

## IMPROVING CORPORATE GOVERNANCE IN STATE-OWNED CORPORATIONS IN CHINA: WHICH WAY FORWARD?

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*This article discusses corporate governance in China. It outlines the basic agency problem in Chinese listed companies and questions the effectiveness of the current mechanisms employed to improve their standards of governance. Importantly, it considers alternative means through which corporate practice in China can be brought into line with international expectations and stresses the urgency with which this task must be tackled. It concludes that regulators in China must construct a corporate governance model which is compatible with its domestic setting and not rush to adopt governance initiatives modelled on those in cultures which are fundamentally different in the hope of also reproducing their success.*

### A. INTRODUCTION

Many company lawyers will be familiar with the Berle and Means analysis,<sup>1</sup> which demonstrates the divergence between the interests of directors and shareholders in widely held corporations. The agency problem stems from the fact of dispersed ownership in these corporations: since shares are widely held, shareholders are not, of themselves, able to effectively monitor the actions of directors. The purpose of corporate governance is thus to align the interests of the directors with the shareholders. Such corporations are typically found in Anglo-American jurisdictions.<sup>2</sup> To mitigate the agency problem between

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<sup>1</sup> A Berle and G Means, *The Modern Corporation and Private Property* (New York, Harcourt, Brace & World Inc, 1932). Despite its dominance in the study of company law, it is argued that the Berle and Means theory is now of limited relevance. Widely dispersed ownership of shares is the exception rather than the norm, in particular in companies in south east Asia. It is now also no longer obvious that widely dispersed shareholding will, in itself, lead to inferior monitoring of directors. See I MacNeil, "Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies" (2002) 2 *Journal of Corporate Law Studies* 289, 292. See also RL Porta, F Lopez-de-Silanes and A Shleifer, "Corporate Ownership Around the World", (1999) 54 *Journal of Finance* 471 and RL Porta, F Lopez-de-Silanes, A Shleifer and RW Vishny, "Law and Finance" (1998) 106 *Journal of Political Economy* 1113.

<sup>2</sup> SYL Cheung and BY Chan, "Corporate Governance in Asia" (2004) 11 *Asia Pacific Development Journal* 1, 5.

directors and dispersed shareholders, priority is given to strengthening shareholder rights so they can effectively hold directors to account. The rules regulating their capital markets often dictate the nature and extent of information which must be disclosed by companies to shareholders and the public so that they can make informed decisions about their relationships with these companies. Takeovers are relied on as a means of corporate control as are independent directors to oversee the actions of the board. Finally, the media, industry and the legal and accountancy professions all undertake an active role in setting appropriate standards for directorial conduct.<sup>3</sup>

A different kind of company set up exists in companies in south east Asia. The pattern of ownership in such companies is not one of dispersed shareholding, with no clearly identifiable majority shareholder. Typically, companies are controlled by substantial shareholders,<sup>4</sup> who may be groups of companies, founding families or the state. Concentration of ownership is evident even in large listed companies where control is secured through pyramid structures or cross holdings among firms. Family ownership is prominent in more than half of the companies in south east Asia, notably in Malaysia, Hong Kong and Indonesia, where the top 10 families can control between 25 and 50% of listed corporate assets.<sup>5</sup> This control often extends to being able to appoint nominees to sit on the board.<sup>6</sup> State ownership of shares is prominent in China. Empirical research shows that, as at the end of 2001, the state controlled 81.6% of listed companies in China, and that its average controlling stake in these companies amounted to just under 50%.<sup>7</sup> Some have argued that this figure is still only a conservative estimate of the control exerted by the state, as it is likely that the second and third largest shareholders are also under its influence or direction.<sup>8</sup> Although the number of investors has soared in the last 10 years, the state still holds approximately two-thirds of the total issued shares in China.<sup>9</sup>

<sup>3</sup> OK Tam, "Ethical Issues in the Evolution of Corporate Governance in China" (2002) 37 *Journal of Business Ethics* 303, 309.

<sup>4</sup> G Walker and T Reid, "Upgrading Corporate Governance in East Asia: Part 2" (2002) 17 *Journal of International Banking Law* 96. These issues are also discussed in L Miles, "Waking Up after the 1997 Financial Crisis: Corporate Governance in Malaysia" (2004) 20 *Journal of International Banking Law and Regulation* 21.

<sup>5</sup> See S Classens, S Djankov and L Lang, "The Separation of Ownership and Control in East Asian Corporations" (2000) 58 *Journal of Financial Economics* 81. The authors conducted research into the control of corporations in east Asia, specifically Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Taiwan, Singapore and Thailand.

<sup>6</sup> *Ibid.* Studies which have been conducted to compare family ownership of companies show that family groups in Malaysia and Hong Kong control up to 78% of total market capitalisation. See Cheung, *supra* n 2, 22.

<sup>7</sup> See GS Liu and P Sun, "The Class of Shareholdings and Its Impact on Corporate Performance: Composition in Chinese Public Corporations" (2005) 13 *Corporate Governance: An International Review* 46.

<sup>8</sup> *Ibid.*, 50-51.

<sup>9</sup> Tam, *supra* n 3, 306 and Q Qiang, "Corporate Governance and State Owned Shares in China Listed Companies" (2003) 14 *Journal of Asian Economics* 771, 774-75.

This article considers the extent to which the duties of directors can be enforced effectively where the affairs of a company are dominated by a majority shareholder. China provides an interesting case study because, as majority shareholder, the state can not only manipulate, but also directly control, the development of corporate governance and its enforcement to its own advantage.<sup>10</sup> Against this backdrop, this article questions the extent to which the objective of ensuring proper corporate governance within its companies can be achieved. Section B provides a brief discussion of the corporate governance framework in China and emphasises the power the state holds as majority shareholder in listed companies. Section C examines the effectiveness of various control mechanisms under Chinese law to ensure responsible standards of governance within the company. Finally, Section D proposes solutions which can be adopted to ensure that companies are managed properly, albeit retaining state control of them. It also considers specific weaknesses in the Chinese governance regime which must be addressed urgently.

## B. A BRIEF OVERVIEW OF THE CORPORATE GOVERNANCE FRAMEWORK IN CHINA

### 1. "Corporatisation" of State-owned Enterprises

The significant efforts put into transforming the planned economy into a market economy in China were largely motivated by its government's desire to compete on the global front, attract financial and human capital and take advantage of the opportunities generated by globalisation. A central theme of the reform programme has been to improve the performance of state-owned enterprises. Under the communist regime, these enterprises were not independent economic entities but were workshops and production units controlled entirely by the state.<sup>11</sup> The state owned them, paid their workers and determined the prices for the goods and services they offered. It also funded their activities and appointed officials to manage them. In running state-owned enterprises, these officials merely ensured that the production plans of the government were met: their responsibility did not extend to making profit. Indeed, state-owned enterprises were not commercial enterprises at all; rather, they were factories which produced goods and services and met targets set by the government. As a result, they were both unprofitable and inefficient.<sup>12</sup>

<sup>10</sup> MacNeil, *supra* n 1, 323.

<sup>11</sup> Tam, *supra* n 3, 305.

<sup>12</sup> C Mallin, *Corporate Governance*, (Oxford University Press, 2004), 183 and CA Schipani and JH Liu, "Corporate Governance in China: Then and Now" [2002] *Columbia Business Law Review* 1.

To make state-owned enterprises more productive, the Chinese government converted them into corporations with separate legal identities (arrangements based on Anglo-American corporate practice). This is also known as the process of "corporatisation". In essence, the state-owned enterprise is given the status of a corporate body. In some cases, this was achieved by registering the state-owned enterprise and making the state its sole shareholder. In other cases, outsiders were permitted to invest in the new corporations, although they were subject to the direct control of the state (see Fig. 1).<sup>13</sup> Indeed, the reform of these enterprises is said to be the key to the success of China's economic growth.<sup>14</sup> Many believed that corporatisation would improve productivity and performance and would allow state-owned enterprises to generate income from other avenues rather than continue to rely on government loans for survival.<sup>15</sup> They also perceived the setting up of corporations as affording superior economic performance<sup>16</sup> and attributed the rise and wealth of western economies to the activities of corporations.<sup>17</sup> At the end of the 1980s and early 1990s, corporatisation was carried out on a pilot basis but, by the end of the decade, the government had decided to pursue the policy vigorously. The 15th Congress of the Chinese Communist Party (1997) stated that large and medium-sized state-owned enterprises should be corporatised and that the process of creating a modern enterprise system should be sped up.<sup>18</sup> Within a short period, the majority of state-owned enterprises were incorporated. Many were converted into public companies and were able to take advantage of the facilities on the Shanghai and Shenzhen stock exchanges. The number of listed companies expanded rapidly, as did the number of registered stock investors.<sup>19</sup> Today, over 1300 companies are listed on China's stock exchanges.<sup>20</sup> Virtually all

<sup>13</sup> For a history of corporate governance in China, see D Clarke, "Corporate Governance in China: An Overview" (2003) 14 *China Economic Review* 494 and YW Wei, "An Overview of Corporate Governance in China" (2003) 30 *Syracuse Journal of International Law and Commerce* 23.

<sup>14</sup> HW Hu, "Independent Directors: A New Chapter in the Development of Corporate Governance in China" available at <http://mans.rmit.edu.au/tsk9lvqayezk.doc>, accessed on 15 December 2004.

<sup>15</sup> Wei, *supra* n 13, 23.

<sup>16</sup> See the 3rd Plenum of the 14th Congress of the Chinese Communist Party (CCP), Decisions on Some Issues in Establishing the Socialist Market Economic System, November 1993, which for the first time called for the establishment of the modern corporation as a key measure in China's economic reform, emphasising the reorganisation of large and medium sized state-owned enterprises into legal entities. See Tam, *supra* n 3, 307-18.

<sup>17</sup> Wei, *supra* n 13, 27 and 51. In instigating corporate reform, the Chinese government was attracted by the Anglo-American corporate model and as a consequence, much effort was put into understanding its characteristics and to emulate Anglo-American style governance in China.

<sup>18</sup> *Ibid*, 23.

<sup>19</sup> The data from December 2004 shows the number of listed companies as 1377 and the total number of registered stock investors as 72.1143 million. See [http://www.csrc.gov.cn/en/homepage/index\\_en.jsp](http://www.csrc.gov.cn/en/homepage/index_en.jsp), accessed on 15 March 2005.

