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Abstract
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Keywords
corporate governance, China

Cover Page Footnote
I would like to thank Professor John Farrar, my supervisor, for his supervision of my PhD study and this article.

A CHINESE PERSPECTIVE ON CORPORATE GOVERNANCE

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Introduction

A corporation must have internal organs to form and express its will, to organise business, to supervise the implementation of its will. We call this kind of internal management corporate governance. Corporate governance is a new and challenging area to the Chinese. This is because the concept and structure of the modern corporation are so different from those of classical enterprises or state owned enterprises in a planned economy. The structural differences between various economic organisations are determined by distinct property rights.

An Economic Perspective On Corporate Governance

A classical enterprise or a classical firm is a business unit which is owned and controlled by the same person or persons.[1] It can be a sole proprietorship or a partnership. Today, these two forms of economic organisation no longer play a dominant role in economic transactions. Although they may be still significant in number, they no longer account for the bulk of economic activity. Nowadays, most economic activities are carried out by large corporations that own a large percentage of all assets.[2]

Although the concept of the corporation can be traced back to Roman Law, corporations have become dominant in economic life only since the end of nineteenth century. In modern history, developments in technology and science enable people to do business on an ever large scale. The earlier forms of the firm are no longer suitable for the needs of rapid business expansion.[3] The increase

* I would like to thank Professor John Farrar, my supervisor, for his supervision of my PhD study and this article.

1 Carlton DW & Perloff JM, *Modern Industrial Organisation*, Scott Foresman & Co, USA (1990) 23. Also see Berle AA and Means GC, The *Modern Corporation and Private Property*, MacMillan, New York (1963) 300-302.

2 Ibid.

3 Classic enterprises suit small-scale productive or commercial activities that rely on traditional resources such as human power, animal power and wind power. They have the advantages of being easy to create having a, high level of flexibility, and the unification of right and control. However, they also have disadvantages such as limited capital, the difficulty of increasing funds, investors the liability of unlimited, they are heavily affected by owners' experience and knowledge, and a short life. These disadvantages become more and more severe along with the development of productivity and the deepening of specialisation.

in the size of the firm requires a new manner of raising large amounts of funds.[4] The increase in complexity of business activities demands specialised and skilled management.[5] A new form of the firm which can accommodate modern business activities is needed. Corporations as an appropriate form of economic organisation arise to supply such a demand. A corporation has the advantages of being capable of raising large amounts of funds in a cheaper way and being able to facilitate specialised and professional management.[6]

The fundamental difference between a corporation and a classical firm in the sense of management lies in the fact that, in a corporation, owners and managers of the corporation are no longer identical.[7] This chiefly results from the introduction of limited liability by incorporation. The process of incorporation involves two processes of separation in relation to ownership. One is that the corporation itself is separate from its investors. In this process, the owners of the properties become the shareholders of the corporation by transferring their properties to the corporation. After incorporation, the properties are owned by the corporation and no longer by the shareholders. The other process is the separation of the right of ownership itself. In the classic sense, the right of ownership is an absolute right which consists of a bundle of rights including residual claimant rights, the right of disposition, the right of control, the right to interest.[8] This means that the owner of the property has a complete and absolute right over the property. Such an absolute ownership exists in a classical firm. The owner(s) of such a firm has the absolute right over his or her property.[9] However, in a corporation, the concept of absolute ownership no longer applies. While shareholders have the residual claimant rights over the property, the right of disposing and using property is exercised by the salaried manager(s).[10] In fact, in a corporation, the bundle of rights attaching to ownership is separately owned and exercised by different people as participants including shareholders, managerial staff, employees, creditors and in some cases, government institutions. Hence, it is appropriate to say that a corporation is a coalition of different groups with different interests.[11] This is the essential difference between the internal structure of the corporation and of the classic enterprises.

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4 Limited liability makes people feel less reluctant to invest in a corporation. This enables a corporation to raise funds from the general public.

