the decision-making process or not, it would cure deals tainted with self-dealing and hence encourage more involvement of the independent director. Second, although tender offers are permitted in Chinese securities law, hostile takeovers, including mergers without previous consent (implicit or explicit) by the government, are rarely seen.[303] Therefore, the way that the independent director functions in the United States probably would not be directly applicable to China at least in the near future.

V. TWO POSSIBLE MODELS IN THE FUTURE

One must consider the broader historical context when observing the development of the independent director mechanism in China—especially its future development. As a corporate law design, an independent director must respond to both what is written in the law and the needs of actors in a changing environment. As the Economic Reform Era in the past thirty years has shown, the State plays a pivotal role in shaping and connecting the pieces in this puzzle in China. Analysis of the role and function of the independent director in China should start with the role the State plays now and may play in the future.

A. Re-identifying the Aims

Identifying the issues affecting corporate design targets in China is

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[303] *See, e.g., Game On: China's Internet*, ECONOMIST, Mar. 5, 2005, at 71-72. This reported a hostile bid of Sina.com, the biggest of China's three big web portals, initiated by Shanda, China's top internet company, in 2005 and describing this case as "unusually aggressive in a country where hostile takeovers among domestic firms are unheard of." This move also triggered a swift response: Sina soon scored another first for China by putting in place a poison pill, which allows it to issue enough stock to dilute an unwelcome shareholder's stake. For similar observations, see John Armour et al., *The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework*, 52 HARV. INT'L L.J. 219, 274-75 (2011).

difficult for various reasons. One reason is the imprecise language used in both legislative deliberation and the wording in the statutes. Lack of case law and court decisions further compounds this problem. Though sometimes there are administrative branch orders that try to clarify the meaning of vague statutory language, these explanatory rulings are often subject to changing policy and a lack of coherence.

The rapid change in the Chinese business environment since the 1980s is another reason why identifying and analyzing the issues that a corporate design targets is difficult. The situation became even more complicated after the late 1990s and 2000s as more factors came into play at an even faster speed. For example, government looting has been a serious problem since the late 1980s, often in the name of "market adjustment" or "promoting common welfare." But the situation is changing as the government gradually becomes used to the idea of a free market and has shown increasing respect for private property. The increase in private owners also contributes to this change. Further, identification of issues is complicated by the substantial division of business law and practice in China and the uncertain interaction between law and practice, which includes a general tendency to look to government and policy first, but not laws.

Analytically, the controlling shareholder/minority-shareholder agency problem and manager/shareholder agency problem are concurrently the two most prominent issues in Chinese corporate governance. The introduction of independent directors in China presumably fits in this general agenda to promote better governance by curbing both agency problems. However, these two agency problems are somewhat different in their predicted future tendencies.

The controlling shareholder/non-controlling shareholder agency problem, as mentioned earlier, has been a serious problem and continues to be so. However, progress has been made, and, as state holding decreases, the problem is anticipated to gradually reduce. In the process of privatizing formerly state-owned companies, the Chinese government intentionally sold formerly state-owned shares to "strategic investors" who are often large foreign companies or capital investors. By doing this, though slowly, more companies were showed modern production and management methods brought by foreign investors and developed a sense of autonomy within corporations. But for many companies, major shareholders are still persistent, which include governments, rich domestic business men, or large foreign institutional investors. Those major shareholders started to face problems such as who has the right to make the final decision and how

to monitor each other.[304] In those companies, the governance issues are often solved by the capital structure and negotiation and contractual arrangement. Sometimes smaller major shareholders may agree to concede control but have the power to appoint independent directors in substitution. In an arrangement like this, managers or controlling shareholders in these companies can less easily strip their companies due to intensive monitoring from independent directors on the board. In short, the controlling shareholder agency problem is gradually alleviated due to the intervention of other large shareholders and the unloading of state shares.[305]

By contrast, the manager/shareholder agency problem has the potential to worsen. For example, the problem of managerial stripping is a variation of the traditional agency problem between managers and shareholders. However, in the Chinese context, it is combined with several distinct facts