<sup>20</sup> All four national commercial banks are considering going public; two of them have officially announced this fact and are undertaking preparatory work to do so. One is now listed on the

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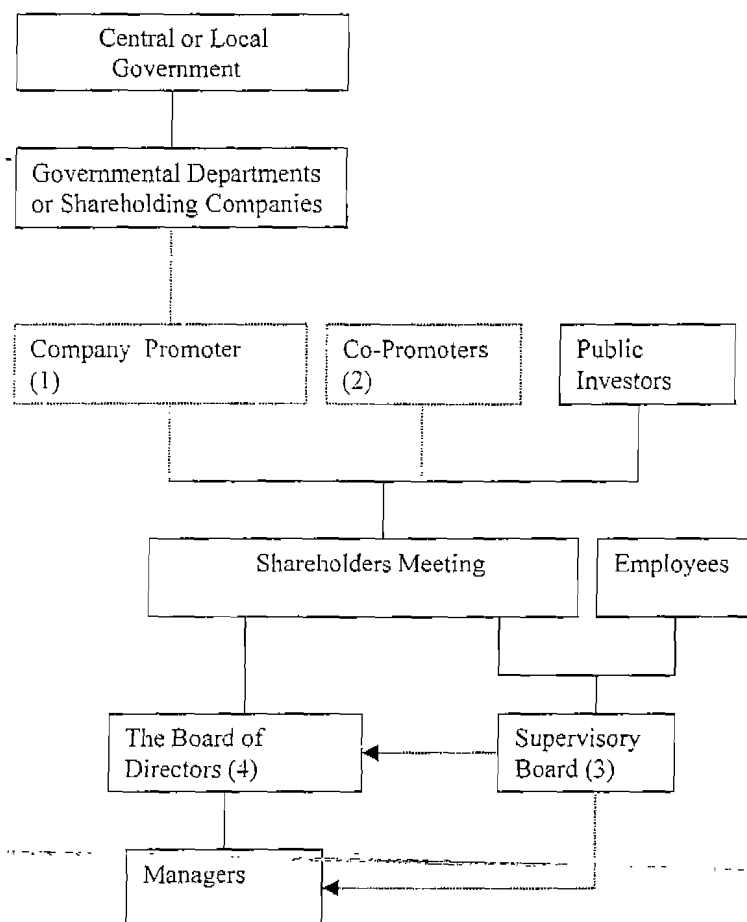


Fig 1. The Structure of a Typical Corporatized State-owned Enterprise.

(1) A company promoter may be a company either wholly or partly owned by the state. In many cases, shares in a listed company are held directly by governmental departments or shareholding companies created to hold shares on behalf of the state. When a public company is set up and the assets in a state-owned enterprise are transferred to the company, state shares in the subsequent company which are held directly by the state or shareholding companies are known as "state-owned shares". (2) A company co-promoter may consist of anyone invited by (1) to help promote the company. These may include private companies. Not all listed companies, however, have co-promoters. (3) Supervisory boards have no power to appoint or dismiss directors. They only have the authority of "supervision". The proportion of shareholder and employee representatives on the supervisory board is stipulated in the articles of association. (4) The board of directors is appointed to manage the company, and many directors are recruited directly from the ranks of civil servants.

of these have been converted from state-owned enterprises, and a substantial number are still under the control of the state. In a short space of time, the corporate landscape in China had changed remarkably.<sup>21</sup>

Despite the emulation of Anglo-American corporate practices, communist ideology still features heavily in the way corporatisation is organised. Both the Communist Party Constitution and the Constitution of China provide that state ownership should be a dominant feature in the economy. Thus, despite converting many state-owned enterprises into corporations, and enabling a significant number of these to be listed, the state maintains control of them. There are various reasons why the state has chosen to do so, but the desire to maintain employment levels, control sensitive industries and ensure social stability feature highly.<sup>22</sup>

The fact that the state is majority shareholder in listed companies has implications for Chinese corporate governance.<sup>23</sup> When majority shareholders dominate the way companies are run, it becomes very difficult to challenge their actions, whether through internal or external mechanisms. The board of directors may be partial to them. Minority shareholders may find their rights and interests harmed by majority shareholders who can override their interests either through decisions of the board (which they control) or through decisions in shareholder meetings (which they also control by virtue of their voting power). Majority shareholders can influence major company decisions, collude with internal management to share rents expropriated from minority shareholders and exploit the financial resources of the company to their own advantage.<sup>24</sup> They may also view the company as a mere extension of their interests and so approve self-interested transactions, refuse to declare dividends or forcibly purchase the shares of minority shareholders at a price below their true value.<sup>25</sup> As minority shareholders do not have sufficient voting power to override the wishes of the majority, they are unable to block these practices.

Controlling shareholders are also in a position to manipulate external constraints on corporate behaviour. For example, they can put pressure on those

Hong Kong Stock Exchange. See BBC News, "China Bank Makes HK Stock Debut", 27 October 2005, available at <http://news.bbc.co.uk/2/hi/business/4380278.stm>.

<sup>21</sup> As discussed in L Miles, "The Implications of the State as Majority Shareholder on Corporate Governance in China" (2005) 8 *Sweet and Maxwell's Company Law Newsletter* 1.

<sup>22</sup> See Clarke, *supra* n. 13, 494.

<sup>23</sup> On the importance of corporate governance to modern China, see CH Zhang, "Corporate Governance: What Is It and Why Does It Matter to China?", available at [www.cipc.org/china/p4\\_chunlin.htm](http://www.cipc.org/china/p4_chunlin.htm), accessed on 27 January 2005.

<sup>24</sup> On the state as controlling shareholder in listed companies in China, see WG Zhang, "Shareholding Structures, Related Party Transactions and Corporate Governance in China", in FA Gul and JSL Tsui (eds), *The Governance of East Asian Corporations*, (Basingstoke, Palgrave Macmillan, 2005), ch 2.

<sup>25</sup> For example, when the majority shareholder wishes to oust the minority shareholders from the company altogether.

in authority for preferential treatment.<sup>26</sup> Also, hostile takeovers will not occur if the controlling owner did not wish this to happen. Its control can thus prevent the market from acting as a corporate control mechanism, although from a corporate governance perspective, the controlling shareholder may well keep its directors in check. Finally, ownership concentration can lead to less transparency and disclosure in company reporting. Minority shareholders may thus not have the information they need to make further investment decisions.

## 2. The Regulatory Framework Governing Directors in China

The internal governance structure provided by the Chinese Corporations Law of 1993<sup>27</sup> combines features from both the Anglo-American and German systems. China operates a two-tier board system, with a board of directors and a supervisory board. The board of directors is responsible for managing the affairs of the company. It convenes shareholders' meetings, implements the resolutions of those meetings, decides the company's business and investment plans, and formulates its basic management system.<sup>28</sup> The supervisory board, which represents the interests of employees and major shareholders,<sup>29</sup> reviews the financial affairs of the company, monitors whether directors have complied with the law, proposes interim meetings of shareholders and requires directors to make rectification when they cause harm to the interests of the company.<sup>30</sup>

The duties of directors are laid down in Articles 59–63 of the Corporations Law 1993. Many of these duties are based on those found in Anglo-American corporate systems. So, for example, directors must perform their duties faithfully, safeguard the interests of the company and not abuse their position and authority for private gain.<sup>31</sup> They may not accept bribes, generate illegal income or misappropriate company funds.<sup>32</sup> Further, they may not engage in business which competes with that of the company.<sup>33</sup> If they cause harm to the company by breaching the law, administrative regulations or articles of association, they will incur liability for the resulting loss.<sup>34</sup> Articles 214 and 215 provide that directors who breach their duties will be ordered to return to the company any assets belonging to it and any gains which they have made as a consequence of

<sup>26</sup> See Classens, et al, *supra* n 5, 109.

<sup>27</sup> This can be viewed at <http://www.eclaw.net/download/companylaw.asp>. The Corporations Law 1993 was recently amended. The new law took effect on 1 January 2006. Where relevant, amendments are highlighted in this article. The Chinese version of the new Corporations Law 2006 can be viewed at <http://www.npc.gov.cn>.

<sup>28</sup> Corporations Law 1993, Arts 46 and 112.

<sup>29</sup> *Ibid.*, Arts 52 and 124.

<sup>30</sup> *Ibid.*, Arts 54 and 126.

<sup>31</sup> *Ibid.*, Art 59.

<sup>32</sup> *Ibid.*, Art 60.

<sup>33</sup> *Ibid.*, Art 61.

<sup>34</sup> *Ibid.*, Art 63.



that breach. They may also be disciplined by the company and contracts which they have entered into in breach of their duties may be set aside.

The Corporations Law 1993 confers on shareholders several powers which they can exercise.<sup>35</sup> Shareholders enjoy rights in proportion to their shareholding and can make important decisions affecting the company, such as determining the company's operational guidelines and investment plans, amending the articles of association, appointing directors and supervisors and determining their remuneration, and making decisions with regard to mergers, dissolutions and company liquidation.<sup>36</sup> They may authorise proxies to attend meetings of the company and vote on their behalf.<sup>37</sup> They can also inspect company documents.<sup>38</sup> Article 104 gives those holding 10% or more of the company's shares the power to request the interim shareholders' meetings to be convened. Finally, Article 111 provides that where a resolution adopted by the shareholders' general committee or the board of directors violates statutes or administrative regulations or infringes the rights and interests of shareholders, shareholders can bring an action to challenge such acts. Interestingly, there are no provisions in the Corporations Law 1993 which allow them to ratify the actions of directors to absolve them of wrongdoing,<sup>39</sup> although in practice, there is no reason why the power to do so cannot be written into the articles of association.

The Chinese Securities Regulatory Committee (CSRC)<sup>40</sup> is the authority responsible for supervising and regulating the securities markets in China. Recently, it introduced guidelines to promote high standards of governance within the company. The "Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies 2001"<sup>41</sup> require domestic listed companies to fill one-third of their board with independent directors.<sup>42</sup> Independent directors owe duties of good faith, due diligence and care towards the company and all the shareholders. They have a duty to protect the interests of the company, and must be "especially concerned with" protecting those of minority shareholders. They must also carry out their duties independently and not subject themselves to the influence of the company's major shareholders, actual controllers, or interested parties.<sup>43</sup> Being "independent" means that the

<sup>35</sup> *Ibid*, Arts 37 and 102.

<sup>36</sup> *Ibid*, Art 102.

<sup>37</sup> *Ibid*, Art 108.

<sup>38</sup> *Ibid*, Art 110.

<sup>39</sup> See the UK position in *Banford v Banford* [1969] 2 WLR 1107. If directors, by approving some transaction of the company, have breached their fiduciary duty toward the company, it is sometimes permissible for shareholders to ratify what the directors have done by passing an ordinary resolution.

<sup>40</sup> See [http://www.chinaonline.com/refer/ministry\\_profiles/CSRCL3.asp](http://www.chinaonline.com/refer/ministry_profiles/CSRCL3.asp) for more information.

<sup>41</sup> The Guidelines can be viewed at [www.csrc.gov.cn](http://www.csrc.gov.cn), accessed on 15 October 2004. See AKI. Lau, "China: CSRC's 'Guiding Opinion' on Independent Directors of Listed Companies—Another First for China" (2003) 24 *The Company Lawyer* 279.

<sup>42</sup> Guidelines, Art 1(3).

<sup>43</sup> *Ibid*, Art 1(2).