5 The owners of the classic firm are overwhelmed by the complexity of the business activities in a modern corporation.

6 This can be attributed to the fact that, in a corporation, shareholders have limited liability. As shareholders only take their risk to an extent of their shares, they feel easier in handing over the management of the firm to the professional specialists.

7 Here the discussion is about the large corporations whose shares are publicly traded on the stock market.

8 Berle AA and Means GC, *The Modern Corporation and Private Property*, MacMillan, New York (1963) 311.

9 Ibid.

10 Ibid 8-9.

11 Rosser M, *Microeconomics: The Firm and the Market Economy,* MacMillan Education, London (1988) 118.

In a corporation, the role of the manager is in the nature of an agent. It is a general belief that people are less vigilant in terms of safeguarding others' properties rather than their own. Moreover, it is normal for a principal and an agent to have different interests. Instead of maximising the interests of the principal, the agent is likely to pursue his or her own interests, such as high salary and prestige.[12] Shirking and slacking are also predictable.[13] Therefore, it is necessary for owners to devise monitoring and control mechanisms, so as to constrain the divergence of interest to a reasonable degree. Today, such a function is usually exercised by the market, the shareholders' meeting, the supervisory board or the board of directors in different legal systems.[14]

In a state owned enterprise, the situation is different. The owner of the enterprise is the state or the people as a whole. In reality, the owner, the people as a whole, has no presence in the enterprise. Hence, at a microeconomic level, there is no real monitoring and control over the management by the owner.[15] The manager of the enterprise is only a government official who has no independent authority in terms of running the enterprise and is not personally liable for the failures in business decision making. The state is both the owner of the enterprise and the coordinator of productivity at a macroeconomic sense. The problem of a state owned enterprise is that it contradicts the concept of ownership rights. The ownership of the people as a whole, in fact, renders ownership rights illusory. This will lead to economic inefficiency. Moreover, this system ignores the important function of microeconomic decision-making of the firm and submits all the business activities to macroeconomic disposition and adjustment.

The analysis of ownership is of importance in studying the case of China. This is because China remained a low-level industrialised economy and a public ownership economy for a long time. The Chinese may have a better idea of what is going on in a classical firm or a state owned enterprise than in a corporation. With thousands of years of experience in traditional business firms and many years of experimentation with public ownership, China is now developing an advanced modern corporate system. It is of interest to the rest of the world to see how this process is being carried out.

The Historical Background Of Corporate Development In China

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12 Farrar JH and McCabe B, 'Corporatisation, Corporate Governance and the Deregulation of the Public Sector Economy' (1995) 6 *Public Law Review* 31.

13 Ibid.

14 In the common law system, the board of directors is usually elected by shareholders to monitor management. The shareholders' meeting has the right of appointing and replacing directors and managers. Meanwhile, an unsatisfied shareholder can sell his or her shares in the market. These are the main constrains imposed on the management, which drive the management to ensure that the corporation makes at least a minimum of profits. Low profits will result in the depression of the share price and make the corporation vulnerable to a take-over bid. See Posner RA, *Economic Analysis of Law* (4th ed), Little Brown and Company, London (1992) 412-415.

15 Such a function is exercised by relevant administrative personnel or institutions. However, there is no incentives for those personnel and institutions to fulfill their duties diligently. Moreover, those people and institutions bring administrative interference which violate economic rules.

The legal concept of the corporation was imported into China at the end of the nineteenth century. Before that, China was an agricultural society with a sophisticated commercial system but no idea of a corporation as a legal individual. Proprietorship and partnerships were the basic forms of business organisation.[16] The non-development of Chinese corporate law can be attributed to the non-development of capitalism in traditional China. With the Western invasion, a capitalist economy began to develop in China. The last dynasty, Qing, seeing the need to accommodate the new economic system, promulgated a new law, the *Great Qing Commercial Code* in 1903. Out of 140 articles, the *Commercial Code* contained 131 articles concerning company matters. This was the first corporate legislation in Chinese history. Based on the company legislation of the Qing government,[17] the Republic government promulgated the Company Regulations in 1914. From 1927 the Nationalist government ruled China. The new government promulgated a *Company Law* in 1929. This was the first comparatively complete legislation concerning companies in Chinese history.[18] The 1929 *Company Law* was largely revised in 1946. The revised application of the Company Law came to an end in mainland China when the Communist party took over the government in 1949.