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[304] One famous case involving French food giant Danone SA and its Chinese partner exemplifies the clash between major shareholders and the difficulties in solving this sort of issue using legal means. Groupe Danone formed a joint venture with the Chinese beverage company Wahaha Group by purchasing Wahaha's 51% shares from its founder Zong Qinghou in 1996. Since then, relying solely on the management of Zong Qinghou, Wahaha successfully expanded its market and became one the largest beverage producers and the largest bottled water provider in the Chinese market. As the market boomed, Wahaha's founder Zong, a national hero who won his reputation by establishing a country-wide brand, allegedly started parallel companies selling similar products with the same name "Wahaha" in which Zong and his family and other partners invested heavily from around 2003. After noticing this irregularity and a long negotiation process starting in 2005, Zong and his partners agreed to sell back their shares in those parallel companies to Danone for $500 million in late 2006. But after signing the agreement, Danone said Zong pulled out of the deal and began creating even more outside companies, including his own separate sales division. Zong argued that Danone officials knew about the outside companies, and in June 2007 he resigned as the chairman of Wahaha, accusing Danone of bad management, ignorance of the Chinese market and culture, as well as a smear campaign against him and his family. Several suits were filed in China and the United States over the right to use the brand name "Wahaha." Zong successfully used this dispute to draw national attention and support, and won some of the court fights conducted in China.

In 2009, after losses in several legal proceedings that had dragged on for years, Danone decided to sell back all its shares in the joint venture to Zong for about $555 million to end this drama. *See* James T. Areddy, *Danone Pulls Out of Disputed China Venture*, WALL ST. J., Oct. 1, 2009, at B1; James T. Areddy & Deborah Ball, *Danone's China Strategy Is Set Back: Dispute with Venture Partner Highlights the Risks of Not Going It Alone*, WALL ST. J., June 15, 2007, at A10; David Barboza & James Kanter, *A Brawl Threatens a Huge Investment by Danone in China*, N.Y. TIMES (June 12, 2007), http://www.nytimes.com/2007/06/12/business/worldbusiness/12iht-anone.3.6110611.html?pagewanted=all; David Barboza, *Danone Exits China Venture After Years of Legal Dispute*, N.Y. TIMES, Oct. 1, 2009, at B8. This case highlights the lack of an efficient and clear rule to solve disputes among major shareholders in large companies in China, especially when political or patriotic sentiments are present.

[305] However, the problem starts to shift to bribery of government officers as professional managers gain more economic power and are in need of less intervention from the state. This is true when the state acts either as a regulator or a major shareholder.

which make it touchier. First, for those companies that do not have other major shareholders other than the State, managers generally have good relationships with government officials or even act as government representatives. As a result, the State is not a reliable source of monitoring in this situation, especially from the standpoint of small shareholders. Second, those managers have often also slowly accumulated a portion of shares of their company during the course of privatization and that in turn gives them better leverage to pursue their own agenda without regard to other non-managing shareholders or even the State. Therefore, what they actually represent here is more like a combination of the controlling/non-controlling shareholder and manager/shareholder agency problems, or both at the same time.

In this sense, the two forms of the agency problems are substantially interwoven due to the uncertain roles of state and other large shareholders. A mixed, flowing combination of governance issues implies that the independent director, which aims to fix corporate governance issues internally, needs to play an adaptive role. Therefore, the future role of independent director in China must be refocused as well as redesigned to address this mix of two forms of agency problems. In the following section, two models will be presented for a better use of the independent director mechanism to fit the changing environment in the future.

B. *The Current Balance*

Throughout the process of its economic development, powerful government intervention and a fiercely competitive market are the two dominant forces in the Chinese corporate landscape. The fact that both appear to be external factors curbing potential managerial misconduct suggests that the internal checks-and-balances mechanism within a company is not soundly established or even needed.

