

# A CRITICAL SURVEY OF THE PEOPLE'S REPUBLIC OF CHINA'S NEW COMPANY LAW

## INTRODUCTION

The bulk of the analytical debate regarding the new Company Law<sup>1</sup> of People's Republic of China, which became effective in July of 1994, has focused strictly on the structure of statutory requirements and internal governance. This note reviews the internal governance structures under China's new Company Law but goes on to raise several critical questions about the weaknesses of the Company Law. These critical questions are posed from the perspective of an American holder of a Chinese company's stock.<sup>2</sup>

This note begins by reviewing the ideological and pragmatic purposes behind this first piece of national company legislation promulgated in the People's Republic of China since its founding. Although, the transition from China's more traditional socialist economic structure will quicken under the Company Law, the enactment of this statute does not foreshadow the coming of capitalism. The Company Law does not even indicate the coming of privatization in China.

This note continues with a review of the types of corporations an American investor is most likely to purchase stock in under the Company Law. After discussing some practical effects of the requirements for incorporation, the note evaluates the corporate governance structure under the Company Law. For instance, Chinese corporations have both a board of directors and a board of supervisors. Further, the Company Law enumerates fiduciary duties that are held by the members of each board and other corporate officials.

Finally, this note analyzes the powers of shareholders in China. The Company Law explicitly states that shareholders are the most powerful force in a corporation. The rights given to shareholders in China actually exceed those of American shareholders in some respects. However, the American shareholder of a Chinese company's stock benefits only marginally from these expansive powers. The reasoning for the marginal control an

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1. Different authors refer to this commercial statute as either the Company Law or the Corporation Law. This note will refer to the statute interchangeably as the Company Law and the Corporation Law.

2. Although this paper concentrates its discussion on the potential difficulties of a U.S. investor in China with relation to the Company Law, the discussion should be equally relevant to any foreigner who invests in The People's Republic of China via stock ownership.

American shareholder could assert in a Chinese corporation is that the government will remain the majority shareholder in most companies.

## I. THE NEW COMPANY LAW AND THE PEOPLE'S REPUBLIC OF CHINA<sup>3</sup>

The national Company Law of the People's Republic of China [hereinafter China] became effective in July of 1994.<sup>4</sup> The Corporations Law is "the first piece of national company legislation promulgated in China, since the founding of the People's Republic of China in 1949."<sup>5</sup> It adopts and codifies most of the organizational and structural principles found in the Western capitalist countries' traditional limited liability companies. There can be no doubt that the Company Law is a very comprehensive body of law and an amazing step by the Chinese government toward conforming Chinese business organizations to international standards.

### A. *Purposes Of the Corporation Law*

There are many reasons why China has decided to enact a national Corporation Law. The ultimate ideological goal of the Corporation Law is to unite Western capitalist corporate structures with existing Chinese enterprises while concurrently retaining and promoting the "socialist market economy."<sup>6</sup> However, this ideological goal does not envision a replacement of the state sector by private enterprises.<sup>7</sup> Instead, the pragmatic purpose of the Company Law is to allow the government to remove itself from the micro-management of enterprises. By removing itself from the day-to-day affairs of a corporation, the government hopes enterprises will become more productive and efficient by the ensuing competition. The competitive enterprises are to then develop and mature, while the means of production remain safely in the hands of the people, who are represented by the Chinese government. In short, with the Company Law the government hopes market discipline will force Chinese enterprises to become more

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3. The Company Law is an extensive piece of legislation including eleven chapters and 230 articles. Yabo Lin, *New Forms and Organizational Structures of Foreign Investment in China Under the Company Law of the PRC*, 7 TRANSNAT'L LAW 327, 329 (1994).

4. Howard Gensler, *Company Formation and Securities Listing in the People's Republic of China*, 17 Hous. J. INT'L L. 399, 400 (1995). A supplement to the Company Law, called the Special Regulation on Limited Stock-Companies and Listing Abroad, was adopted in August of 1994. This note treats the Corporations Law and the Special Regulation as a single body of legislation.

5. Lin, *supra* note 3, at 329.

6. Corporation Law, art 1., in 2 China L. For. Bus.: Bus. Reg. (CCH Int'l) ¶¶ 13-518 (1994).

7. Robert C. Art & Minkang Gu, *China Incorporated: the First Corporation Law of The People's Republic of China*, 20 YALE J. INT'L L. 273, 275 (1995).

productive and efficient. However, the government intends the private sector to only be a supplement to the state sector.<sup>8</sup>

A second goal of the Company Law is to keep the means of production in the hands of the people. This goal underscores the important point that the Company Law is not an effort or willingness by the Chinese government to encourage or allow enterprise privatization, such as that occurring in the former communist states of the Eastern Europe.<sup>9</sup> Under the Company Law, "the [Chinese government] will still maintain the ultimate control and majority ownership of the largest enterprises. . . ."<sup>10</sup> These are the same type of enterprises that will most often offer stock to foreign investors.