From the final years of the Qing Dynasty to 1949, a period of about 60 years, the development of the corporation in China was very slow. Up to 1949, there were about 1,300,000 enterprises in China. Among them, there were only 11298 companies, less than 1% of the total number of enterprises.[19] The others were partnerships and sole proprietorships.[20]

There were a number of reasons for the lack of development of corporate practice. Firstly, Chinese businessmen had a longstanding fear of government. The early Republic government was too weak to enforce its law and failed to provide a stable legal and political environment for business. Businessmen, instead of being protected properly by the law, were more vulnerable to exorbitant taxes and fees by registering their businesses as companies, which would divulge more information to the government.[21] Secondly, there was a public rejection of the corporate idea which might have cultural roots. As Li Chun explains: “The idea that members of the public would be invited to join one’s business and share in its control and profits was indeed repugnant. On the other hand, the notion that one’s money be put into the pocket of some

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16 Kirby WC, ‘China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China’ (1995) 54 *The Journal of Asian Studies* 47.

17 The Qing Government ended in 1910.

18 Xu Y, *Principles of Company Law*, Publishing House of Law, Beijing (1997) 16.

19 Jiang P, ‘General Introduction’ in Jiang P and Liufang F (eds), *The New Textbook of Company Law*, Publishing House of Law, Beijing (1994) 47.

20 Ibid.

21 Kirby WC, ‘China Unincorporated: Company Law and Business Enterprise in Twentieth-century China’ (1995) 54 *The Journal of Asian Studies* 50.

strangers for them to run a business was just as unthinkable."[22] Thirdly, Chinese national industry was very weak and relied heavily on foreign countries in relation to market, technology, equipment, and resources.[23] The development of different industrial sectors was not even. The country's production was mainly concentrated in a few labour intensive sectors in light industry, such as textile industry, and in the few coastal cities. All of these factors limited the development of modern corporate practice.

After 1949, China began a process of reforming privately owned enterprises. During this process, the ownership of private owned enterprises was transferred to state owned or collective by owned enterprises. The reform was completed in 1956. Although many reformed enterprises were still called companies and many newly established enterprises were also called companies, they were no longer companies in the traditional sense. The productivity of those enterprises was brought into the national plan. Administrative mechanisms replaced markets. The state allocated resources inside the enterprises and determined the output of the enterprises.

During the early stage of economic recovery, the problems inherent in state owned enterprises were not so apparent. The economy grew at a rapid rate.[24] However, from 1958 the country's economy faltered.[25] There was increasing awareness of the impact of the inefficiency of state owned enterprises on the economy.[26] Quite a few attempts at reforming state owned enterprises had been made but all in vain. The first reform happened in 1958. The state decided to hand down 87% of its enterprises to local provinces and municipalities. However, this was simply a process of shifting central administrative control to local administrative control. The reform had little effect in terms of increasing efficiency. Consequently, the state resumed central control in 1961. The second reform was carried out in 1964. The central government delegated the power of allocating funds and materials for non-industrial projects to local governments. The power was returned to the central government again as the result of failure of the reform. In 1970, another reform was launched. Half of the state owned enterprises were turned over to local governments again. Its fate was no better than the first two reforms. As discussed earlier in this article, the fatal deficiency of the state owned enterprise was the lack of incentives for the enterprises to improve their performance. Firstly, there is no effective monitoring and control from the owner of the property. Secondly, the managers do not take

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22 Li C, 'The Guang Xu Lu of 1904 and the Modernisation of Chinese Company Law' [1974a] 10 *Chengda Faxue Pinglun* 172;

23 Liu Y, Zhang G, and Meng C (ed), *Complete Works on the Company Law of the People's Republic of China for Practice*, Harbin Publishing House, China (1994) 16-17.