However, as the economy develops, the model starts to evolve. At a practical level, the government's roles as equity owner, loan supplier (through the control of banking system and even the exchange rate), and administrative regulator are all still decisive to the survival and development of Chinese enterprises, especially large ones. The State continues to serve as a strong regulator that firmly controls Chinese society, and the various non-economic ways that the State can exert pressure on enterprises are powerful enough to substitute various forms of the internal governance adopted in developed economies—if the State decides to do so. In this sense, the dependent relationship (managers on government officers, or corruption as the other side of the same token)[306]

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[306] A recent newspaper article cites a report of the People's Bank of China indicating

constitutes a strong threat to corporate governance mechanisms in the Chinese corporate landscape, though in some exceptional cases the unbelievable efficiency that the government demonstrates may help solve problems, such as by removing managers who commit misconduct overnight and completing the whole trial process in three months.[307]

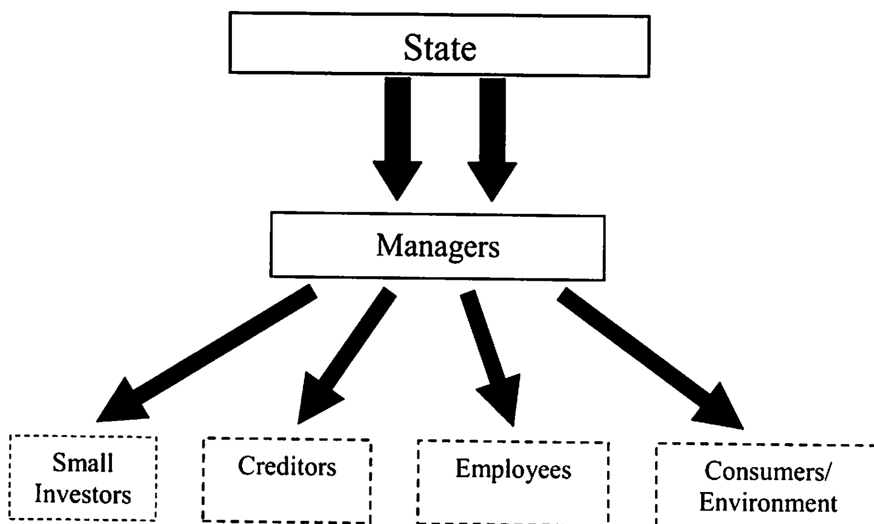

Figure 1: Power Structure in State-Dependent Companies in China [308]

The State is strong in terms of equity control and political control. Constituencies are comparatively vulnerable and unstable and their strategy

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official corruption with estimates that up to 18,000 corrupt officials and employees of state-owned enterprises have fled abroad or gone into hiding since the mid-1990s. They are suspected of pilfering coffers to the tune of RMB 800 billion, or $123 billion. James T. Areddy, *Report: Corrupt Chinese Officials Take $123 Billion Overseas*, China Realtime Report, WALL ST. J. (June 16, 2011, 7:00 PM), http://blogs.wsj.com/chinarealtime/2011/06/16/report-corrupt-chinese-officials-take-123-billion-overseas/. Another newspaper article, citing a private research firm based in Beijing, reports that some 500,000 corruption cases were investigated in China from 2000 to 2009, and about 64 percent of them were linked to international trade and foreign businesses. Chen Weihua, *Multinationals Under Scrutiny for Corruption*, CHINA DAILY (Sept. 8, 2010, 7:26 AM), http://www.chinadaily.com.cn/usa/2010-09/08/content_11273809.htm. For a more detailed discussion about recent cases of U.S. foreign corruption investigations involving China, see F. Joseph Warin et al., *FCPA Compliance in China and the Gifts and Hospitality Challenge*, 5 VA. LAW & BUS. REV. 33, 48-57 (2010).

[307] This is particularly true for many large companies in highly-regulated areas such as banking, financial service, communication, transportation, and heavy industries. Even for large manufacturers, a less intrusive measure such as land use permission, infrastructure support, tax benefits, suppression of labor protests, and even criminal indictment are all common with considerable impacts on business activities in China.