The implications of the ideological and pragmatic purposes behind the promulgation of the Company Law are fundamental. China is adopting Western corporate organizational structures that will appear familiar to stock investors from the United States. Nonetheless, the ideological underpinning is unquestionably socialist in nature and explicitly rejects capitalist ideology. This foundation evidences the operative attitude of the Chinese government that "[c]ompan[ies] are a necessary evil to be closely regulated rather than an economic engine to be encouraged and released."<sup>11</sup>

## B. *Types of Corporations*

Three types of limited liability companies are defined by the Company Law.<sup>12</sup> There are limited liability companies (limited companies), limited

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8. *Id.*

9. Generally, privatization in the former communist states of the Eastern Europe entails a shift of control over enterprises from the state to the private sector. *Id.* at 282.

10. *Id.* at 275.

11. *Id.* at 289. See generally Barbara Campbell Potter, *China's Equity Joint Venture Law: A Standing Invitation to the West for Foreign Investment?*, 14 U. PA. J. INT'L BUS. L. 1, 4-6 (1993). Although Potter's article addresses Equity Joint Ventures which have been in existence in China since 1983, government sentiment does not appear to have changed. To some extent the sentiment is based on the ideologic underpinning of the Chinese concepts of Li and Fa. Simplistically, Fa is law, and Li is propriety. Li looks to moral force to maintain order. Within this structure, the rules of conduct are defined by relationships. This moral force is equated with good. Fa looks to physical coercion to enforce order. The sanction of physical coercion is tainted with evil. Thus, statutory law, such as the Company Law, is tainted with evil. See also Benjamin Schwartz, *On Attitudes Toward Law In China, in GOVERNMENT UNDER LAW AND THE INDIVIDUAL*, AMERICAN COUNCIL OF LEARNED SOCIETIES 27 (Milton Katz ed., 1957).

12. It is important to note that the Company Law does not supersede the previous laws regarding equity joint ventures, contractual or cooperative joint ventures, and wholly owned state enterprises. "Article 18 of the Company Law provides that the Company Law is to apply to foreign invested-limited liability companies, but that the laws regarding foreign investment enterprises will prevail over the Company Law if the former provides otherwise." Lin, *supra* note 3, at 341. For a good brief review of these forms of enterprises and the laws that govern them see Lin, *supra* note 3, at 331-40.

stock-companies (stock companies) and companies wholly owned by the state (state companies). This note will concentrate on the limited stock-companies, and a specific subcategory of limited stock-companies called listed companies.<sup>13</sup> These two categories are the most relevant because they are the types of corporations where a foreign investor will most commonly purchase stock.

The procedures for forming limited stock companies and listed companies are specifically defined in the Company Law. As a practical matter, limited stock-companies have generally already existed before an enterprise has become a listed company. Listed companies may list their stock on any approved securities exchange, foreign or domestic.<sup>14</sup> This should make the stock of listed companies the most readily available to United States investors. For both types of corporate formations there are the following requirements. First, 10,000,000 Renminbi (RMB) must be fully subscribed. Second, "the company must be organized at a stockholders' meeting."<sup>15</sup> Third, the issuance of stock and the formation of the company must conform to all regulations. Fourth, a company constitution or articles of incorporation must be drafted by the initiators.<sup>16</sup> Fifth, "the company [must have] an appropriate name . . ." and "appropriate organization."<sup>17</sup> Sixth, the company must have an established permanent residence.<sup>18</sup> Seventh, "the company [must have] adequate resources to begin operation."<sup>19</sup> Eighth, "the board of directors [must have] applie[d] to the Registrar of Companies for registration of the company by submitting the

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13. Gensler, *supra* note 4, at 426. Different authors vary as to the exact names of these corporate categories. The direct Chinese translation of the category this note has termed limited stock-companies is "shareholding limited company." Art & Gu, *supra* note 7, at 291 n.109. Lin, *supra* note 3, at 329. Gu has altered the direct translation of "shareholding limited company" to "joint stock company." Art & Gu, *supra* note 7, at 291. The bases for his different translations is that "[w]hat the term [shareholding limited company] denotes is that the company is characterized by share ownership and provides limited liability to shareholders. Because all corporations provide limited liability, [this translation] . . . uses the phrase 'Joint Stock Company' as the most descriptive translation." *Id.* at 291 n.109. Gensler calls this category of companies "limited stock-companies." He further differentiates between the limited stock companies who can list only domestically and those that can list both domestically and abroad. Those that can list abroad fall under the heading "listed company." Gensler, *supra* note 4, at 413. This note uses Gensler's terminology out of personal preference.

14. The New York Stock Exchange is an approved securities exchange.

15. Gensler, *supra* note 4, at 414.

16. *Id.* Initiators are the initial investors who organize the limited stock company. Initiators have many of the same functions and liabilities as promoters in the United States. *Id.*

17. *Id.*

18. *Id.* Residence of the corporation is determined by its primary place of business.