24 Eang GC, 'Introduction' in Wang GC (ed) *Economic Reform in the PRC, in Which China's Economists Make Known What Went Wrong, Why, and What Should Be Done About It,* Westview Press, Oxford (1982) 1-2.

25 Ibid.

26 Ibid.

responsibility for business failure. The state takes unlimited liability for the debts of state owned enterprises.

After the economic reform in 1979, efforts were continually made to improve the performance of state owned enterprises. These included contracting out, leasing, and joint operation. Those practices did not solve the essential problem, of introducing a mechanism which could straighten out the relationships between the different participants, and make enterprises into microeconomic decision-making units, independent and responsible for their own activities and outcome. As a result, adopting the modern corporate system to reform the existing state owned enterprises is the final solution.

The Chinese Experience Of Corporate Governance

Prior to corporatisation, corporate governance was a topic largely ignored by Chinese legislators and jurists. The 1981 *Economic Contract Law* was the first legislation to introduce the term "juristic person" in the history of the People's Republic of China. A few years later, the 1986 *Civil Code* for the first time provided a definition for "juristic person". The defect of the law is that it only provides for a person, representative of a juristic person, but does not specify the internal organs of the juristic person. This defect has its historical causes. It coincided with the reform promoting a managerial responsibility system within state owned enterprises during 1980s.[27]

The governance structure in a state owned enterprise is overly simple. Such a structure cannot cope with the development of modern economic activities, which requires huge amounts of pooling and large scales of productivity.[28] The governance structure in a modern company is far more complicated and sophisticated, with the mechanism of division of power and interaction among internal organs. Since 1994, after a long period of preparation, China has undertaken the reform of corporatisation.[29]

In a corporation, the shareholders' meeting is the organ of primary authority. Under the shareholders' meeting, there are managerial and supervisory organs. The arrangement of management and supervision in Western legal systems can be divided into two basic models the two-tier board system and the other one is one-tier board system.

The two-tier board system originated in German law. The *Reform Act* of 1870 had the provision that, apart from a board of directors, required an obligatory

27 Gan P, *Enterprise and Company Law*, Publishing House of Beijing University, Beijing (1998) 127-131.
28 Jiang Pand Zhao Xudong, *The Theory of Juristic Person*, Publishing House of China University of Political Science and Law, Beijing (1994) 304-305.
29 Gan P, *Enterprise and Company Law*, Publishing House of Beijing University, Beijing (1998) 139-143.

supervisory board, *Aufsichtsrat*.[30] The *Aufsichtsrat* is an outside board. It links people other than the owners with the enterprise.[31] It was introduced with the intention of enhancing the monitoring of management. The supervisory board has the right of appointing and replacing members of the managing board and the obligation of supervising the management of the company.[32] There are mechanisms preventing the possibility of conspiracy between the supervisory board and the managing board. For example, the law forbids managerial functions to be delegated to the supervisory board.[33] The distinctive feature of the German supervisory board is that it is a system of labor co-determination by means of representation on the board. The number of labor representatives can be half of the total number of the board.[34] It is believed that co-determination helps to build a consensus between capital and labor, and is advantageous in terms of resisting hostile takeovers.[35] This practice is highly appreciated by Chinese jurists and is regarded as a means of enhancing internal unity and the performance of the company.[36] The two-tier board system is common in the European legal system.[37]

The one-tier board system is the practice of common law countries. Under the shareholders' meeting, there is only one board - the board of directors. The managerial function of the managing board in the European system is performed by managers. The task of supervising management is exercised by the board of directors. Unlike the supervisory board in the European system, the board of directors can exercise managerial functions. Sometimes, directors are managers. We call the directors involved in management managing directors or executive directors. When this happens, the supervisory capacity of the board of directors decreases considerably. The common practice of solving this problem is to introduce outside directors or non-executive directors and independent auditors.[38] In addition, common law countries such as the USA and the United Kingdom have used their highly developed stock exchange market as an important discipline for management.