[308] Figure developed by author. Black arrows and rectangle indicate a dominance relationship and relative power. Dash lines indicate a volatile, easy-exit status.

is to exit once the management goes too far in the wrong direction, if possible. Put in a blunt way, the Company Law is not the only factor that determines which level of corporate governance companies adopt in China today. A complex net of political decisions and other policy/administrative reasons also play an important, if not bigger, role. Since the State is a dominant player in all aspects relating to the arena of corporate governance, how managers respond to various corporate governance issues will largely depend on the government's attitude. In other words, through permission or acquiescence of the government, enterprises can freely enjoy the benefit of suppressing labor, producing unsafe products, and conducting unfair market operations, such as manipulation (both in the capital market, such as insider trading, and in the product market). Constituencies being pressed may choose to exit, or fall vulnerable due to weak legal protection and lack of experience in organizing themselves to fight for their rights.

To sum up, in China today, when the State and the market are enough to meet the needs of various actors, there is not much left for the law or corporate governance to do. The independent director, in this situation, understandably does not have much say in corporate affairs, no matter how the mechanism is designed. But if the cooperation from the constituencies is a key element in supporting a long-term growth and shaping the dynamic of corporate governance as a whole, then the independent director mechanism could find its way. Similarly, the long-term trend of decreasing direct intervention into private economy sector at individual company level by the State could also play a role in reshaping the independent directors mechanism in China.

C. *Emerging Patterns and Two Potential Roles of the Independent Director in China*

Though the current situation is that the State is still in flux, the weakening of the State is expected and in fact observable in long-term developments. The Chinese government is not showing signs of quickly receding. However, the increasing economic power of growing private sectors (and to a certain extent, local governments) is not something to be ignored. An emerging managerial centrism can be seen on the Chinese corporate horizon.

As this trend gradually unfolds, a system of checks-and-balances and a new form of monitoring become necessary. The choices and the problems that the State will face are multiple. The first possible scenario is that the State might become an absent equity owner. In the face of increasing private shareholding, the State may lose its absolute power in selecting managers and direct control over the company, even though they retain shares. This will render it vulnerable to managerial exploitation or

inefficient management as a non-controlling shareholder, and may signal a resurgence of the traditional agency problem.

A second possibility is that the State may gradually step aside in various companies and shift its control from that of major equity holder to its regulatory role. This development may well echo a line of policies to decrease state holdings and to increase the efficiency that began with the Economic Reform Era of 1978. In this case, the problem will be how to protect constituencies from managerial exploitation and curb wealth inequality.

If the current path is maintained, with enterprises gaining more muscle, the State may need to move toward a more neutral and indirect role in which it is responsible for facilitating proper business decisions and balancing public concerns with private economic development in the long run. However, judging from a political standpoint, it is not likely that the State will simply step aside all of a sudden and leave the market to solve problems on its own. During this transition, independent directors might ideally serve as intermediaries to mitigate different interests as all actors attempt to fit into new roles.

The independent director mechanism could serve as an interim balancing measure as well as a long-term design. The key point in this design is to meet the needs from both sides; an indirect involvement which uses the design of independent directors may function as a buffer for all actors and avoid direct conflict.