**Table 1: Introduction of Initiatives Related to Corporatisation and Corporate Governance in China**

Period	Governmental Action
1979-1980s	Initiation of reform and an "opening up" policy. Managers were allowed more autonomy in running their enterprises
Late 1980s and early 1990s	Experiments with corporatisation. The opening of the Shanghai & Shenzhen stock exchanges
1992	Establishment of the CSRC
1993	Introduction by the CSRC of Rules on Information Disclosure in the Event of Initial Public Offerings. Introduction of Provisional Regulations on the Issuing of Stock and Trading
1993	Formal promulgation of the policy of corporatisation by the Chinese Communist Party. Enactment of the Corporations Law 1993
1997-99	Corporatisation of large and medium-sized state-owned companies. The process of creating a modern enterprise system was speeded up. Introduction by the CSRC of Guidelines for Articles of Association for Listed Companies
1998	Enactment and implementation of the Securities Law 1998
2000-1	Adoption of the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies. Introduction by the CSRC of The General Requirements Governing Shareholders' General Meetings
2002	Introduction by the CSRC of the Code of Corporate Governance for Listed Companies. Formal decision on the part of the state that apart from a few that would be kept in the form of one-person companies, all state owned enterprises would be corporatised with multiple shareholders
2003	Establishment of the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC)
August 2005	Reform to address the problems caused by the non-tradability of shares in listed companies
October 2005	Amendment of the Corporations Law 1993 and of the Securities Law 1998

director has no posts in the company other than the position of director, and maintains no relations with the listed company and its major shareholder that might prevent him from making objective judgments independently.<sup>44</sup> He has a responsibility to make a judgment with regard to "major related party transactions"<sup>45</sup> within the company and approve them, and express independent opinions on issues such as the nomination, appointment, remuneration or removal of senior managers and on any matters which he thinks may damage the interests of minority shareholders.<sup>46</sup> The Guidelines obligate the company to cooperate with him and to "actively" provide him with assistance by furnishing information and documents.<sup>47</sup>

### C. EFFECTIVENESS OF CURRENT CORPORATE GOVERNANCE MECHANISMS

Good corporate governance necessitates that the board acts in the best interests of the company and behave in a responsible and diligent manner. In Anglo-American jurisdictions, the task of monitoring the conduct of directors and ensuring good governance within companies is undertaken by, inter alia, independent directors, shareholders, the capital market, the media and corporate governance codes. However, due to fundamental differences in corporate culture, not all of these governance mechanisms can be relied on to promote good governance in China. Ironically, it is the state as majority shareholder which stands in the way of the various corporate mechanisms from operating effectively. Where the state controls the appointment and employment of directors, and is willing to ratify their conduct, there is little point in introducing a legal framework to regulate directors to raise levels of governance. When the law does not take minority shareholders seriously, they cannot participate in the governance of the company. When monitors of management are also appointed by the majority shareholder, it is unrealistic to expect them to disregard its wishes when supervising management. Finally, when the judicial system is underdeveloped, the courts cannot set standards to guide the conduct of directors. This section will consider the effectiveness of existing corporate governance mechanisms to ensure proper directorial conduct in listed companies in China.

#### 1. Ambiguity of the Law

Whilst legal provisions set standards against which directors must act, it is unrealistic to expect them to play a significant role in guiding directorial

<sup>44</sup> See *ibid*, Arts I(1) and III.

<sup>45</sup> *Ibid*, Art V.

<sup>46</sup> *Ibid*, Art VI.

<sup>47</sup> *Ibid*, Art VII. The requirement to recruit independent directors is now incorporated into the Corporations Law 1993. See Corporations Law 1993, Art 123, as amended.

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behaviour if the majority shareholder is willing to ratify breaches of duties by directors. Until this fundamental problem is overcome, any evaluation of how effective the legal framework is in setting appropriate standards of conduct will, to a large extent, only constitute an academic exercise. This apart, many of the provisions on the duties of directors under the Corporations Law 1993 are drafted in an ambiguous manner. For example, the law states that directors may not engage in activities which are detrimental to company interests.<sup>48</sup> But "detrimental" activity is not quantified. Neither are "company interests"; do they mean the interests of the company as a business entity or the interests of the body of shareholders as a whole? The law also prohibits the giving of company assets as security for the debts of individuals<sup>49</sup> but not, it appears, of entities. What is the rationale for distinguishing between individuals and entities? The Corporations Law 1993 further provides that directors may not seek personal gains arising out of their position and authority.<sup>50</sup> Again, in the absence of more specific guidance, it is difficult to know what this means. Certain actions may be beneficial to the company but may also, at the same time, advance the personal interests of the directors.<sup>51</sup> How should directors act in these circumstances? The ambiguous manner in which these provisions are drafted not only makes it difficult for directors to know what is and what is not acceptable conduct, it also makes enforcing the law a difficult task.<sup>52</sup>

The same can be said for the provisions on the rights of shareholders. Article 104 provides that interim meetings can be convened where shareholders holding at least 10% of the company's stock request one to be convened. The CSRC "Guidelines for Articles of Association of Listed Companies 1997"<sup>53</sup> (mandatory company articles) supplements this by providing that shareholders wanting such a meeting to be convened must first make a proposal to the board for it to do so. If the board refuses, they may convene the meeting themselves.<sup>54</sup> But if the board refuses to convene a meeting and shareholders themselves convene one (by implication without the approval of the board), are the resolutions passed at these meetings valid?<sup>55</sup> The Corporations Law 1993 is silent on this issue, although the 1997 Guidelines imply that they are valid.<sup>56</sup> Guidelines issued by

<sup>48</sup> Corporations Law 1993, Art 61.

<sup>49</sup> *Ibid.*, Art 214.

<sup>50</sup> *Ibid.*

<sup>51</sup> See, eg the circumstances in *Regal Hastings v Gulliver* [1967] 2 AC 134 in the UK.

<sup>52</sup> Compare and contrast this with well settled case law and legal regulation in the UK, ie *Re City Equitable Fire Insurance* [1925] Ch 407, *Norman v Theodore Goddard* [1991] BCLC 1028, *Re D'Jan of London* [1993] BCC 646, *Re Barings PLC* [2000] 1 BCLC 523 and Insolvency Act 1986, ss 214-15.

<sup>53</sup> Available at <http://www.csrc.gov.cn/cn/homepage/index.jsp> (Chinese version only).

<sup>54</sup> See Guidelines, Arts 44 and 54.

<sup>55</sup> Z Ying, "Minority Shareholder Protection in China: Present Approaches and Further Improvements" (2004) 5 *Griffins View* 77, 80.

<sup>56</sup> Article 56 of the Guidelines provides that:

the CSRC, however, rank lower than the law and are not legally binding. Their legal significance is thus unclear.

The power to propose shareholder resolutions is another example of poor drafting. A common reason why shareholders may want to propose resolutions is to call for the dismissal of directors or force the consideration of issues which the directors were unwilling to include on the agenda. Again, the Corporations Law 1993 is silent on whether shareholders may propose resolutions, although the 1997 Guidelines provide that those who individually or collectively hold 5% or more of the voting rights may do so.<sup>57</sup> However, they go on to provide that even when resolutions have been proposed, directors may still decide not to consider them at the general meeting.<sup>58</sup> In effect, shareholder resolutions can be ignored by the directors. As a result, it is futile for shareholders holding less than 10% of the voting rights to propose resolutions; without the 10% shareholding, they will be unable to convene a separate meeting to consider these resolutions.<sup>59</sup> This is an unnecessarily burdensome provision. The ability of shareholders to convene meetings and pass resolutions is important in a culture like that in China, where the state shareholder holds a disproportionate amount of the shares in a company. From a cynical point of view, where a majority exerts significant influence over the company, it may not matter very much whether or not minority shareholders are able to convene a meeting or propose a resolution. But the ability of minority shareholders to do precisely these can help inform other shareholders of what is happening in the company. Ironically, allowing minority shareholders to properly convene a meeting or propose a resolution may also bring to the attention of the majority shareholder matters which the directors (whom they have appointed) are concealing from them, or matters which they are ignorant about.

Article 111 enables shareholders to bring an action to challenge directorial behaviour which breaches the law or which harms their rights and interests. It provides:

"Where a resolution adopted by the shareholders' general meeting or the board of directors violates the relevant national statutes or administrative regulations, or infringes on the rights and interests of the shareholders, a shareholder is entitled to bring a suit to the People's Court to enjoin such illegal act or infringing act."

"... the supervisory board or shareholders can hold interim meetings themselves, in accordance with the process stipulated in Article 54, if the board of directors does not convene an interim meeting within the time limit provided for in Article 54".

By way of contrast, see Companies Act 1985, s 368 in the UK, which clothes such meetings with legal authority.

<sup>57</sup> Guidelines, Art 57. By way of contrast, see Companies Act 1985, s 376 in the UK.

<sup>58</sup> Guidelines, Arts 59 and 60.

<sup>59</sup> See Corporations Law 1993, Art 104, as discussed on p 222.

But several ambiguities surround this provision. For example, it does not stipulate the conditions under which the shareholder may bring the action. It is also unclear whether internal remedies must first be exhausted or who it is that must pay the costs of litigation. If the action is successful, what remedies may be awarded? Will the minority shareholder be compensated? Further, it is uncertain whether the action is to be brought only when the personal rights of the shareholder are infringed or if the action could be construed as a derivative action, one which is brought on behalf of the company.<sup>60</sup>

Finally, the Corporations Law 1993 does not provide for which departments of the state are responsible for enforcing the duties of directors. If behaviour on the part of the board constitutes a criminal offence, the state can prosecute them. Indeed, there are sporadic examples of this.<sup>61</sup> However, it is unclear which public body is responsible for pursuing those directors who breach the Corporations Law. If shareholders do not resort to litigation in the courts to highlight misbehaviour on the part of directors, there may be no remedy for managerial misconduct at all. This is ironic, given the central role administrative organs play in China in enforcing other areas of the law.<sup>62</sup>

## 2. Shareholders as Monitors of Management

Under company law, directors are accountable to the body of shareholders who can monitor their actions and hold them to account. Needless to say, the majority shareholder will be able to influence this process significantly. But the Chinese experience shows that the state as majority shareholder is ineffective in monitoring the actions of directors. Listed companies in China are controlled either directly or indirectly by the state. In the former case, the registered shareholders are central or local governmental departments or companies created specifically for the purpose of holding shares on its behalf. In the latter, the registered shareholders are incorporated state-owned enterprises of which governmental departments or shareholding companies are the sole or majority shareholders. Despite the ability of the state as majority shareholder to appoint

<sup>60</sup> This is discussed in L Miles and M He, "Protecting the Rights and Interests of Minority Shareholders in Listed Companies in China: Challenges for the Future" (2005) 16 *International Company and Commercial Law Review* 275.

<sup>61</sup> In view of the scandals that have occurred on the stock markets and the continual plummeting of share prices in 2004, the Chinese government, to prevent stock markets from being marginalised, took steps to strengthen enforcement of the law against corporate management. These included bringing prosecutions under the criminal law. During the first 2 months of 2005, 11 listed company directors were either subject to criminal investigation, had been arrested or were facing prosecutions. See *Shanghai Securities News*, 17 February 2005, 5, available at <http://paper.cristock.com/ssnews/2005-2-17/default.htm> (in Chinese), accessed on 2 November 2005.