30 Hopt KJ, 'The German Two-Tier Board (Aufsichtsrat) A German View on Corporate Governance' in Hopt KJ and Wymeersch E (ed), *Comparative Corporate Governance, Essays and Materials*, Walter de Gruyter, New York (1997) 6.

31 Ibid.

32 Ibid.

33 *Aktiengesetz* 1965, s 111.

34 According to the *Co-determination Act* 1976, where a company has less than 2,000 workers, the labor representatives in the supervisory board should be one third of the total number; whereas in a company with more than 2,000 workers, the labor representatives in the board should be half of the total number.

35 Hopt KJ, 'The German Two-Tier Board (Aufsichtsrat) A German View on Corporate Governance' in Hopt KJ and Wymeersch E (ed), *Comparative Corporate Governance, Essays and Materials,* Walter de Gruyter, New York (1997) 10.

36 Xu Y, *Principles of Company Law*, Publishing House of Law, Beijing (1997) 239.

37 This refers to the civil law system mainly represented by the French legal system and the German legal system.

38 Farrar JH and McCabe B, 'Corporatisation, Corporate Governance and the Deregulation of the Public Sector Economy' (1995) 6 *Public Law Review* 32.

The one-tier board system is regarded as not sufficient in terms of supervising management and coordinating the relationship between capital and labor by the Chinese,[39] particularly when external monitoring devices, such as the stock market, are not well developed. Therefore, after studying foreign experiences and the actual situation of China, China adopted the two-tier board system. However, only a joint stock company (public company) is required to adopt the two-tier board system.[40] In the case of a limited company (private company), the two-tier board system is adopted in a flexible manner. The law requires a large sized limited company to have a supervisory board, whereas a limited company that has a small number of shareholders and is small in size can have one or two supervisors instead of a supervisory board.[41] A detailed discussion about shareholders meetings, the board of directors and the supervisory board follows.

Shareholders' Meeting

The modern development of corporate governance is a movement from the shareholders' meeting to the board of directors, as a result of the division of ownership and control.[42] Although the power of the board of directors has been increasing and the power of the shareholders' meeting has been decreasing, its importance is unquestionable.

The Chinese *Company Law* provides for three types of companies - joint stock company (public company), limited company (private company) and wholly state owned company. It is of interest that, in a wholly state owned company, there is no shareholders' meeting. The function of the shareholders' meeting is delegated to the board of directors.

Modern company laws set out the extent of the powers of a shareholders' meeting. The Chinese *Company Law* stipulates that a shareholders' meeting is the organ of primary authority of the company and exercises its function and powers in accordance with the *Company Law*.[43] Article 103 and Article 38 provide the range of powers of the shareholders' meeting. Compared with the legislation of some other countries, such as the USA, Germany and Japan, the Chinese *Company Law* gives the shareholders' meeting a wider range of powers. The shareholders' meeting has the power of passing resolutions on mergers, division, dissolution and liquidation, electing and removing directors and supervisors, and amending the articles of association of the company.[44] Beyond that, the *Company Law* also gives the shareholders' meeting decision making

39 Liu Y, Zhang G, and Meng C (ed), *Complete Works on the Company Law of the People's Republic of China for Practice*, Harbin Publishing House, China (1994) 211.

40 *Company Law 1994*, art 124.

41 *Company Law 1994*, art 52.

42 Dine J, 'Private Property and Corporate Governance Part II: Content of Directors' Duties and Remedies' in Fiona Macmillan Patfield (ed), *Perspectives on Company Law:1* (1995) 117; Xu Y, *Principles of Company Law*, Publishing House of Law, Beijing (1997) 232.

43 *Company Law 1994*, art 37 and 102.