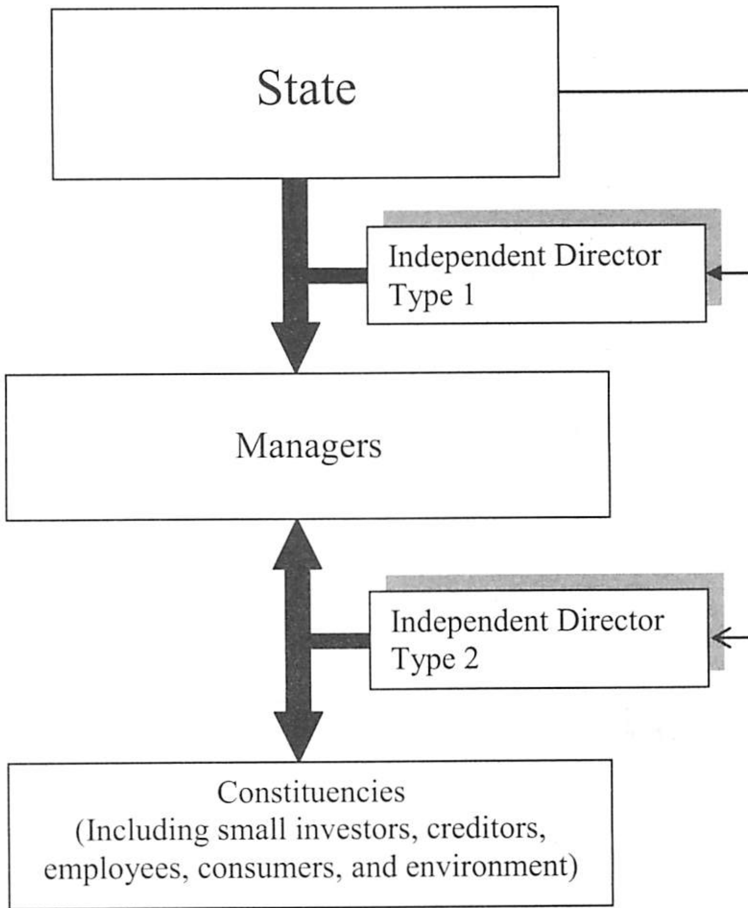

Figure 2: New Power Balance[309]

As the market economy grows, the State gradually loses its grip due to equity dilution and its difficulty in maintaining control due to the complexity of the modern business environment. At the same time, the division of economic powers becomes more stable as companies gain scale and constituencies are less capable of moving or changing their position easily. The "locking in" of constituencies will force them to negotiate with managers for better management, instead of the previous strategy of "voting with their feet." In this sense, both sets of relationship (State v. managers; managers v. constituencies) need buffers or mediators to avoid

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[309] Figure developed by author. Black arrows and rectangle size indicate a dominance relationship and relative power.

direct confrontation.

In this scenario, the State starts to lose its ability and/or willingness to exert direct control. In the absence of such power—like the ability to appoint and remove managers via administrative decisions—the Type 1 independent director, mainly appointed by the State, would serve as a representative of the State. In the meantime, independent directors may team up with constituencies to balance the managerial centrism and asset stripping. The main goal is to avoid the traditional managerial agency problem and alleviate the problems caused by the absence of the State as a regulator. The latter is especially essential when legal protection to either an equity holder or the public in general (the consumer in particular) is not adequate.

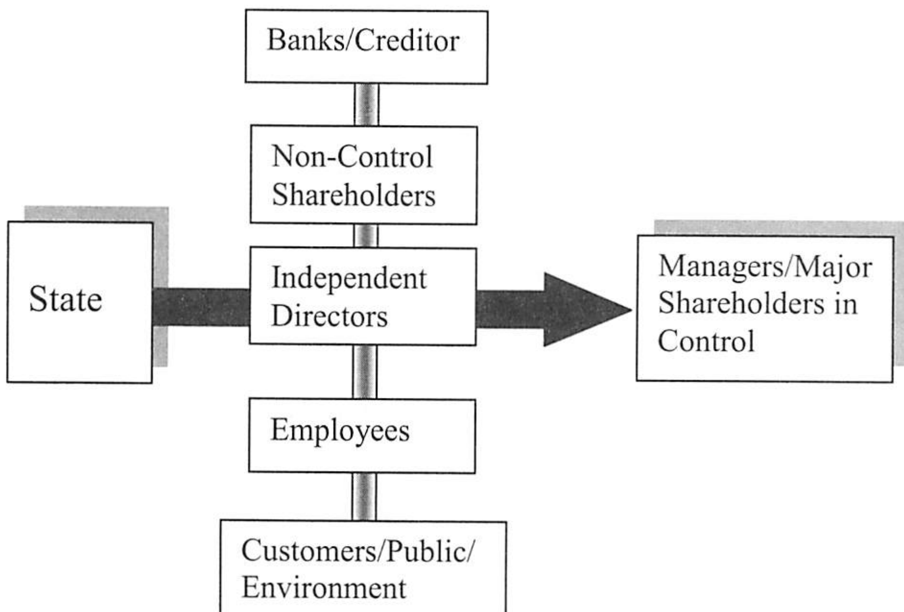

Figure 3: Type 1 Independent Director under New Model—Public Control Type Governance (State controls as regulator and the independent director works as an intermediary)[310]