19. *Id.*

appropriate document[s]."<sup>20</sup> Last, the government must give its approval.<sup>21</sup>

The following additional requirements must be met when forming a listed company. First, the minimum amount of registered capital is raised to 50,000,000 RMB. This minimum capital must be fully subscribed. Second, stock issuance must have been approved by the securities administration department. Third, the enterprise must have been in business for a minimum of three years. Fourth, no major unlawful acts may have been committed by the company within the last three years. Finally, the company must not have made a false statement in any financial report for three years.<sup>22</sup>

Listed companies are further divided into two groups: small companies and large companies. The additional requirements for small companies are: (1) "the company [must have] earned profits in the last three years; [2] there [must be] more than 1000 stockholders; [3] the par value of the stock exceeds 1000 RMB; and [4] at least twenty-five percent of the stock [must be] held publicly."<sup>23</sup> For large companies the capital stock must exceed 400,000,000 RMB; and at least fifteen percent of the stock must be held publicly.<sup>24</sup>

The effects of these requirements are relatively straight forward. Each requirement reenforces the belief that corporations are a dangerous albeit necessary means to an end. The Company Law does not make incorporation a right; rather it is a privilege. The privilege will only be granted in such a manner as to "protect against corporations being established wantonly."<sup>25</sup>

The requirements of minimum registered capital and minimum amounts of time the corporation has been in business are fashioned to prevent wanton establishment of corporations. These requirements are intended to impede the Company Law from becoming the province of small entrepreneurs. Although, "[a] secondary function of the Company Law is to . . . promote the development of small private enterprises,"<sup>26</sup> the government does not want the Company Law to start wholesale establishment of fly-by-night enterprises. The fundamental focus of the Company Law is on reforming the state-owned enterprise, not on the

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20. *Id.*

21. *Id.*

22. Gensler, *supra* note 4, at 415, 426.

23. *Id.* at 427. According to one author "public shareholders" means government entities. Art & Gu, *supra* note 7, at 303.

24. Company Law, art. 152(4).

25. Art & Gu, *supra* note 7, at 289 n.103 (quoting Quanguo Renda Falu Wei yuanhui Guanyu 'Zhonghua Renmin Gongheguo Gongsifa (Chaoan)' Shenyijieguo de Baogao [The Law Committee of the National People's Congress, Report Concerning the Examination of Chinese Company Law (draft)] (Dec. 17, 1993)).

26. Art & Gu, *supra* note 7, at 275.

development of entrepreneurial, capitalist businesses.<sup>27</sup> The registered capital and the time-in-business requirements work to preserve this fundamental focus. Additionally, the requirement that corporate formation occur at a shareholders' meeting foreshadows the tremendous power that the shareholders will exercise over the corporation.

From the perspective of the American holder of a Chinese company's stock, each of these requirements are positive. The pre-incorporation requirements work to assure the U.S. investor that incorporated Chinese enterprises are relatively large and secure businesses that will be controlled by shareholders. Of course, providing a feeling of stability and security to the foreign investor is a goal of the Company Law, although not explicitly mentioned as such. To this end, the requirements for incorporation provide a great deal of screening before an enterprise can incorporate. In short, with this list of pre-incorporation requirements, the government assures the potential stock investor that an incorporated enterprise is a substantive enterprise.

### C. *The Structure of Corporations Under China's Company Law*

The structure of a company under China's Company Law is very similar to that of a traditional limited liability corporation in the United States. Significantly, "the Corporations Law adopts the familiar principle that a corporation is a 'legal person,' an entity that enjoys civil rights and owes civil responsibilities to the full extent of its assets."<sup>28</sup> Shareholders are explicitly protected from liability beyond their capital contributions.<sup>29</sup> The American shareholder of a Chinese company's stock should favor the existence of this familiar legal fiction.

However, the corporation, as a legal entity, has the added Chinese characteristic of a human "legal representative."<sup>30</sup> Generally, "the legal representative is the chairman of the board [of directors] or president" of the corporation.<sup>31</sup> The legal representative serves as an agent for the Chinese corporation in that he can "act on behalf of and . . . bind the company."<sup>32</sup> Distinctively, the Chinese corporation's legal representative is also subject to sanctions for the corporation's improper activities. For example, "the legal representative is personally at risk if the corporation engages in business beyond its authorized scope, conceals facts from registration and tax authorities, or hides [corporate] property to evade repayment of [corporate] debts."<sup>33</sup>

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27. *Id.*

28. Art & Gu, *supra* note 7, at 293.

29. *Id.* at 293-94.

30. *Id.* at 294.