44 *Company Law 1994*, art 38.

powers on a range of financial matters, such as deciding policies on the business operation and investment plan of the company; reviewing and approving the annual financial budget, the final accounts, and the plan of profits distribution; and deciding on the increase or reduction of the registered capital of the company and the issuance of debentures by the company.[45]

Two types of shareholders' meetings are stipulated in the Chinese *Company Law*, regular meetings (general meeting) and interim meetings (special or extraordinary meeting).[46] The regular meeting must be held once every year.[47] It reviews and approves the annual financial budget and accounts and decides the plan of profit distribution and recovery losses. An interim meeting must be held if the following events occur: the number of directors is insufficient to comply with the law; the company's net accumulated losses have reached one-third of its total paid-up capital; it is requested by shareholders holding more than ten per cent of the shares; or it is requested by the board of directors or the supervisory board. An interim meeting must be held within two months after the occurrence of one of these circumstances.[48] Unlike the law of some other countries, Chinese law does not have provisions on class meetings and statutory meetings.

The principle of one share, one vote is firmly established by the 1994 *Company Law*.[49] Regarding the voting rights attaching to different shares, there were different practices in established legal systems. The UK, France, Japan and most states of the USA permit companies to issue non-voting shares. Germany, Italy and Australia do not permit companies to issue non-voting shares but allow them to issue non-voting preferential shares. The Chinese *Company Law* remains silent on whether companies can issue non-voting shares or preferential shares. However, Article 135 of the Law states that the state council may adopt separate regulations governing the issuance of other kinds of shares which are not provided for. This means that the law leaves room for issuing special kinds of shares, if necessary.[50]

It is of interest to note that although Chinese companies issue A-shares, B-shares, H-shares and N-shares, these different kinds of shares are not treated as different classes of shares but as the same class of shares – ordinary shares. A-shares refer to the shares issued by Chinese companies to Chinese citizens. B-shares are those issued to foreign investors by Chinese companies whose stocks are listed in a domestic stock market.[51] B-shares must be purchased in a

45 Ibid.
46 *Company Law 1994*, art 43.
47 Ibid.
48 *Company Law 1994*, art 104.
49 *Company Law 1994*, art 106.
50 Wang G and Tomasic R, *China's Company Law: An Annotation*, Butterworths Asia, Singapore (1994) 116.
51 Foreign investors include legal and natural persons of Hongkong, Macao, Taiwan and foreign countries. The 1995 *Listing of Foreign Investment Shares inside China by Company Limited by Shares Provisions*

convertible currency.[52] H-shares are issued to foreign investors for convertible currency by Chinese companies whose stocks are listed in the Hong Kong stock market. N-shares are issued to foreign investors for convertible currency by Chinese companies whose stocks are listed in foreign stock exchange markets. The issuance of B, H and N shares reflects the country's strategy of requiring foreign currency without putting Chinese stocks at risk of being much affected by fast-changing in stock markets. Moreover, this is also a strategy to prevent foreign currency outflows.

One of the legislative defects of the 1994 *Company Law* is that it fails to stipulate the quorum of shareholders at shareholders' meetings and the minimum holdings of shareholders. In a joint stock company, resolutions are made on the basis of shareholdings. Therefore, theoretically, a shareholders' meeting can be held with any number of shareholders holding only one share.

Board of Directors

In Germany, the board of directors has power over all matters regarding business operations.[53] The shareholders' meeting can deal with those matters only if the board of directors requests it to do so. The *Model Business Corporation Act* of the USA gives the board of directors an even wider range of powers over business decision making and business operation.[54] Similar provisions can also be found in French law and Japanese law. In comparison, the Chinese *Company Law* gives the board of directors fewer powers. The board of directors only has the power of formulating business and investment plans. However, the power of approving the plans is in the hands of the shareholders' meeting. The main task of the board of directors is to implement resolutions passed at shareholders' meetings.

In a limited company, the number of members of the board ranges from 3 to 13 and in a joint stock company from 15 to 19. The Chinese law, like the laws in other systems, contains provisions in respect of qualifications for directors. It disqualifies certain people from the position of director. A person who has no civil capacity cannot be a director. However, unlike the laws in other systems, the Chinese *Company Law* does not set a top limit on the age of a director.[55] A person is also disqualified for a period of 5 years after imprisonment for certain crimes, or a period of 3 years after bankruptcy or revocation of a business licence, liable for the bankruptcy or revocation.