<sup>62</sup> Government departments are relied on heavily to enforce the law in China. For example, the CSRC is relied on almost exclusively to enforce securities regulation in China. The role played by private persons in the enforcement of law is negligible.

only the most highly skilled and entrepreneurial individuals as directors, in reality it does not do so. Chinese directors are appointed by bureaucrats from government departments, and not capitalists interested in the economic performance of companies.<sup>63</sup> As those responsible for appointing directors neither benefit from appointing competent directors nor bear negative consequences if they appointed unsuitable ones, there is no incentive for them to find and employ only the most able and highly skilled individuals. In many cases, directors themselves have associates in the Communist Party as well as in governmental departments and derive support from them. As such, they have no fear of being dismissed for mismanagement or embezzlement. It also comes as no surprise that many directors can enhance their personal financial position significantly in a short time, although it may be that they have to surrender part of their financial gain to their "cronies" from the inner circle.<sup>64</sup>

The other difficulty is that as the state does not have a physical presence within companies, it is unable to prevent negligence or abuses of power from occurring.<sup>65</sup> An absent shareholder cannot monitor the activities of the board.<sup>66</sup> To overcome this problem, the state appoints agents or representatives to exercise ownership rights (which includes the right to monitor directors) on its behalf. But, not being the typical private owner with an interest in how the company is performing, they have no incentive to exercise these rights responsibly and prudently. In fact, many such agents do not view exercising their rights in a way which increases the wealth of the company as a priority. On the contrary, because of their partiality to state matters, they may be more concerned with issues such as preserving jobs in their respective jurisdictions.<sup>67</sup> The lack of effective monitoring of the board stems from a lack of proper control by the state over its agents or representatives. As a consequence, these agents and representatives have no incentive to monitor the board. Worse still, they may abuse control rights for their own benefit.<sup>68</sup>

### 3. The Effectiveness of the Supervisory Board

The supervisory board also plays only a very limited role in China in ensuring proper conduct on the part of directors.<sup>69</sup> China's two-tier board system has

<sup>63</sup> See WY Zhang, "China's SOE Reform: A Corporate Governance Perspective", available at <http://www.gsm.pku.edu.cn/wuan1/EnglishPapers/SOEREF.rtf>, accessed on 15 October 2004.

<sup>64</sup> *Ibid.*

<sup>65</sup> Qiang, *supra* n 9, 776-78; Tam, *supra* n 3, 314.

<sup>66</sup> Tam, *supra* n 3, 307-8.

<sup>67</sup> T Plafker, "China Races to Higher Standards, but Road Isn't Smooth" *International Herald Tribune*, 26 September 2003, 17.

<sup>68</sup> On the importance of proper ethics in Chinese corporate governance, see LH Jing, WQ Zhou and YC Tse, "Corporate Governance in China: Ethical and Legal Problems", available at [www.departments.bucknell.edu/management](http://www.departments.bucknell.edu/management), accessed on 31 October 2004.

<sup>69</sup> YW Wei, "A Chinese Perspective on Corporate Governance" (1998) 10 *Bond Law Review* 363, 376.



certain curious features. First, there is no hierarchical relationship between the board of directors and supervisory boards. Neither is accountable to the other; they function on an equal level. Given the rationale for having supervisory directors in companies (that is, to monitor the board), one would have thought the power to hold the board accountable should lie in their hands. Currently, if the board of directors disregards their demands to rectify a particular action, the supervisory board may propose that an interim shareholder meeting be held.<sup>70</sup> The behaviour of the board can be brought to light at these meetings. The law was amended recently to the effect that if the board of directors ignored their proposal to do so, the supervisory board may convene the meeting itself.<sup>71</sup> Even so, if the majority shareholder is not prepared to challenge the misconduct of directors at these meetings, there is little point in the supervisory board convening one. The law was also amended to allow the supervisory board to propose that action be taken against the board or that particular directors be dismissed.<sup>72</sup> But again, if the majority shareholder does not support their proposal, the supervisory board will be unable to discipline the board.

Many supervisory directors also have strong affiliations with the state.<sup>73</sup> One danger in this is that they may be inclined to promote and protect state interests rather than the interests of the company. More worrying, however, is the fact that many supervisory directors identify themselves as friends and associates of the board of directors. As a result, they may be reluctant to expose abuse of power or neglect or ensure that directors are disciplined. Finally, few supervisory directors possess the necessary experience and expertise in matters of law, accounting and finance to carry out their responsibilities.<sup>74</sup> In part, this is exacerbated by the fact that the market for supervisory directors is small and underdeveloped.<sup>75</sup> Training schemes and professionally qualified organisations can play a valuable role in advising and assisting supervisory directors in carrying out their responsibilities. In many developed economies, it is already well-established practice to rely on such organisations. In the UK, for example, organisations such as the Institute of Directors, the National Association of Pension Funds and the Association of British Insurers provide education and training and stipulate the standards expected of directors so that they may discharge their duties efficiently and responsibly.<sup>76</sup>

<sup>70</sup> Corporations Law 1993, Art 54.

<sup>71</sup> The right to do so became effective on 1 January 2006. See Corporations Law 1993, Art 54(4) as amended.

<sup>72</sup> *Ibid.* See Corporations Law 1993, Arts 54(2), 54(6) and 152, as amended.

<sup>73</sup> See J Dahiya, Y Karbhari and JZZ Xiao, "The Supervisory Board in Chinese Listed Companies: Problems, Causes, Consequences and Remedies" (2002) 9 *Asia Pacific Business Review* 118, 125, 126.

<sup>74</sup> *Ibid.*, 128-29.

<sup>75</sup> *Ibid.*, 131.

<sup>76</sup> Courses, conference, seminars and events conducted by the IOD for directors can viewed at <http://www.iod.com>, accessed on 26 October 2005.

#### 4. The Role of Independent Directors

Whilst the introduction of independent directors into listed companies has been a positive step, several reservations exist as to whether they can ensure proper corporate governance in their companies. Ironically, the biggest stumbling block to their performance is the company majority shareholder. Article IV of the "Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies 2001" provides that the board of directors, the supervisory board and shareholders who solely or collectively hold more than 1% of issued shares of a listed company may nominate persons to be appointed as independent directors. Needless to say, it is the majority shareholder who can determine who is nominated or appointed. But if independent directors are to protect the overall interests of the company and "be especially concerned with protecting the interests of minority shareholders",<sup>77</sup> should they really be appointed by majority shareholders? For the same reason, it is unrealistic to expect them to usefully supervise affiliated transactions between majority shareholders and the company.<sup>78</sup> Further, their remuneration must be approved by the shareholders in general meeting.<sup>79</sup> Again, this will depend on the votes of the majority shareholder. But it may be difficult for an independent director to be critical if he knew that the majority shareholders had the power to approve his remuneration. It is also idealistic, in this case, to expect him to be able to express an independent opinion on events which he considers to be detrimental to the interests of minority shareholders.<sup>80</sup>

Secondly, introducing independent directors into a system where there is already a supervisory board may be problematic. What is the relationship between the board of supervisors and the independent directors? Is one supposed to be monitoring the other? Whose views prevail in the event of a disagreement? The Guidelines do not address this issue. This lack of clarity may lead to both sets of directors interfering with, rather than cooperating with, each other.<sup>81</sup> Thirdly, and most importantly, the culture in China may not lend itself to facilitating the use of independent directors as monitors of the board. An independent director must be inquisitive and must not be afraid to ask penetrating questions. He may have to, on occasions, speak his mind and "rock the boat". He must carry out his responsibilities autonomously, free from the influence of controlling shareholders and other interested parties. But all of these traits may be viewed as assertive and antagonistic in a culture which is

<sup>77</sup> Guidelines, Art I(2).

<sup>78</sup> *Ibid.*, Art V.

<sup>79</sup> *Ibid.*, Art VII (5).

<sup>80</sup> *Ibid.*, Art VI.

<sup>81</sup> EE Lehman, "Independent Directors: Will the New Regulations Improve China's Corporate Governance?" (2001) 8 *Corporate Counsel* 29 and JY Zhu, "The Liability of Outside Directors in Corporate Governance: A Comparative Study, Part 2" (2001) 3 *Perspectives*, available at [http://www.oycf.org/Perspectives/15\\_123101/contents.htm](http://www.oycf.org/Perspectives/15_123101/contents.htm), accessed on 12 December 2004.

influenced by Confucian values. In such cultures, conformity, tolerance, humility and respect for others is encouraged. For this reason, many Chinese companies may find working with independent/outside directors a strange and unfamiliar experience. For the same reason, it might be equally difficult to recruit individuals from the domestic market who are willing and able to act as independent/outside directors in companies.

### 5. The Capital Market as a Governance Mechanism

An active capital market encourages competitiveness amongst companies and can provide a mechanism to discipline directors. A takeover by one company of another for example, replaces a less efficient board of directors. A market which is stringently regulated deters fraud, encourages compliance with internationally accepted accounting and disclosure standards and assures investors that it is a clean place in which to do business. However, stock markets do not play a significant role in disciplining directors in China. Its markets are controlled by the state, but corruption, fraud, insider dealing and manipulation of share price are widespread. Share prices have plummeted since 2001.<sup>32</sup> Initial public offerings are now rare. Investors are not able to make informed choices about their investment or take action to improve governance in their companies because the levels of disclosure and transparency in company reporting are low. Much blame has been placed on the non-tradability of state shares.<sup>33</sup> As indicated above, the state controls approximately two-thirds of shares in Chinese listed companies. State shares are not tradable on the capital markets. They are held to preserve its control in various industries, organise economic activities and ensure social stability. Because state shares are not tradable, their prices remain constant and do not react to fluctuations in the market.<sup>34</sup> In the main, movements in share price are caused by trading among individual shareholders, which is often conducted on a speculative and random basis. The non-tradability of large blocks of shares means that directors are insulated from market discipline. They have little need to account for their decisions or behave responsibly. Why worry if there is no threat to their jobs? Indeed, the non-tradability of state shares has been criticised as the key reason for the failure of

<sup>32</sup> Between June 2001 and June 2005, Shanghai and Shenzhen share indexes plummeted from 2200 to 1000 and the market lost more than half its value. See XH Yang, "Household Business and Middle Class: Two Types of Investors in Stock Markets" *Sun Lian Life Week*, Issue 340 (20 June 2005), available at <http://www.lifeweek.com.cn/2005-06-23/0000112213.shtml> (in Chinese), accessed on 3 November 2005.

<sup>33</sup> See XQ Qiu, "Eight Dangers in the Split between Tradable and Non-tradable Shares", *China Securities*, 12 January 2004, available at <http://www.cs.com.cn/csnews/20040112/457126.asp> (in Chinese), accessed on 5 November 2005. See also Article I(2), Guiding Opinions Concerning the Reform of Non-Tradable Shares in Listed Companies (adopted by the CSRC, State-Owned Assets Supervision and Administration Commission, Fiscal Ministry, Central People's Bank and Ministry of Commerce on 23 August 2005).

<sup>34</sup> Tam, *supra* n 3, 305.

stock markets and corporate governance in recent years. Despite the existence of takeover laws, the restrictive movement of shares on the capital markets in China prevents them from operating as a control mechanism over management. Until shares are released from the control of the state and allowed to be freely traded on a strong and functioning market, there may not be an effective market for corporate control.<sup>85</sup>

In August 2005, the Chinese government initiated reform to address the problems caused by the non-tradability of state shares. The core of the reform process was that holders of non-tradable shares can, in exchange for the opportunity to trade on the stock exchange, compensate holders of tradable shares for this privilege. The level of compensation is determined through negotiation between the two types of shareholders.<sup>86</sup> To avoid volatile price fluctuations caused by the sudden influx of tradable shares on the stock markets, the law provides that non-tradable shareholders holding more than 5% non-tradable shares in a company cannot sell more than 10% of those shares within 3 years after they become tradable.<sup>87</sup> At the end of October 2005, non-tradable shares ceased to exist in approximately 150 Chinese listed companies.<sup>88</sup> It is anticipated that the problems caused by the non-tradability of shares will diminish quickly. It may well be the case that state ownership of shares can also, in theory, be sold to private investors on the open market, leading to a fairer market for corporate control.