31. *Id.*

32. *Id.*

33. Company Law, art. 49.

The penalties imposed on the legal representative can be very serious. The legal representative may be "fined or subjected to administrative sanctions, [ranging from] warnings . . . [to] dismissal from office, with the attendant loss of prestige, status, and face." All violations of the Company Law also have the potential to have criminal liability attach.<sup>34</sup> "[I]f the company's offense constitutes a crime, the legal representative may be criminally prosecuted."<sup>35</sup> In China, "[t]he punishment for white collar crimes can be [extremely] severe, including . . . death."<sup>36</sup>

The reasons for adopting the legal representative are numerous. First, the legal representative appears intended to provide some amelioration for the limited liability of the Company Law. The possible rationale being that since the legal representative can be punished for the corporation's wrongs, he will strive to prevent those wrongs. Thus, if some improper action occurs an actual person is punished, not a faceless corporation. Therefore, the legal representative appears to represent a compromise between socialism and limited liability. Interestingly, the practical effect of attaching liability places the legal representative in the position of watchdog over corporate affairs.<sup>37</sup>

The importance of the legal representative to the American purchaser of Chinese stock is not readily apparent. Superficially, it does appear to give the chairman of the board of directors, as legal representative, a strong incentive to ensure the corporation is operating lawfully. The question is: Should this time-consuming function be that of the Chairman of the board of directors? In the United States, for example, the Chairman of the board of directors, generally is more involved in overall company strategies and planning the corporation's direction. Under the Chinese Company Law the chairman of the board of directors would spend much of his time policing the internal functions of the corporation.<sup>38</sup> There is, of course, merit to both positions.

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34. Art & Gu, *supra* note 7, at 299. "At least 15 separate articles state that in addition to the other more specific sanctions, criminal liability (which is not defined in the Company Law) applies 'in accordance with the law.'" *Id.* at 299 n.184 (quoting Company Law, arts. 206-14, 217-24).

35. Art & Gu, *supra* note 7, at 294.

36. *Id.* at 299-300 n.185.

37. The Company Law's use of a legal representative and the prohibition about piercing the corporate veil could place the legal representative in the position of a marked man. If a corporate official took some action that resulted in the corporation violating the law then the legal representative could also be punished. It is easy to see how the legal representative concept could be subject to abuse. However, this potential abuse is mitigated by personal liability attaching to a specific director for "action taken that violates law or company policy unless such director dissented." Gensler, *supra* note 4, at 421.

38. The Company Law is silent about what standard the legal representative must adhere to in the performance of his functions. However, his concurrent position as chairman of the board of directors probably provides his standard of performance.

Also, it is critical to note that the Company Law is not making the legal representative personally liable for corporate debts. Thus, the legal representative himself still operates behind a financial corporate veil.<sup>39</sup> The legal representative is subjected only to a sanctioning system.<sup>40</sup> These sanctions do not go to the shareholder, but are fines paid to the government, thus the benefit to American shareholders is strictly the enforcement of the legal representative's watchdog function. This conclusion is strengthened by the Company Law not specifying whether the legal representative is subject to suit by shareholders for not effectively performing his duties.

### 1. *The Board of Directors*

The Company Law adopts the familiar corporate governance strategy of using a board of directors. "Every [large, limited liability] corporation must have a board of directors, generally elected by the shareholders for terms of up to three years."<sup>41</sup> The number of directors on the board must fall within a range set by the Company Law.<sup>42</sup>

A Chinese corporation's board of directors must follow many of the same formalities as a board of directors in the United States. For example, the Chinese corporation's board of directors must follow strict notice requirements for shareholders' meetings.<sup>43</sup> Further, "[t]he board must meet, at least, twice per year" and directors "should be given at least ten days advance notice [of these] meeting."<sup>44</sup> Also, "[d]irectors should attend meetings personally or authorize another director in writing to vote with explicit instructions."<sup>45</sup> Resolutions<sup>46</sup> before the board of directors are

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39. The Company Law does not mention a concept of "piercing the corporate veil." Art & Gu, *supra* note 7, at 294.

40. The use of sanctions points to a fundamental difference between the legal system in China and the legal system in the United States. One commentator has indicated that China has a "disciplinary system" as opposed to a legal system. A disciplinary system attempts to maintain order and coerce cooperative behavior. A legal system concentrates more on the protection of the rights of individuals. See generally THOMAS B. STEVENS, ORDER AND DISCIPLINE IN CHINA (1992) (Although the distinction is inflated by Stevens, the differentiation does provide useful insights into the perspective from which laws are promulgated in China.).

41. Art & Gu, *supra* note 7, at 295. See also Lin, *supra* note 3, at 369.

42. The statutory number of directors in limited stock corporations must fall in a range between five and nineteen. The corporation's constitution should designate the specific number within this range. Company Law, art. 115, in Lin, *supra* note 3, at 369.

43. For instance, "[s]tockholders are to be notified of the [annual shareholders meeting's] agenda thirty days in advance." This is the board of directors responsibility. Gensler, *supra* note 4, at 418. "When a shareholders' meeting is to discuss the issuance of bearer shares, the company must make a public announcement about the matter forty-five days before the convening of the meeting." Lin, *supra* note 3, at 22.

44. Gensler, *supra* note 4, at 420.

45. *Id.* at 421.