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permits Chinese citizens residing abroad to purchase B-shares. However, there is no such relaxation available in relation to H-share and N-share investment.

52 Shanghai stock exchange market requires that B-shares are to be purchased in Hongkong Yen, and Shenzhen stock exchange market required that B-shares are to be purchased in US dollar.

53 *Aktiengesetz 1965*, s 119.

54 *Model Business Corporation Act,* s 8.01.

55 In UK a person over 70 years old is not permitted to take the post of director. In France, the number of the directors who are over 70 years old cannot exceed one third of the total numbers of the directors.

The Chinese *Company Law* contains provisions in relation to the duty of loyalty. According to the law, directors should faithfully perform their duties to the company and should uphold the interests of the company. The directors should not use their position to seek personal gain. A director is forbidden from engaging in the business operation of another company carrying out the same business as the company that he or she is serving, and engaging in activities which may adversely affect the interests of the company.[56] The law also contains provisions regarding self-dealings.[57] However, there are no provisions in respect of fiduciary duties, the duty of care or the business judgement rule. The absence of such provisions causes some inconvenience in practice. A recent case highlights the situation. The facts of the case are as follows:

> Yanzhong Industrial Stock Co Ltd of Shaghai (Yanzhong), Zhongtian International Ltd of Hong Kong (Zhongtian) and Jinbang Second Industrial Company of Jiading District of Shanghai (Jinbang) set up a joint venture company to produce distilled water in 1992. The board of directors of the new company consisted of six members; three from Zhongtian, two from Yanzhong, and one from Jinbang. According to the articles of association, the chairman of the board was from Yanzhong and the quorum for a board meeting was five. From September 1995 to March 1996, Yanzhong established two subsidiary companies to produce another brand of distilled water with identity mark similar to the products of the joint venture. The board chairman of the two subsidiary companies was also the chairman of the board of directors of the joint venture. The directors of the joint venture, who are from Zhongtian, called an extraordinary meeting. A resolution to bring a law suit by the joint venture against Yanzhong was passed by a vote of 3:1. However, the lawsuit was withdrawn by the chairman of the joint venture on the ground that the extraordinary meeting was void. Finally, Zhongtian, as a shareholder of the joint venture, brought the matter to a court.[58]

The two key issues of the case were whether Zhongtian as a shareholder could bring a suit on behalf of the interests of the joint venture against Yanzhong and whether the chairman of the joint venture breached his duty. The first issue involved a derivative suit and the second issue involved directors' fiduciary duty. The 1994 *Company Law* fails to address both of the issues. As a result, the final decision in the case was delayed many months.[59]

It is worth noting that a board of directors of a Chinese company is an organ of decision-making for day to day business operations, but not an organ for

56 *Company Law 1994*, art 59, 60, and 61.
57 *Company Law 1994*, art 61.
58 The facts are from the materials provided in the published article 'Practical Demands to Update the Company Law' by Zhang X. See Zhang X, 'Practical Demands to Update the Company Law' (Pt 2) (1998) 28 *Hong Kong Law Journal* 248-9.
59 Ibid, 249.

carrying out daily business operations. The tasks of daily business management are carried out by the manager of the company. The board of directors together with the manager comprise the managerial capacity of the company. This characteristic distinguishes a board of directors of a Chinese company from a board of directors in a European system where the board of directors is the managerial organ of a company.

Problems arise in practice. As the function of a board of directors is decision-making over day to day business operations, the manager as the executive plays a very important role in daily business management. This makes some people believe that the manager is the centre of managerial power. Moreover, the law stipulates that the board of directors can only hold a board meeting twice a year.[60] This may result in inefficiency in terms of performing the duties of the board in reality.