#### 6. The Role of the Judiciary in Corporate Governance

Judges can play an important role in corporate governance, for example by making and clarifying the law governing directors. But they can only do so if they are properly qualified, and can exercise their role independently and without fear of reprisal. It is useful to illustrate the role the judiciary can play in enforcing proper standards of directorial behaviour by reference to the judiciary in the UK, where their experience is highly valued and where they play a central role in shaping the content of the law regulating directors.

Judges in the UK are appointed from the ranks of successful lawyers. They are well respected, highly qualified and experienced. They face considerable pressure to perform well, as their judgments are subject to scrutiny. They are also well paid, their salaries reflecting their experience and the contribution they make to a particular area of the law. Judges are usually barristers or solicitors with a number of years' experience. They are subject to training. In addition,

<sup>85</sup> MacNeil, *supra* n 1, 322 and Tan, *supra* n 3, 310.

<sup>86</sup> Article 3(8), *supra* n 83.

<sup>87</sup> Article 5, Notice on Issues Concerning the Experiment of Reform of Non-Tradable Shares in Listed Companies (Issued by the CSRC on 8 May 2005).

<sup>88</sup> See Statistics on the designated website on the reform of non-tradable shares, <http://gqfz.p5w.net/gqfz/index.html> (in Chinese), accessed on 5 November 2005.

doctors, social workers, probation officers and other professions may be asked to share their experience with them, especially with the passing of new legislation which may influence the way cases are decided in the future. Most importantly, the judiciary is independent from the government. Judges enjoy security of tenure and cannot be removed by the executive or legislature. By the same token, they can review the decisions of other branches of government, and declare their decisions invalid if deemed to have been made in contravention of the law.

The Chinese view their judicial system as merely another bureaucratic body which is part of the state. Despite the fact that there are over 200,000 judges in China, they are mere civil servants who have little legal education or training. Traditionally, they were appointed for political reasons. They are not regarded with respect. It is not unusual for courts to decide not to deal with a particular matter, regarding it as being beyond their competence and instead referring it to another branch of government.<sup>89</sup> Courts are also reluctant to implement or enforce their judgments (especially those involving coercive measures) against state-owned enterprises if they were responsible for the same locality, or if their judgments would lead to the closure of the enterprise and unemployment of workers.<sup>90</sup> Judges in China also lack security of tenure. Article 36 of the Organic Law of the People's Courts and Article 63(4) of the Constitution of the PRC both provide that they may be removed from office. But neither the grounds for removal nor the limits set on this power of removal are specified clearly.

In recognising the need to reform the judiciary, and encourage more experienced judges into office, the Chinese government is overhauling the judicial system. Recently, it announced a 5 year plan to boost the qualification of its judges. Until recently, only 41% of judges in China studied to university level.<sup>91</sup> The Judicial Training Regulations (1 January 2001) and The Judges Law (1 January 2002) now require judges to undergo more intensive legal and professional training. Article 9(2) of The Judges Law requires judges to have at least 2 years' working experience in law and a university degree in law or a joint law degree. The Supreme People's Court now also requires judges under the age of 40 who do not possess an undergraduate degree to gain this qualification within 5 years. Judges above the age of 40 must undertake a special legal training course lasting between 6 and 12 months.

The judiciary in China has not played a dynamic role in developing a body of law to guide directorial behaviour. With the number of businesses growing at a rapid rate and shareholders being invited to invest in the country, it is imperative that the government address this issue. Significant financial and human resources

<sup>89</sup> R Tomasic and J Fu, "Chinese Company Law", in R Tomasic, (ed), *Company Law in East Asia* (Aldershot, Ashgate, 1999), 141.

<sup>90</sup> *Ibid.*

<sup>91</sup> See [http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/newscenter/2004-03/11/content\\_1360136.htm](http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/newscenter/2004-03/11/content_1360136.htm)].

may need to be expended in order to enable Chinese judges to obtain proper legal qualifications and undergo the relevant legal training. Law reporting facilities must also be improved so that judgments can easily be accessed by litigants and lawyers.<sup>92</sup>

#### D. THE WAY FORWARD

The fact that the state is majority shareholder has negative consequences for corporate governance in Chinese companies. As discussed above, current mechanisms to promote good corporate governance are inadequate. To improve corporate governance, it may be that the state will need to relinquish its dominant position in its companies. The argument is that until ownership of the company is given over to private owners, corporate governance will not improve fundamentally.

For political reasons, however, it is unlikely that the Chinese government will substantially divest itself of the ownership of shares in the foreseeable future. It is anticipated that state ownership of shares will remain dominant in Chinese companies for a long time to come. To reduce the agency problems inherent in state ownership, therefore, one may need to look for other solutions to strengthen corporate governance. The rest of the article considers mechanisms which have been instituted in other jurisdictions to promote governance in state owned corporations. Some ways forward may be to strengthen the rights of minority shareholders so that they can participate in governance issues within the company; encourage institutional shareholder activism, link directorial remuneration to performance and issue debt to create a class of private investors who can provide an additional layer of monitoring.<sup>93</sup> Given that these mechanisms have been proposed to cure governance problems in economies which share similar characteristics to that in China, it may be possible to implement them in the Chinese context.

##### 1. Strengthening the Rights of Minority Shareholders

Currently the role played by minority shareholders in Chinese corporate governance is negligible. Given that the state as majority shareholder is unable to ensure good company governance, the potential for minority shareholders to do so should not be ignored. How can the rights of minority shareholders be improved? First, the relevant provisions in the Corporations Law 1993 relating to the right to convene interim meetings and propose resolutions (as discussed

<sup>92</sup> As discussed in Miles and He, *supra* n 60.

<sup>93</sup> DA Skeel, "Virtual Privatization: Governance Reforms for Government Owned Firms" (2002) 2 *Journal of Corporate Law Studies* 82.



above) should be redrafted to remove the unnecessary burdens standing in the way of shareholders. Secondly, the law should allow shareholders to negotiate the exercise of flexible rights within the company. If shareholders are able to do this so that they can participate in its affairs, this may encourage them to invest.<sup>94</sup> The Corporations Law 1993 as it originally stood did not allow for the issuing of, for example, preference shares or shares which give weighted voting rights to their holders in listed companies. The law has now been amended to allow cumulative voting in listed companies.<sup>95</sup> This is a step in the right direction. Cumulative voting can strengthen the hand of minority shareholders. For example, if cumulative voting is used in the appointment of directors, minority shareholders can appoint persons of their choice to be directors to provide a fairer balance of interests within the board which otherwise will almost exclusively be appointed by the majority shareholder.<sup>96</sup> Cumulative voting can even be extended to determine other matters within the company, such as whether to bring an action against the board or whether transactions which specifically affect the interests of minority shareholders should be approved.

Thirdly, in the event of dispute, shareholders wishing to exit the company ought to be given a legal right to have their shares purchased at a fair price, either by the majority or by the company. Shares must be bought at a "fair" price,<sup>97</sup> which does not necessarily mean the current market price, which may reflect the majority's disregard of the minority. The law may even provide that "exit" rights be exercised when the majority shareholders have breached a particular standard under the law regulating their conduct (eg acting in a way which is unfairly prejudicial to the interests of minority shareholders) or where they have taken a particular course of action and the minority shareholders did not agree to this (eg if the majority shareholders decided that the company's business should be transferred to another location against the wishes of the minority shareholders).<sup>98</sup>

Last but not least, the opportunity to commence derivative actions where appropriate should be strengthened. We discussed earlier the ambiguity surrounding the procedural aspects of Article 111. It is not surprising that shareholders have not been able to utilise it in the event of a conflict.<sup>99</sup> In 2004,

<sup>94</sup> Ying, *supra* n 55, 83.

<sup>95</sup> See Corporations Law 1993, Art 106 as amended.

<sup>96</sup> Each share is allocated a number of votes equivalent to the number of directors being elected. The shareholder may distribute his votes in any way he wishes across the directors to be elected. Minority shareholders may be able to ensure the election of their candidates as directors by concentrating their votes on a small number of directors.

<sup>97</sup> This could, for example, be determined by a mutually agreed mechanism or arbitration.

<sup>98</sup> PL Davies, *Introduction to Company Law* (Oxford University Press, 2002), 217–30. The Corporations Law 1993 as amended afforded, from 1 January 2006, dissenting shareholders the right to have their shares be purchased by the company, albeit in extremely limited circumstances. See Corporations Law 1993, Art 75 as amended.

<sup>99</sup> See reports by *Shanghai Securities News* on 22 April 2003, available at [http://www.cnstock.com/cjxwzx/ssgs/t20030422\\_403268.htm](http://www.cnstock.com/cjxwzx/ssgs/t20030422_403268.htm) (in Chinese), accessed on 5 November 2005.

for the first time, a minority shareholder commenced a derivative action against the board of a state-controlled listed company and its controlling shareholder. This action was accepted and tried by a sympathetic local court. The defendant, however, accused the court of violating the law by claiming that the right to sue belonged to the company and that, as yet, no legal provision exists for the bringing of a derivative action in China.<sup>100</sup> Because this was the first derivative action that was accepted and tried, the case was widely reported. However, more than 12 months have passed since the commencement of the case but the court has not yet issued any judgment. The media has also been strangely silent.

The Corporations Law 1993 was recently amended to clarify the circumstances under which shareholders may bring a derivative action.<sup>101</sup> The amended law provides that shareholders who individually or jointly hold more than 1% shares of a company may bring such an action, but they should first have held their shares for a minimum of 180 days. They should also have first instructed the supervisory board (where the action is against the board of directors) or board of directors (where the action is against supervisory directors) to pursue an action against the other. If either board fails to do so, shareholders can commence a derivative action. Regrettably, the law is still silent on the issue of who bears the cost of litigation. The 1% threshold is also arbitrary. Very few shareholders would hold the number of shares required, especially in a listed company. Further, it is curious why a shareholder wishing to commence a derivative action must wait 180 days before being able to do so. This means he cannot bring an action immediately after he finds a violation of the law but would have to wait for a significant period of time to pass. For derivative actions to play a role in corporate governance in China, these restrictions should be removed.

## 2. Institutional Shareholder Activism

In the west, institutional shareholders take a keen interest in ensuring proper behaviour on the part of directors in order to safeguard their stake in the company. Indeed, activism on the part of institutions in the UK and US in securing good governance in their companies has been applauded and admired. Institutional shareholders can exert pressure on directors to act in a responsible and efficient manner. As they have considerably more resources and influence when compared with the individual shareholder, they can employ analysts to carry out the necessary research into their companies, request one-to-one meetings with directors and appoint their representatives onto the board. Any threats to sell their shareholding in the company may have adverse implications

<sup>100</sup> See reports by *Shanghai Securities News* on 22 July 2004, available at [http://www.cnstock.com/cjxwzx/ssgs/t20040722\\_610919.htm](http://www.cnstock.com/cjxwzx/ssgs/t20040722_610919.htm) (in Chinese), accessed on 5 November 2005.