"adopted by a simple majority vote of the directors in attendance."<sup>47</sup> "[T]he minutes of the board meeting must be kept and signed by the attending directors."<sup>48</sup>

The Company Law has adopted responsibilities for the board of directors that are similar to those found in the United States. First, the board must convene and conduct shareholders' meetings and report to shareholders on the performance of the corporation at these shareholders' meetings. Second, they must carry out the decisions reached by shareholders at the meetings.<sup>49</sup> Third, they must decide "the company's operation and investment plans."<sup>50</sup> Fourth, the board of directors has the responsibility of "formulat[ing] the company's annual financial budget plans and final accounting plans."<sup>51</sup> Fifth, they must "formulate the company's profit distribution plans"<sup>52</sup> and a "plan to satisfy any budget deficit."<sup>53</sup> Sixth, they must make needed adjustments to the amount of required registered capital. Seventh, they must formulate plans for the issuance of corporate bonds.<sup>54</sup> Eighth, they have the responsibility "to draft plans regarding mergers, separation[s] [or] dissolution of the company."<sup>55</sup> Ninth, they must appoint and remove corporate management, including the general manager.<sup>56</sup> Tenth, the board must "formulate the company's fundamental management system."<sup>57</sup> Finally, the board of directors may elect, by a majority of all directors, a chair and one or two vice-chair(s) of the board.<sup>58</sup>

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46. Both the members of the board of directors and shareholders may propose resolutions.

47. Gensler, *supra* note 4, at 421.

48. Lin, *supra* note 3, at 372.

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.* at 369.

53. Gensler, *supra* note 4, at 421.

54. *Id.*

55. *Id.*

56. The general manager of the company has responsibility for the "day-to-day management of the company, to implement the board of directors' resolutions, and to draft various plans on the company's basic management system." He also attends board of directors meetings in a non-voting capacity. Lin, *supra* note 3, at 372.

57. *Id.* at 369.

58. Gensler, *supra* note 4, at 421. See also *supra* notes 12 -14 which point out that the chairman of the board of directors is the legal representative of the company. Further, "while the functions and authorities of the chairman of the board of directors in a limited liability company are not specified, the Company Law provides the following functions and authorities for the chairman . . . ." Lin, *supra* note 3, at 24. "First, to preside over the shareholders' meeting, and convene and preside over the meeting of the board of directors. Second, to examine the sufficiency of the implementation of the resolutions of the board of directors; and to sign the company shares and company bonds." *Id.*

A fundamental difference between the American method of legislative enactment of laws and such legislative enactments in China appears when the board of directors' responsibilities are examined. In China, the laws (i.e., legislatively written statutes) are pronounced in generalized format, resembling policy pronouncements rather than traditional laws. Then, it is left to the regional governments to flesh out the specifics. Thus, local interpretation can have a major affect on the board of directors' responsibilities, especially during the early stages of a law's existence. The board's responsibility to determine "the company's operation and investment plans" illuminates this difference. There is no historical reference to determine what this responsibility entails. Hence, the primary roles of Chinese corporate boards of directors — to determine the general direction of the corporation, to make judgments about extraordinary business transactions, and to report such transactions to shareholders, must be refined at the local levels. In practice, this removes some of the American shareholders' protection provided by the national Company Law because of uncertainty as to how the regional government will interpret the national legislation.

## 2. *The Board of Supervisors*

The Company Law also requires Chinese corporations to have a second board, acting in essence as a board of supervisors.<sup>59</sup> China has adopted this concept from German corporate law.<sup>60</sup> The board of supervisors is made up of a minimum of three members, one of which will be elected the convener.<sup>61</sup> The board of supervisors represents "the stockholders and the employees in a proportion established by the company

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59. The translations of the Company Law differ between authors in this area. Gu addresses the "board of supervisors" by the name of "supervisory committee," Art & Gu, *supra* note 7, at 295. Lin, however, uses the "board of supervisors" terminology, Lin *supra* note 3, at 273. This note opts to use Lin's version out of personal preference. In addition, there is an inconsistency as to whether a board of supervisors is actually required or whether it is merely optional. Both Gensler and Lin hold that it is required, with Lin qualifying this by stating that it is "mandatory . . . only if the company is of large scale in its business operation." Lin, *supra* note 3, at 373. Gensler, *supra* note 4, at 422. The discussion in this note most relates to large scale business operations. Hence, this note opts to address the board of supervisors as a corporate requirement.

60. See generally Gregory J. Thwaite & Jurgen Pesch, *A Guide for the Perplexed: Some Aspects of German Merger and Acquisition Law Explained for Foreign Counsel*, 20 INT'L BUS. LAW 566 (1992). Additionally, the Czech Republic, the Republic of Slovakia and Poland have all adopted similar supervisory boards. Bulgaria adopts the supervisory board as one of two possible corporate governance structures. See generally Vassil Breskovski, *Directors' Duty of Care in Eastern Europe*, 29 INT'L LAW. 77 (1995). All appear to have borrowed this concept from Germany.