60 Article 116 of the 1994 *Company Law* states: 'The board of directors meetings shall be held at least twice a year'.

Supervisory Board

Although many European countries have supervisory boards or a similar device in their corporate laws, the detailed provisions about the operations and powers of the supervisory board or supervisory organ differ. For instance, in Japan, a supervisor or auditor is of equal rank with the board of directors in a company.[61] Both supervisors and the members of the board of directors are appointed by the shareholders' meeting. They are both responsible to the shareholders' meeting. In such case, a supervisory board or a supervisor is merely a supervisory institution and responsible for supervising the work of the board of directors and corporate operation.

In Germany, a supervisory board not only has the power of supervising the board of directors and company operation, but also of supervising the financial affairs of the corporation and making business decisions to a certain extent.[62] Its members are appointed by the shareholders' meeting. After its appointment, the supervisory board will elect the members of the board of directors. The board of directors has the duty of submitting their work reports to the supervisory board. In such a case, the supervisory board is not only the supervisory institution but also the decision-making institution of the corporation and has authority over the board of directors.

China adopted the Japanese model. According to the *Company Law*, the shareholders' meeting has the authority of electing both directors and supervisors of a company. Both of the boards are obliged to submit their reports to the shareholders' meeting for review and approval.[63] A supervisory board should have no less than three members. Among them there should be an appropriate proportion of employee representatives. Unlike the German practice where the proportion of employee representatives is stipulated by law, the Chinese law leaves this to the articles of association of a company. It is noteworthy that the representatives of the employees in a supervisory board are to be elected by the employees of the company not by the shareholders' meeting.[64]

The Chinese law only requires joint stock companies and large-sized limited companies to set up supervisory boards. A limited company which has a limited number of shareholders and is small in size can have one to two supervisors instead of a supervisory board.[65]

The *Company Law* generally confers upon a supervisory board or a supervisor the powers of supervising the work of the directors and the manager and

61 Xu Y, *Principles of Company Law*, Publishing House of Law, Beijing (1997) 294-5.
62 *Company Law 1994*, art 38 (4), (5).
63 *Company Law1994*, art 38.
64 *Company Law1994*, art 52 and 124.
65 Ibid.

proposing the holding of interim shareholders' meetings. However, it falls short of supplying provisions for implementing the powers and duties. There are no provisions concerning rules of procedure, rules of voting, and rules of proposing and holding meetings of the supervisory board.[66] Those matters are well settled in the laws of other systems. This has caused concern amongst Chinese scholars.[67] At a time when the actual control of the shareholders' meeting is declining and powers of the board of directors are expanding, the supervisory function of the supervisory board is crucial in terms of monitoring management and reducing agency costs. In a country like China where awareness of shareholders' rights is not well developed among the general public, it is even more important to provide a means of enhancing the supervisory capacity of the supervisory board.

Conclusion

Chinese Company Law adopts the model of the European system in terms of corporate governance, and the law follows the current developments in corporate legislation. The problem is that the law is stated more in terms of principle than detail. It states that a director has the duty of upholding the interests of the company, but fails to address the directors' fiduciary duty. It gives a wide range of powers to shareholders' meetings, but does not have a requirement on the quorum of shareholders attending the meetings. It has provisions which disqualify certain people from taking the position of director, but forgets to set a ceiling on the age of directors. It gives supervisory powers to supervisors, but does not prescribe how to exercise the power, nor the liabilities of supervisors in case of breach of duty. This may result from the fact that the law anticipates developments in practice. If so, with more feedback from developments in practice, the *Company Law* will be completed and improved over time.

A major task for the Chinese is the implementation of the *Company Law* in practice. After forty years of experience a planned economy, with principles and concepts of corporations are quite alien to the Chinese. It is a challenge for the Chinese business decision makers, entrepreneurs and the general public to learn to implement the law properly in practice.

In the modern global economy, competition exists not only in products but also in corporate governance systems. Reforming current corporate legislation in order to reduce unnecessary confusion in practice, will improve the performance of Chinese enterprises and will increase the capacity of those enterprises to perform efficiently in a system increasingly characterised by global competition.

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66 These matters are all left to the articles of association.

67 Xu Y, *Principles of Company Law*, Publishing House of Law, Beijing (1997) 303.