<sup>101</sup> See Corporations Law 1993, Art 153 as amended.

for the board and the market position of the company. Institutions are thus well positioned to assess directorial competence and apply pressure to secure change.<sup>102</sup>

Institutional investment is growing in China, but its growth was encouraged primarily to "stabilise" the stock markets, not to enhance corporate governance. Long-term (as opposed to speculative) investment would prevent the volatile fluctuating of share prices.<sup>103</sup> After the bubble burst in 2001, and when private individuals withdrew from investing on the stock markets, the government was anxious to find ways to channel funds into the markets to counter the downward movement of share prices. As a result, foreign institutions were allowed to invest in the domestic exchanges from 1 December 2002.<sup>104</sup> Today, national social security funds, insurance companies and enterprise pension funds all invest on the stock exchanges.<sup>105</sup> The volume of shares held by securities investment funds has also increased considerably. At the end of November 2004, shares held by these funds alone accounted for 13% of the total value of tradable shares.<sup>106</sup> It is expected that in a short period of time, institutional investors in China will attain a level of importance comparable to their western counterparts. In order to play a prominent role in monitoring directorial behaviour however, institutional shareholders will need to take a long term view of their relationships with their portfolio companies and be willing to play a pro-active role in monitoring management.<sup>107</sup> Foreign institutional investors, used to investor activism in their own countries, can play an important role here in leading by example. The Chinese government is however, still very cautious about permitting foreign investment. Currently, foreign institutional investors must obtain approval from the CSRC before they can invest on the domestic stock exchanges. The criteria for approval are stringent. Further, there is a limit on the overall amount of

<sup>102</sup> See L Miles, "The Role of Institutional Shareholders in Corporate Governance: Recent Developments in the UK" (2003) 8 *Scottish Law and Practice Quarterly* 204.

<sup>103</sup> See speech by the former chairman of CSRC, Zhou Xiao Chuan, addressed to the Second International Forum on Securities Market of China (Shanghai) on 7 June 2002, available at [http://news.xinhuanet.com/fortune/2002-06/07/content\\_428778.htm](http://news.xinhuanet.com/fortune/2002-06/07/content_428778.htm) (in Chinese), accessed on 5 November 2005.

<sup>104</sup> See "Temporary Provisions Concerning the Regulation of Domestic Investments of Qualified Foreign Institutional Investors", issued by the CSRC and the Central People's Bank of China on 7 November 2002.

<sup>105</sup> See "Temporary Provisions Concerning the Regulation of Stock Investments by Insurance Companies", issued by the CSRC and the China Insurance Regulatory Commission on 25 October 2004 and "Trial Provisions Concerning the Regulation of Enterprise Pension Funds", issued by the Ministry of Labour, China Banking Regulatory Commission and CSRC on 24 April 2004.

<sup>106</sup> See Speech by the Chairman of CSRC addressed to the International Forum on Securities Investment Funds in China on 10 December 2004 in Shenzhen, available at [http://news.xinhuanet.com/stock/2004-12/10/content\\_2317191.htm](http://news.xinhuanet.com/stock/2004-12/10/content_2317191.htm) (in Chinese), accessed on 6 November 2005.

<sup>107</sup> See MacNeil, *supra* 1, 321.

investment that foreign institutional investors can make on the Chinese stock markets, although this was raised from US\$4 billion to US\$10 billion recently.<sup>108</sup> The benefits to corporate governance of keen activity on the part of institutions are obvious. It is hoped that the Chinese government will continue to welcome foreign institutional investors. Their number will also depend on the extent to which the state is willing to relinquish its shareholding in its listed companies.

### 3. Incentive-based Compensation

The issue of improving governance in government-owned corporations has been the subject of research in other economies where businesses are structured as corporations but are owned by governmental rather than private shareholders.<sup>109</sup> Indeed, even in the most market based of economies, governments still retain extensive control over important industries, in particular, those traditionally viewed as natural monopolies or those which, if given over to private ownership, might undermine social welfare.<sup>110</sup> Many large corporations in successful economies such as Australia and New Zealand are government-owned, conducting activities and providing services in a commercially orientated environment.<sup>111</sup> Many reasons exist as to why governments choose to apply company management techniques and structures to government departments, but the desire to improve management, achieve a more efficient use of resources and prevent regular budget deficits in the public sector often rank high in their decisions to do so.<sup>112</sup>

The Queensland's Government Owned Corporations Act 1993<sup>113</sup> in Australia allows publicly owned enterprises to be transformed into corporations in order to compete on an equal footing with private companies, whilst preserving state ownership of them.<sup>114</sup> Each government-owned corporation has two voting shareholders: the Treasury and the minister of a particular department (eg transport, utilities, ports, gambling and finance).<sup>115</sup> Government-owned corporations are run by directors who are appointed by the Governor in

<sup>108</sup> See report by *China Securities* on 16 May 2005, available at [http://news.xinhuanet.com/stock/2005-05/16/content\\_2961691.htm](http://news.xinhuanet.com/stock/2005-05/16/content_2961691.htm) (in Chinese), accessed on 6 November 2005.

<sup>109</sup> Skeel, *supra* n 93, 82-84.

<sup>110</sup> In some industries, such as prison and hospital services, private firms might cut costs to maximise profit. This might work to the detriment of the industries.

<sup>111</sup> For a useful text on government-owned corporations, see J. Farrar, *Corporate Governance in Australia and New Zealand* (Oxford University Press, 2001), ch 31.

<sup>112</sup> *Ibid.*, 385.

<sup>113</sup> This Act is one of many in Australia allowing public sector enterprises to be transformed into corporations owned by the government. Another example of such legislation is the New South Wales Act 1989.

<sup>114</sup> Information about the Office of Government-owned corporations and its responsibilities can be obtained from [www.ogoc.qld.gov.au](http://www.ogoc.qld.gov.au). In 2004, the value of this sector was estimated at AU\$30 billion. See Queensland Treasury Annual Report 2003-2004 at <http://www.treasury.qld.gov.au/knowledge/docs/annual-reports/2003-04/pdfs/ogoc.pdf>.

<sup>115</sup> GOC Act 1993, s 79.

Council.<sup>116</sup> They have a responsibility to manage the corporations as successful businesses at the same time as fulfilling their social objectives.<sup>117</sup> The shareholding ministers monitor the actions of the directors according to a contract which is drawn up between themselves and the directors. This contract provides a detailed plan of the corporation's financial condition, a description of current and future borrowing, and a discussion of plans for expansion, and specifies the corporation's community service obligations.<sup>118</sup>

It has been argued that one way in which agency costs between shareholders and directors in government-owned corporations can be reduced and proper standards of governance encouraged is to link the remuneration of the board to the performance of the corporation.<sup>119</sup> Although it may not be possible to provide incentives to the board by offering them stock or stock options (as there are no other shareholders in the corporation apart from shareholding ministers), it has been suggested that directors' pay should be based on alternative performance measures such as the firm's return on capital.<sup>120</sup> It is, however, acknowledged that there are difficulties with utilising performance-based compensation in government-owned corporations, not least because it can be very difficult to determine the value of the compensation. Performance-based compensation can play a useful role only if the relationship between directorial performance and returns on capital is relatively direct, as is the case with private companies. But as government-owned corporations have mixed objectives, its directors are often required to pursue both financial and non-financial goals. Indeed, their shareholders commonly exert significant pressure on them to pursue non-financial goals, such as ensuring that the services of the corporation are provided at a particular price to certain segments of the community. In pursuing non-financial goals, there will not be returns on capital to speak of, and one therefore cannot use the fulfilment of these goals to determine the compensation that directors are entitled to.<sup>121</sup> Secondly, a typical government-owned corporation is heavily regulated. They are subject to extensive direction from their respective departments and the government. The corporation's market is also often relatively fixed. Directors thus only have a limited range of options for the future direction of the firm. They cannot diversify, take advantage of business opportunities which may come their way or expand into other areas of industry.<sup>122</sup>

<sup>116</sup> GOC Act 1993, sch 1, s 11.

<sup>117</sup> Skeel, *supra* n 93, 91.

<sup>118</sup> GOC Act 1993, ss 111–22.

<sup>119</sup> Skeel, *supra* n 93, 90.

<sup>120</sup> On the factors which should be considered when designing executive pay packages, see S Watts and F Gemson, "Designing Executive Pay Packages: A Balancing Act" (2004) 9 *Global Counsel* 40.

<sup>121</sup> Skeel, *supra* n 93, 90–91.

<sup>122</sup> Skeel, *supra* n 93, 91.

Government-owned corporations in Australia share many of the governance problems experienced by state-owned enterprises in China.<sup>123</sup> But it is arguable that the problems which prevent the use of performance-based compensation in government-owned corporations in Australia are not relevant in the Chinese context. This is because corporatised state-owned enterprises in China are commercial entities in the full sense of the word. The relationship between directorial performance and returns on capital is relatively direct. So, would introducing performance-based compensation enhance governance standards in Chinese listed companies? Indeed, there have long been calls for the introduction of performance-based compensation, including stock options, in China.<sup>124</sup> However, currently, directors have little incentive to work to earn this compensation. Due to a lack of a proper legal structure to penalise wrongful conduct on their part, directors who embezzle money belonging to their companies by and large escape punishment.<sup>125</sup> Embezzlement is an easy and cost-efficient way for directors to enrich themselves. Until such wrongdoing is properly penalised, performance-based compensation will not encourage directors to behave responsibly. Indeed, it is argued that even if performance-based compensation was introduced, accounting figures could be manipulated to give a false picture of directorial performance. The solution is to make performance-based compensation attractive. Directors must judge that the benefits of working to earn their compensation outweigh the act of misappropriating company property to enrich themselves. This can only be done if a proper penalty regime to punish wrongful conduct is introduced. The ethics of the accounting and audit professions must also be tightened so that they can give a credible measure of directorial performance.

#### 4. Role of Creditors in Corporate Governance

It has also been suggested that governance in government-owned corporations can be improved by issuing bonds to create a class of private investors to provide

<sup>123</sup> As with the state shareholder in Chinese listed companies, shareholding ministers in government-owned corporations in Australia do not invest their private money in the corporation. Secondly, as with listed companies in China, the shares of government-owned corporations cannot be bought and sold on stock markets, and so its board is insulated from market pressure to perform well. Also, as these corporations do not trade on the stock exchange, they are not exposed to the forces in the securities markets. Finally, as with state representatives in state-owned enterprises in China, shareholding ministers in government-owned corporations do not themselves have a financial interest in the corporation, so they may be tempted to collaborate with the board to misappropriate the assets of the firm. See Farrar, *supra* n 111, 397-98.

<sup>124</sup> CA Schipani and JH Liu, "Corporate Governance in China: Then and Now" (2002) *Columbia and RD Ewing*, "Chinese Corporate Governance and Prospects for Reform" (2005) 14 *Journal of Contemporary China* 317.

<sup>125</sup> Studies suggest that for every four occurrences of securities crime three escape punishment. See Wu Xiao Liang, "A Study on the Punishment of Securities Crime" *Caijing (Finance Magazine)*, 27 June 2005 (in Chinese).



additional monitoring. Such corporations can issue bonds which would entitle their holders to insist that the corporation repurchase them within a certain time. In the normal course of things, bond holders would exercise this when the value of their bonds fell below the price at which they were issued. If the company was solvent, it would be able to repay the bondholders. If it could not, this would suggest that the corporation was insolvent. This would alert regulators to initiate insolvency proceedings. In this sense, it is a corporate governance mechanism.<sup>126</sup>

This scheme would only work if at least two criteria were fulfilled. First, it must be possible to ascertain the value of the corporation. This is necessary so that the bondholders can decide when to demand repayment of the debt. Secondly, the government must be willing to allow the corporation to fail. If it continually bails troubled corporations out, the scheme would serve little purpose. If investors in poorly performing corporations are confident that their debt will always be paid in full, they will not be anxious to demand repayment when the corporation performs badly. This goes against the very purpose behind the scheme.<sup>127</sup>

Is there a role for private creditors in enhancing governance in listed companies in China? The issuing of bonds by companies is currently heavily regulated in China. Companies intending to issue bonds must not only obtain permission from the securities authority, they must also meet stringent requirements. For example, the net assets of the company must not be less than 30 million Yuan, the capital which the company intends to raise must not exceed 40% of its net assets and the average profit of the company in the past 3 years must be sufficient to pay 1 year's interests on the bond.<sup>128</sup> The reason why the issuing of corporate bonds is so heavily regulated is because the government fears that a debtor company may not be able to pay off its debt. Cases in the past indicate that such fear is not unfounded.<sup>129</sup> When companies failed, the Chinese government bailed them out, especially when such companies were substantial and the government considered that their failure would lead to social "instability". As few companies are able to issue bonds, the number of private creditors is low.