61. Gensler, *supra* note 4, at 422. What exactly this title entails is not made clear by the Company Law, but the conveyor is probably the rough equivalent to a chairman.

constitution."<sup>62</sup> Examining the following listed duties given to the board of supervisors one must conclude that the board of supervisors, essentially "acts as an auditing watchdog of the company."<sup>63</sup>

The following responsibilities are given to the board of supervisors by the Company Law. First, the board must "inspect the financial affairs of the company."<sup>64</sup> Second, it is required to watch for violations of "laws, regulations or [the] articles of association" by the board of directors or the general manager when acting in their corporate capacities.<sup>65</sup> Third, the board of supervisors must ask "the directors and general managers to correct acts harmful to the interests and benefits of the company."<sup>66</sup> Fourth, it proposes "interim shareholders' meetings."<sup>67</sup> Lastly, it performs all other acts designated to it by the company's constitution."<sup>68</sup> To facilitate performance of each of these tasks, the members of the board of supervisors "attend meetings of the board of directors in a non-voting capacity."<sup>69</sup>

At first glance, the board of supervisors appears to provide extra protection for a company's shareholder; however, there is a problem with this protection. Although the board of supervisors has policing functions, the mechanisms for the board of supervisors to enforce their policing functions are indirect. For example, the board of supervisors can "request" that the board of directors and general managers "correct acts harmful to the interests and benefits of the company."<sup>70</sup> The weakness of this function is fundamental by its own language, the board of supervisors can make only a "request." If the board of directors does not comply, then the board of supervisors does not have the ability to enforce its request. The only enforcement mechanism available to the board of supervisors under the Company Law is to propose a shareholders' meeting.<sup>71</sup>

Because of the government's strong control over the shareholders' meetings, the single enforcement capability effectively transforms the board of supervisors into a private quasi-regulatory representative for the government within each corporation.<sup>72</sup> In the end, the result of the board

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62. *Id.* at 422. "The employee representative(s) must be elected by and from the [corporation's] employees." *Id.*

63. Company Law, arts. 54, 126.

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. Art & Gu, *supra* note 7, at 296.

70. Company Law, arts. 54, 126.

71. For this to be an effective, albeit indirect, mechanism of enforcement, the board of supervisors would have to contact the shareholders directly.

72. However, the independence of the board of supervisors is strengthened by the requirement that no current members of the board of directors or other corporate officers may be on the board of supervisors.

of supervisors' watchdog function is to run-and-tell the government when the board of directors or other corporate officers have been "bad."<sup>73</sup>

### 3. *The Chinese Boards' Duties of Care and Loyalty*

#### a. *The Duty of Care*<sup>74</sup>

The Company Law states that "[b]oth directors and supervisors owe fiduciary duties to the corporation and are subject to liabilities for breach."<sup>75</sup> Further, the Company Law states that corporate officials (e.g., directors, supervisors and general managers) must "abide by the company's articles of association and must perform their duties and protect the interests and benefits of the company with loyalty and honesty."<sup>76</sup> Hence, directors, supervisors, and general managers must perform their duties sincerely and diligently with loyalty and honesty.

The duty of care espoused by the Company Law is the weakest portion of the Company Law. The inherent weakness stems from the absence of any explanation about what sincerely and diligently and with loyalty and honesty mean. The Company Law provides this language but then goes no further. Additionally, there is no mention of the familiar American concept of the business judgment rule or any standard, such as gross negligence.

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73. This is probably the intent behind China grafting the supervisory board concept into its Company Law. "A characteristic feature of the German economy, [from which this concept was grafted], is that most German companies are financed not through equity but through bank loans." Lin, *supra* note 3, at 375. There are a few dominant banks in Germany. Thus, the Chinese government, as "The Bank" in China has adopted the German system that has been effective at protecting the large German creditor banks. See generally Breskovski, *supra* note 60. There is, however, some evidence that might be seen as refuting this conclusion: "[t]he Company Law provides that a civil servant, such as a governmental employee is not allowed to serve as a director, supervisor or manager of a company. The policy consideration underlying this provision may be to minimize governmental interference in the operation of a company and to separate the State from the corporate sector." Lin, *supra* note 3, at 375.

74. For a quick review of the duty of care for directors and officers in the United States see 1 ALI, PRINCIPLES OF CORPORATE GOVERNANCE 68 (1994). Section 4.01(a) states, in part, that "[a] director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances." See also *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (Requiring directors to exercise the degree of care that an ordinarily prudent person would exercise under similar conditions).

75. Art & Gu, *supra* note 7, at 296.

76. *Id.*

In the United States, the duty of care for directors and corporate managers is generally thought to require a mixture of four different duties.<sup>77</sup> First, there is the "duty of inquiry . . . [or] the duty to follow up reasonably on information that should raise concern."<sup>78</sup> Second, there is "the duty to employ a reasonable decision-making process" when making corporate decisions.<sup>79</sup> Third, there is the duty to make decisions that are reasonable.<sup>80</sup> Finally, there is "the duty to supervise or monitor the conduct of the corporation's business."<sup>81</sup> Each of these sub-duties have substantial case histories that have defined what they encompass. By contrast, in China, the words sincerely, diligently, with honesty and loyalty are all that is known. There are no case histories. In short, the duty of care language in the Company Law sounds positive, but one must critically question how this language's substance will be defined.