The Type 2 independent director, on the other hand, is designed to represent minority shareholders' and constituencies' interests. It is especially needed when the government still plays an active role in

[310] Figure developed by author. The vertical grey zone line indicates an alignment relationship. The horizontal arrow indicates a control/regulation relationship. The independent director serves as a mediator that avoids director control from the government.

directing some company's business even in a way detrimental to the minority's interest. In those companies, a minority's interest is less protected when managers have the strong support from the government as an equity holder.

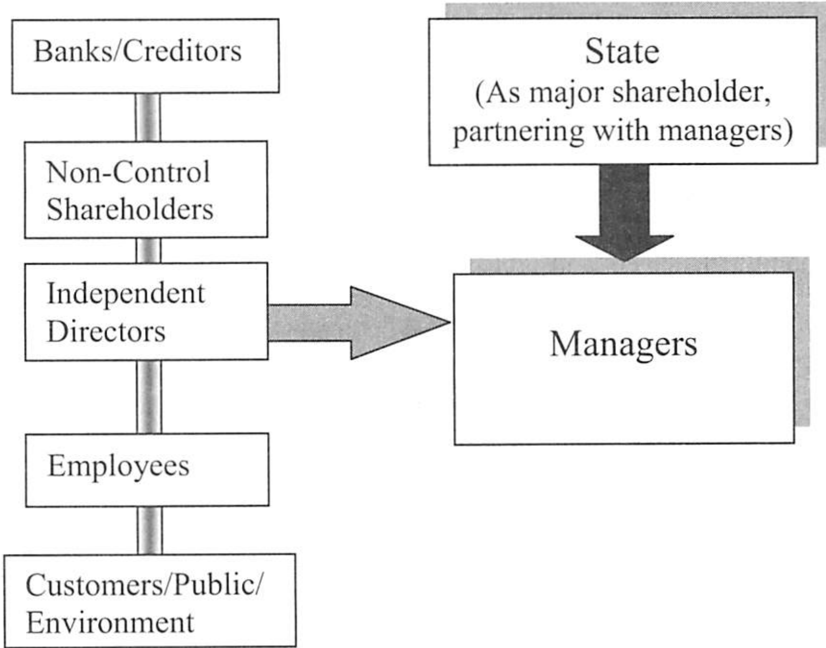

Figure 4: Type 2 Independent Director under New Model ---Minority Protection Type Governance (State controls as a major shareholder and independent director works as representative of other constituencies)[311]

Two important issues arise in this scenario. First, under the absolute control of the government and their delegate managers, constituencies may face random target-setting and the interference of non-economic factors. Second—which is even worse and more common in China—when direct control of selecting managers does not function well, all governance control is lost and professional managers are free to run their companies in a way benefitting themselves only. In other words, the first case is a problem of an absent State as a regulator, and the second one is a problem of an absent State as an equity owner. In any event, an independent

[311] Figure developed by author. The vertical grey zone line indicates an alignment relationship. The horizontal arrow indicates a control/regulation relationship. The independent director serves as a mediator that unites constituencies to balance the control of the government and professional managers.

director could act in the interest of the constituencies and minority shareholder, which is similar to the role played by the labor director in a labor-participation regime in comparative corporate law.

D. Summary

The above two potential models have been developed according to the following observed tendencies: a growing private economy, a lack of market checks from capital providers (including intermediaries such as experienced institutional investors), a rising demand for more responsible corporate behavior, and a less-skilled regulatory power of the government. In the type 1 scenario, the independent director is designed to be an arbitrator. On the one hand, he or she works as a representative of the State to monitor managers and protect the State's equity interest. On the other hand, he or she also helps eliminate governmental intervention and protect managers' or constituencies' interests. This is especially true when a State's equity power is not strong enough to exert control like in the old days but, at the same time, it still wants to play a "father-like" role to direct everything. In this way, a type 1 independent director works in both directions and is used to re-establish a careful balance between the State and business, which is essential to a smooth transition of ownership restructuring.