<sup>126</sup> Skeel, *supra* n 93, 98.

<sup>127</sup> *Ibid*, at 98-99. For the growing role of creditors in corporate governance today, see DG Baird and RK Rasmussen, "Private Debt and the Missing Lever of Corporate Governance", Vanderbilt Law and Economics Research Paper No 05-08/University of Chicago Law & Economics, Olin Working Paper No 247 (24 March 24, 2005), available at <http://ssrn.com/abstract=692023>, accessed on 2 November 2005.

<sup>128</sup> Corporations Law 1993, Arts 159-73.

<sup>129</sup> Recently the central government injected large amounts of capitals into two of the 'big four' national commercial banks so as to enable them to be listed on overseas stock markets. The government has also had to inject funds into a number of failing securities companies in order to bail them out. This help has even been extended to listed companies controlled by families, given the large amounts of bank loans involved.

What of the role of other creditors, such as banks, in corporate governance?<sup>130</sup> A creditor, to protect its loan, has an incentive to formulate a detailed contract to restrict the debtor from engaging in strategic behaviour or slacking in its performance. Because the board of the debtor company which fails to comply with its contract will be removed, it has an incentive to observe the contract. Also, in order to repay its creditor, a debtor needs to be profitable. Thus its management is under considerable pressure to perform.<sup>131</sup> In China, however, nearly all banks are state-owned. These banks suffer serious governance problems themselves. As a result, they are unable to discharge a monitoring role over their debtors. Even worse, as insolvency legislation is not properly enforced, directors in debtor companies seldom fear that they would be replaced. Even if a company collapses, its directors may be handed a better job if they enjoyed the support of the inner circle of the Communist Party or the government. Hypothetically, if directors of the debtor company can accumulate a substantial amount of personal wealth by embezzlement without being subject to punishment, would they really care if they lost their jobs? All state-owned banks currently have large amounts of non-performing loans. They survive because they can rely on the support of the government. This fact may make it difficult for regulators to rely on banks to play a role in the governance of corporatised state-owned enterprises. If a more proactive role for banks in corporate governance is to be encouraged, the first step must be to improve the governance of the banks themselves.<sup>132</sup>

### 5. Learning from the Governance Experience in Transition Economies

Following the collapse of communism in 1989, many eastern European economies privatised their former state-owned enterprises in an effort to promote profit and efficiency and separate the state from the enterprise sector.<sup>133</sup> Laws were enacted to allow different business mediums to be set up to carry out trade, eg limited liability companies, joint stock companies, and general and limited partnerships. State control over the emerging enterprise sector was lifted and managers were encouraged to be competitive and pursue profit to increase the

<sup>130</sup> See the limited role that banks play in Chinese corporate governance in C Law and P Wong, "Corporate Governance: A Comparative Analysis Between the UK and China" (2005) 16 *International Company and Commercial Law Review* 350, 358.

<sup>131</sup> For the role of debt as a corporate control device in transition economies, see HL Baer and CW Gray, "Debt as a Control Device in Transitional Economies: The Experiences of Hungary and Poland", World Bank Policy Research Working Paper No 1480 (June 1995), available at <http://ssrn.com/abstract=604905>, accessed on 2 November 2005.

<sup>132</sup> See TG Arun and JD Turner, "Corporate Governance of Banks in Developing Economies: Concepts and Issues" (2004) 12 *Corporate Governance: An International Review* 371.

<sup>133</sup> S Estrin, "Competition and Corporate Governance in Transition" (2002) 16 *Journal of Economic Perspectives* 101, 107.

wealth of the corporation. Privatisation was achieved through various methods. Some countries issued coupons or vouchers which could be directly exchanged for shares in corporations.<sup>134</sup> Others sold shares to the management and employees of the corporation.<sup>135</sup> Still others sought to privatise state-owned enterprises through auctioning them off to domestic and foreign investors.<sup>136</sup> Institutional shareholders such as pension funds and private investment companies were able to concentrate their holding in many corporations. Compared with voucher privatisation and management and employee buy-outs, privatisation through direct asset sales to external investors resulted in the most concentrated share ownership structures in corporations.<sup>137</sup> The wide range of privatisation methods used led to different ownership structures in the new corporations, notably those whose ownership is dominated by managers and/or employees (insider governance) or domestic and/or foreign investors (outsider governance).

Not unlike those in China, privatised corporations in European transitional economies struggle with many weaknesses in their governance systems.<sup>138</sup> Their legal and social structures, influenced for many decades by communist values, have not been able to adapt to the dramatic changes brought by the process of corporatisation. The enforcement of legal rights in these economies is weak. Fundamental institutional arrangements under company law, such as the presence of an active regulator, bankruptcy laws and an effective capital market, are underdeveloped. These economies also trail behind industrialised countries in terms of respect for the rule of law and curbing corruption.<sup>139</sup> Where ownership is concentrated, the rights and interests of minority shareholders are disregarded. Further, their stagnant capital markets do not enable fresh capital to be injected into corporations. The development of securities regulation is hampered by a lack of experience, supporting institutions and skilled personnel

<sup>134</sup> The Czech Republic used this as the primary method.

<sup>135</sup> This was used as the primary privatisation method in Poland, Romania, Slovenia, Slovakia and the Ukraine.

<sup>136</sup> This was used in Hungary and Estonia (foreign investors) and in Poland, Russia and the Czech Republic (domestic institutions). See also J Gillies, J Leimann and R Peterson, "Making a Successful Transition from a Command to a Market Economy: The Lessons from Estonia" (2002) 10 *Corporate Governance* 175.

<sup>137</sup> A Dyck, "Privatisation and Corporate Governance: Principles, Evidence and Future Challenges" (2002) 16 *The World Bank Research Observer* 59, 73-74.

<sup>138</sup> G Jobome and J Crotty, "Corporate Governance in Transition Economies: A Synthesis of the Evidence", Research Paper 0402 (January 2004), 6, available at <http://www.abs.aston.ac.uk/newweb/research/publications/docs/RP0402.pdf>, accessed on 1 June 2005. For a review of the corporate governance problems in Russia, Croatia and Hungary, see RW McGee and GG Preobragenskaya, "Corporate Governance in Transition Economies: The Theory and Practice of Corporate Governance in Eastern Europe" paper presented at the Global Conference on Business Economics, Association for Business and Economics Research, Amsterdam, 9-11 July 2004, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=538582](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=538582), accessed on 1 June 2005.

<sup>139</sup> Jobome and Crotty, *supra* n 138, 6-7.

in this area.<sup>140</sup> Overall, the ambition to generate a competitive environment within which corporations can operate has not materialised, and despite privatisation, in some cases the state continues to hold significant blocks of shares in corporations, discharging an authoritarian role.<sup>141</sup>

In an effort to emulate the successes of companies in western industrialised economies, many transition economies subscribed to their governance models. Russian reformers opted for the Anglo-American model of corporate governance.<sup>142</sup> Central European economies, such as Poland, Slovenia and Croatia, preferred the German model.<sup>143</sup> As is well known, the Russian experience of mimicking Anglo-American governance has not been entirely successful.<sup>144</sup> Even for those economies which adopted the German model of governance, several deficiencies have hindered its successful implementation. Supervisory boards have slacked in the exercise of their legal obligations to the shareholders, and management boards have exploited the company and misappropriated its assets to benefit themselves. In many cases, directors were also majority shareholders who managed the company as they wished, ignoring the interests of minority shareholders.<sup>145</sup>

It is argued that transition economies have simply rushed to subscribe to different governance models without first examining whether they were appropriate for their particular social, historical and political settings. In the majority of cases, the rudiments necessary to support the operation of these mechanisms were either missing or underdeveloped.<sup>146</sup> In practice, privatisation was completed very quickly, and little consideration was given to whether the adoption of corporate governance mechanisms from industrialised and market-based economies would engender positive outcomes when applied in companies still in the transition process. The assumption was very much that legal rules and institutions would arise "naturally" once the privatisation process was complete. This, of course, has not happened.<sup>147</sup> It is argued that many of the

<sup>140</sup> D Pucko, "Corporate Governance in European Transition Economies: Emerging Models" (2005) 10 *Management* 1, 10-11 Estrin, *supra* n 133, 112-13.

<sup>141</sup> The Russian government, for example, retained more than 20% of shares in 37% of privatised firms and more than 40% of shares in 14% of the firms it privatised. See Estrin, *supra* n 133, 110.

<sup>142</sup> See, eg the Russian Code of Corporate Governance 2002 and the Independent Director Code 2003 at <http://www.rid.ru> and <http://www.independentdirector.ru> respectively. See also McGee, and Preobragenskaya, *supra* n 138, 14-16.

<sup>143</sup> Pucko, *supra* n 140, 7.

<sup>144</sup> See DJ McCarthy and S Puffer, "Corporate Governance in Russia: Towards a European, US or Russian Model?" (2002) 20 *European Management Journal* 630 and W Judge and I Naoumova, "Corporate Governance in Russia: What Model Will It Follow?" (2004) 12 *Corporate Governance*, 302.

<sup>145</sup> Pucko, *supra* n 140, 10.

<sup>146</sup> Jobome and Crotty, *supra* n 138, 11-13 and JW Salacuse, "Corporate Governance in the New Century" (2004) 25 *The Company Lawyer* 69, 83.

<sup>147</sup> Jobome and Crotty, *supra* n 138, 13.

governance problems currently experienced by transition economies would not have occurred had a more gradual approach to reform been adopted.<sup>148</sup> Anglo-American style corporate governance structures may not necessarily work well in economies where concentrated ownership structures are the rule rather than the exception and where the right of stakeholders to participate in company decision making is strongly favoured.<sup>149</sup>

Many economists argue that transition economies must return to basics in order to construct a governance model compatible with their particular historical, social and political characteristics, and that the appropriateness of western models of corporate governance in transition economies should be reassessed.<sup>150</sup> Others have proposed that transition economies should develop an approach to corporate governance that can accommodate the needs of various stakeholders as this corresponds better to the situation in these economies. The governance policies adopted by transition economies have so far been excessively "shareholder focused" and the naïve belief on the part of reformers in the shareholder theory has led stakeholders to act in a non-cooperative manner.<sup>151</sup> Directors must also become skilled at their role. For many, this will mean learning to be flexible and willing to adapt and evolve in changing environments. They must also learn to recognise opportunities, meet demands in a competitive environment and be able to develop effective monitoring and governance systems. This change will be dramatic, not least because their experience of communism has not equipped them with sufficient knowledge of how to do so. The learning process will present significant challenges for directors in transition economies.<sup>152</sup>

There are lessons that Chinese regulators can learn from the privatisation experiences in transition economies. Many such economies adopted governance systems which they perceived to be more successful without first examining whether those systems were necessarily applicable in the local settings. The Chinese government carried out the process of corporatisation on a large scale and over a relatively short period. It may be tempting to press ahead with introducing more codes, enacting more laws or adopting more Anglo-American practices to prove to domestic and global investors that China is ticking all the right boxes. But this will have negative implications for corporate governance.