In sum, China attempts to graft the Western concept of duty of care into its Company Law; however, the attempt appears very timid and completely ambiguous. To a United States shareholder of a Chinese company's stock, this brevity regarding the duty of care is cause for concern. Nonetheless, it is doubtful, given the sophistication of the Company Law that this weakness results from lack of consideration or insight by the National People's Congress. The weakness probably will be worked out in a fairly short period of time.<sup>82</sup> Most commentators seem to assume that "sincerely and diligently, [is] a prescription that corresponds to American law's duties of loyalty, good faith, and care."<sup>83</sup> This assumption appears premature.

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77. This classification process is drawn from Melvin Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 948 (1990).

78. Breskovski, *supra* note 60, at 86.

79. *Id.*

80. *Id.*

81. *Id.*

82. This note comes to this conclusion because, *inter alia*,

[u]nder the legal system of China, legislation begins when the National People's Congress adopts a new economic law, composed of general rules and principles. The State Council . . . then promulgates detailed regulations for the implementation of those principles. . . . This system is often criticized by foreign lawyers because of a time lag of more than one year between the enactment of a law by the [National People's Congress] and the promulgation of its implementing regulations by the State Council. However, this system works well because the government receives feedback on the law, allowing it to reevaluate its economic reform and, through implementing regulations, readjust the law to meet policy considerations.

Lin, *supra* note 3, at 333. Although the Company Law has already passed through this usual reevaluation period, the National People's Congress adopted it in 1993, the Company Law is the most extensive economic legislation in China; therefore, it may require more time to "perfect". Art & Gu, *supra* note 7, at 273 n.1.

83. Art & Gu, *supra* note 7, at 295.

b. *The Duty of Loyalty*

In addition to the duty of care, directors and general managers of a corporation "are prohibited from engaging in any acts harmful to the interests and benefits of the company, and any profits derived from such acts will be appropriated by the company."<sup>84</sup> "If the directors, supervisors, or managers of a company conduct an illegal act and cause damage to the company, they must bear the compensation liability."<sup>85</sup> With this language the Company Law develops a duty of loyalty.<sup>86</sup>

The Company Law continues by codifying a specific rule against self-dealing<sup>87</sup> by the corporations's directors, supervisors and managers.<sup>88</sup> Self-dealing appears defined as a corporate officer<sup>89</sup> "advanc[ing] any personal interests by exploiting their official positions, . . . accept[ing] bribes [or] other illegal gains."<sup>90</sup> The following activities are specifically listed as forbidden under the Company Law. First, there must be no lending of corporate funds.<sup>91</sup> Second, no corporate assets may be deposited in the personal accounts of the director or others.<sup>92</sup> Third, the company assets may not be used to guarantee individual debt.<sup>93</sup> Fourth, a director or corporate official may not operate a competing business.<sup>94</sup> Fifth, a corporation's officer cannot reveal corporate business secrets.<sup>95</sup> Finally, a corporate official is "prohibited from concluding agreements or conducting other transactions on [his] own behalf or on other people's behalf with his company."<sup>96</sup>

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84. Company Law, arts. 61 and 123.

85. Art & Gu, *supra* note 7, at 295.

86. There is no specific demarcation in the Company Law between the duty of care and the duty of loyalty, it is strictly a convention of this note. Further, while the "duties" are discussed in two different areas of the Company Law, articles 59-63 and article 128, each area blends this note's demarcation of the "duties."

87. The term "self-dealing" is not used in the Company Law. This note uses the term simply as a short hand method of referring to the list of activities forbidden under the Company Law which appear to parallel the activities generally referred to as self-dealing in the United States.

88. Some sections of the Company Law address general manager, directors, and supervisors while other do not address all three. This could be significant or just stylization of translations by those authors who have translated the Company Law. Either way, differentiation of "duties" between various corporate officials is beyond the scope of this paper. This note simply uses the translations as given.

89. Corporate officer refers to members of the board of directors, members of the board of supervisors and general managers.

90. Company Law, arts. 59 and 123.

91. Lin, *supra* note 3, at 374.

92. *Id.*

93. *Id.*

94. *Id.*

95. Company Law, art. 123.

96. Lin, *supra* note 3, at 374.

However, significant mitigation of the prohibition of self-dealing exists in the Company Law. Through the appropriate language in the articles of association, a corporation can opt out of all these prohibitions of self-dealing. Further, a self-dealing act may be approved at a shareholders' meeting.<sup>97</sup> The Company Law leaves whether shareholder approval must be given ex post or ex ante uncertain. The ability of shareholders to approve self-dealing becomes more menacing upon realizing that the government will remain the majority shareholder.

Notwithstanding these mitigations the Company Law's treatment of the duty of loyalty appears more complete than its treatment of the duty of care. Nevertheless, some vagueness exists. For example, the statute provides no guidance as to what constitutes a competing business or a corporate secret. As previously alluded to the refinement of these details will probably occur at the regional level, which creates the probability of inconsistencies between regions.

There are additional examples of the vagueness under the duty of loyalty. First, the Company Law lacks an explanation of "compensation liability."<sup>98</sup> The American shareholder of a Chinese company's stock should also be concerned with the opt out provision's lack of clarity regarding ex ante or ex post application. Because one of the purposes of the Company Law is to allow foreign investors to develop more confidence in the internal governance of Chinese corporations, this vagueness is counterproductive.