A type 2 independent director, however, is mainly focused on the controlling shareholder agency problem. It can include the situation when managers exploit all shareholders (including the government) when government oversight is absent, and both are similarly likely. In this sense, the independent director is working as a monitoring mechanism to prevent exploitative situations from arising.

The above two models are designed to address the rising hybrid managerial agency problem and the now-apparent realities in China, including the growing power of private ordering and China's vulnerable constituencies. In short, the growing power of private ordering and the vulnerability of Chinese constituencies are both starting points and major concerns in these designs. The background assumptions mentioned above are ubiquitous in the Chinese scene. The likelihood that large shareholders will exploit small shareholders, and that managers will exploit shareholders, is undeniably substantial, and this exploitation will be more likely when monitoring from capable investors who have a large enough economic interest is absent.

The point is that in a fast-changing economy like China today, politics, as well as the change of economic structure, is a pivotal aspect, which no one can ignore. Corporate law is not an isolated issue, but rather has to respond to what its society aggregately needs or what its political decisions

require. In other words, corporate law design, both in theory and practice, cannot be considered. It is not only affected by politics, but is part of politics. Looking at it from an opposing direction, the independent director mechanism is a corporate law design that can then maximize its utilization if it is remodeled to suit the needs of various actors, both political and economic.

If things unfold in this way, a new governance organ will be needed as the power structure and environment change from their earlier pattern. But what people will need to deal with in the real world will become more obscure due to the lack of stability and norms within each institution. People conceivably need to spend time learning to reach the best compromise among their competing interests. In this sense, an independent director may function as a buffering mechanism or a mediator to ease the direct confrontation of different interests. To be more specific, an independent director may help rebuild the position of shareholders vis-à-vis managers, though many roles fall under the title of shareholder in China.[312]

VI. CONCLUSION

Corporate governance is not only about corporations. A more comprehensive approach to understanding Chinese corporate governance issues considers the bigger picture, including other relevant political and social institutions. Taking this complexity into account, the old reasoning found in traditional corporate literature may not be as applicable as it was in other developed countries. Because many relevant mechanisms in corporate law do not exist to a similar degree of maturity or sometimes even at all, simply observing one particular mechanism or rule is much less helpful than expected. What makes the situation even trickier is that everything may appear fine on the micro level, but the meaning of a mechanism or rule, or the way it functions, changes dramatically due to the differences in environment. All these particularities and barriers to obtaining a comprehensive picture makes the careful design of organizations, mechanisms, and their rules an even more crucial task.

In modern China, many supplemented institutions outside corporate law, which are determinant to modern corporate governance and its

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[312] The story of privatization here is a simplified version. The argument about privatization in the Chinese experience, either at the theoretical level or in practice, is a more complicated issue. The reason that a simplified pattern is presented is that the deviations in the process of privatization are somehow misleading because they miss the big picture, which becomes clearer when observed from a longer horizon. For a more complete discussion of the Chinese experience in this regard, see Lan Cao, *Chinese Privatization: Between Plan And Market*, 63 LAW & CONTEMP. PROBS. 13, 43 (2000), particularly Part V, which discusses the State's purpose in detail and the interaction between the public and private sectors.

designations—such as a well-functioning stock market with a certain amount of rational, sophisticated investors, well-functioning financial intermediaries that can make independent lending decisions, and coherent policy and non-intervening government—are still absent or ill-functioning. In a similar guise, an independent director is in itself a neutral mechanism. The independent director mechanism can work just as expected if good people are picked and put on the board. But just like most other organizational designs, the mechanism itself cannot guarantee that good people will be picked. However, this defect is not a result of the design itself, but from practice. Therefore, when critiques arise, one should be aware of where the criticism points to and where a possible remedy comes from. Only with this in mind can an institution be fairly assessed and implemented in a way that maximizes its efficacy.