<sup>148</sup> *Ibid.*, 14.

<sup>149</sup> *Ibid.*, 16.

<sup>150</sup> For sources, see Jobome and Crotty, *supra* n 138, 12–19 and Salacuse, *supra* n 146, 83.

<sup>151</sup> JE Stiglitz, "Quis Custodiet Ipsos Custodiet? Corporate Governance Failures in the Transition", keynote address at the World Bank Annual Bank Conference on Development Economics, Paris, cited in Jobome and Crotty, *supra* n 138, 18.

<sup>152</sup> I Filatotchev et al, "Governance, Organisational Capabilities and Restructuring in Transition Economies" (2003) 38 *Journal of World Business* 331, 334, 342.

We argue that there are three concerns surrounding corporate governance which must be addressed urgently.

First, attention should be paid to the proper enforcement of laws in order to deter directors from engaging in embezzlement. Misappropriation of company property by insiders is a prominent problem in many Chinese companies. In part, this is caused by the lack of effective legal deterrence. By and large, directors who embezzle escape punishment. There are no mechanisms to compel them to pay back their illegal financial gains. Shareholders who wish to bring a derivative or securities action are put off by the lack of clarity in the law and the procedural difficulties surrounding it. In the few cases where a shareholder has gone to court, it is the company that has paid damages, not the directors. The penalties which have been imposed on directors have also been ridiculously lenient, taking the form either of denouncement or a trivial fine. Criminal enforcement by the state against directors who misappropriate company property is sporadic, notwithstanding its common occurrence. There is also no authority such as the Department of Trade and Industry and the Financial Services Authority in the UK which can investigate misappropriation and bring an action against directors. Overall, the costs to directors of misappropriation are small and they have little fear that they will be subject to punishment.

The challenge is thus to ensure that the public authorities, as well as the judiciary, have the will, integrity and resources to fulfil their law enforcement duties. Until laws are enforced properly, misappropriation of company property will continue. The introduction of novel forms of governance initiatives (see Table 1), such as performance-based compensation and governance by creditors, would do little to enhance governance standards if a proper enforcement regime were not established and if directors believed that no action would be taken against them for engaging in wrongdoing.

Research which has been conducted to analyse the type of ownership structures which enabled the company to perform best<sup>153</sup> in transition economies may also hold valuable lessons for governance in China. Studies suggest that corporations which are governed by outsiders (domestic institutions or foreign investors) performed better than those governed by insiders (its management and employees). Studies also suggest that corporations owned predominantly by foreign investors performed better than corporations owned predominantly by domestic institutions. Foreign investors have introduced radical changes to enhance corporate governance within the corporation. They have dismissed

<sup>153</sup> Performance was defined as total factor productivity, material cost per unit of revenue and labour productivity: see A Pivovarsky, "Ownership Concentration and Performance in Ukraine's Privatised Enterprises" (2003) 50 *IMF Staff Papers* 10 and WL Megginson and JM Netter, "From State to Market: A Survey of Empirical Studies on Privatisation" (2001) 39 *Journal of Economic Literature* 321, both cited and discussed in Jobome and Crotty, *supra* n 138, 40-41. See also Filatotchev et al, *ibid*, 342-43.



inefficient boards, forced companies to restructure themselves and appointed their own nominees to sit on the board.<sup>154</sup> Along with technological know-how, they have introduced more knowledgeable and experienced personnel into the corporation. These new recruits have helped the corporation adapt to market forces and local and internal firm conditions.<sup>155</sup>

"Foreign ownership and control may impose stringent and robust check on managerial discretion and improves the prospects for a successful restructuring . . . outside investors may provide knowledge and expertise that are necessary for designing and implementing restructuring strategies."<sup>156</sup>

Corporations which are dominated by insiders are limited both in their corporate governance systems and learning capacity. In large part, this is due to the fact that management has had little prior experience of effective leadership. In many cases, whilst they have had the right incentives and the means to restrain abuse of power on the part of management, they have lacked the experience to do so.<sup>157</sup> The Chinese government ought to welcome foreign participation in local corporations. The experience and expertise that they bring can help directors to be entrepreneurial, curb waste, and adhere to the law and governance codes.

The potential contribution that foreign investors can make to corporate governance has been recognised by the Chinese government. In reforming the "big four" national commercial banks, the Chinese government is welcoming "strategic foreign investors". The Construction Bank of PRC recently announced that two foreign financial firms have become its shareholders, each holding approximately 9% of its shares. In another city bank, controlling stakes were sold to an American financial firm. However, the government is still cautious in this respect and the pace with which foreign participation is allowed into corporations may be very slow. Also, stock markets have not been a feasible place for foreign investors to gain control of domestic companies. Not only are state shares not publicly tradable, foreign investment in Chinese stock markets is also restricted. To facilitate and encourage foreign investment, stock markets should be opened further. The restrictions on foreign industrial and financial companies to invest on the domestic stock exchanges should also be relaxed.

<sup>154</sup> See N Barberis, M Boycko, M Shleifer and N Tsukanova, "How Does Privatisation Work? Evidence from the Russian Shops" (1996) 104 *Journal of Political Economy* 764; N Uhlenbruck and J De Castro, "Foreign Acquisitions in Central and Eastern Europe: Outcomes of Privatisation in Transitional Economies" (2000) 43 *Academy of Management Journal* 381; SA Zahra and G George, "Absorptive Capacity: A Review, Reconceptualisation and Extension" (2002) 27 *Academy of Management Review* 185; and HK Steensma and MA Lyles, "Explaining IJV Survival in A Transition Economy through Social Exchange and Knowledge Based Perspectives" (2000) 21 *Strategic Management Journal* 331, cited in Filatotchev et al, *ibid*, 340.

<sup>155</sup> Filatotchev, *ibid*, 340.

<sup>156</sup> *Ibid*, 341.

<sup>157</sup> *Ibid*, 337.

Finally, we observed that directors in listed companies are often appointed from the ranks of civil servants who have little experience in managing their companies. Due to the flaws in the appointment process, there is no incentive to find only the most highly qualified and entrepreneurial persons as directors. Further, the director community does not possess the level of maturity necessary to appreciate and follow the spirit, rather than the letter, of non-legal codes governing their behaviour. If companies are to grow, directors must become skilled at their role. They must learn to be conversant with international standards of governance, meet demands in a competitive environment and be able to develop effective monitoring and governance systems. Apart from welcoming foreign investors to share their expertise with local directors, regulators in China ought also to establish professional directorial associations in order to set standards to guide directors and provide training and education so they can discharge their responsibilities efficiently.<sup>158</sup> For example, whilst best practice provisions in non-legal codes provide that directors must be responsible, diligent and prudent, Chinese directors may not necessarily understand what they entail in the business context.

Other countries in south east Asia are taking steps to ensure their directors are properly equipped to manage the company. In Malaysia, the listing rules of the stock exchange were revised recently to require all directors of public listed companies to undergo mandatory accreditation programmes with organisations who are able to provide the relevant training that directors need.<sup>159</sup> In addition, on a yearly basis, directors must participate in a Continuing Education Programme (CEP).<sup>160</sup> Both programmes seek to enhance professionalism amongst directors and increase their knowledge and understanding of recent developments in laws, regulation and business practices,<sup>161</sup> primarily through providing training programmes on corporate governance matters. Many organisations have been accredited with CEP points to authorise them to conduct training programmes for directors.<sup>162</sup> The requirement is that directors must accumulate a certain number of points annually so they can prove they understand their obligations and can keep abreast of developments in domestic and international corporate practice.<sup>163</sup>

<sup>158</sup> See Wei, *supra* n 13, 44.

<sup>159</sup> Paragraph 15.09 of the Listing Rules of Bursa Malaysia, see accompanying Practice Note 5/2001.

<sup>160</sup> *Ibid.*, see accompanying Practice Note 15/2003.

<sup>161</sup> See FS Cheah and K. Kaur, "Malaysia: Training Directors", *Chartered Secretary: The ICSA Magazine*, August 2004, 17-19.

<sup>162</sup> *Ibid.* These include the Securities Industry Development Centre, the Malaysian Institute of Chartered Accountants, the Malaysian Association of the Institute of Chartered Secretaries and Administrators and Rating Agency Malaysia Berhad.

<sup>163</sup> These issues are discussed in Miles, *supra* n 4.

### E. CONCLUSION

It is crucial for the success of a company that its directors act responsibly and in its best interests. This article has discussed the various corporate governance mechanisms to ensure proper behaviour on the part of directors in China. It surmises that currently, none of these mechanisms work effectively to deter improper conduct on the part of directors. Serious concerns exist over the lack of clarity and coherence of the current law and over the lack of effective enforcement mechanisms to make sure that directors act responsibly. The judiciary suffers from heavy interference from the state and lacks the experience to influence or shape the content of company law. The director community has not yet attained the level of maturity necessary to be able to appreciate the rationale behind laws and non-legal codes governing their behaviour. But the biggest hurdle preventing these mechanisms from working properly is the state itself. The state can not only manipulate, but directly control governance structures to its own advantage. So long as the state exerts control over the law or influence the appointment of the monitors of directors, the intrinsic governance problems discussed in this article will persist. Neither a better designed set of corporate governance laws nor better qualified personnel can enhance governance as long as the state can override their effectiveness. Non-state shareholders will continue to be powerless in monitoring directorial conduct, and the rights and interests of minority shareholders will continue to be disregarded.

The strategy of seeking to reform state-owned enterprises, with the government remaining in control, may not be sustainable in the long term. If governance is to improve, the state may have to reduce significantly its ownership in listed companies and allow its shareholding to be diversified among private investors. The task of ensuring good corporate governance is more effectively undertaken by those who have a financial interest in how the company is performing. Full privatisation may thus constitute an effective step towards achieving better governance. But it is unlikely, for political reasons, that the government will relinquish its majority shareholding in its listed companies any time soon.

This article has explored alternative ways, short of full privatisation, that can be adopted to ensure proper corporate governance within listed companies in China. Specifically, it has explored the possibility of strengthening minority shareholder rights, making use of incentive based compensation and creating a class of private investors to provide an additional layer of monitoring. Finally, based on the governance experience in transition economies, it argues that it is prudent to reflect on the usefulness of governance structures which have already been put in place. Which areas of the law are currently weak and hinder the implementation of good corporate governance? What alternative strategies can help improve governance? Ensuring that governance works is crucial to the

success of listed companies in China. Adopting governance models from Anglo-American jurisdictions in order to raise standards of governance is one thing; ensuring that they work is another. It is hoped that this article will contribute to the emerging debate about how governance within companies dominated by a majority shareholder can be improved. The Chinese government must now focus on constructing a workable corporate governance model to enable its companies to attain the standards of governance which will inspire confidence in both domestic and foreign investors.

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