In sum, the Company Law provides a point of reference regarding the duties of care and loyalty corporate officials in China must follow when transacting corporate business. Yet, how these duties translate into functional, defensible rights for shareholders remains uncertain.

#### D. *Chinese Stock Issuers And World Markets Before Company Law*

In 1992, before the enactment of the Company Law, the stock exchanges in Shanghai and Shenzhen China<sup>99</sup> began selling "a class of shares reserved for [foreigners] and traded only in foreign currency, the so-called 'B Shares.'"<sup>100</sup> "Class A' stock [is] available for purchase by

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97. *Id.*

98. Company Law, art. 63

99. Shanghai and Shenzhen were the first and at that time the only stock exchanges in mainland China after the Communist takeover. Although Shanghai remains the largest and most influential stock exchange in China, a number of other exchanges currently exist.

100. Lee B. Spencer, Jr., *Chinese Issuers and the U.S. Market*, 845 PLI/Corp 203, 203 (1994). Mr. Spencer was a partner in the law firm of Gibson, Dunn & Crutcher at the time he wrote this article. In this capacity he "represented either the issue of the underwriter in the first three initial public offerings in the U.S. for China-based [enterprises] (Brilliance China Automotive Holdings Limited, Ek Chor China Motorcycle Co. Ltd. and China Tire Holding Limited) in which the [enterprises] obtained primary listing for their common stock

Chinese citizens only . . . and 'Class H' stock has been used for transactions on the Hong Kong stock exchange."<sup>101</sup> Additionally, Chinese enterprises' shares have been available for purchase on the New York Stock Exchange since October of 1992.<sup>102</sup> The difference between shares for foreigners and shares for Chinese nationals has been one of the most distinctive features of young stock companies in China.

#### E. *Issuance Of Shares Under the Company Law*

Incredibly, the Company Law makes no mention of shares being distinguished by the nationality of the shareholders rather than by their characteristics. This Company Law's silence provides no indication of how holders of A, B and other classes of stock may exercise their rights, leaving open many questions unanswered. For example, whether the various types of shares vote as a common group or whether they vote by class.<sup>103</sup> If they are to vote by class, would each classes' approval "be necessary to approve a [corporate] resolution[?]"<sup>104</sup> The answers to these unaddressed questions have tremendous ramifications to a holder of B-shares. For example, "a corporation might adopt a rule of equal application on its face that is actually far . . ." less favorable to some shareholder in another class.<sup>105</sup> In sum, the failure of the Company Law to address the different classes of shares is puzzling and a definite weakness.<sup>106</sup>

The Chinese word for investor translated literally means "one who throws or tosses capital."<sup>107</sup> The Company Law has made substantial progress in making this literal translation an anachronism by standardizing

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on the New York Stock Exchange." *Id.*

101. Art & Gu, *supra* note 7, at 301.

102. There are three "Chinese" companies which made stock offering on the New Stock Exchange before the enactment of the Company Law. All three are Sino-foreign joint venture enterprises. The Company Law as well as the relevant Chinese joint venture laws are both applicable. However, the offerings of these three companies were actually accomplished through holding companies incorporated in Bermuda. The sole asset of each Bermudian company is its respective namesake corporation in China. The three companies are Brilliance China Automotive Holdings Limited, Ek Chor China Motorcycle and China Tire Holdings Limited. The effect of the Company Law on these three companies is far beyond the scope of this paper. See generally Spencer, *supra* note 100.

103. Art & Gu, *supra* note 7, at 301.

104. *Id.*

105. *Id.* For instance, a resolution requiring share transfers to be made by registration in person at the corporate headquarters would affect foreign shareholders far more than Chinese shareholders.

106. This note can only speculate about this conspicuous absence. The Company Law is too thoughtful for this to be a mere oversight. One conceivable answer is that the issue of different types of shares will be addressed in national securities regulation. The national securities regulation is scheduled for enactment in the near future.

107. Matthew D. Latimer, *Note & Comment: Gilding the Iron Rice Bowl: The Illusion of Shareholder Rights in China*, 69 WASH. L. REV. 1097, 1097 (1994).



the issuance of shares.<sup>108</sup> The Company Law does this by first reducing classifications of shares into only two types: registered shares and bearer shares. "[R]egistered shares are share certificates where the names and residences of shareholders must be recorded in the company's shareholder register, and transfer [of the shares] must be endorsed by the transferring shareholder."<sup>109</sup> In contrast, recording the name and residence of bearer shareholders is not necessary.<sup>110</sup> Transfers of bearer shares can be accomplished by handing the shares over to the transferees at a stock exchange.<sup>111</sup> Both registered and bearer shares may be issued to the public.<sup>112</sup> The "[i]ssuance of shares must conform to . . . 'open, fair and impartial principles.'"<sup>113</sup> In addition, "shares of the same class must have equal rights and [equal] profits."<sup>114</sup>

"The current regulatory framework does not stipulate a method for resolving disputes between B Share holders and the Chinese parties in interest such as the company, its management or A Share holders."<sup>115</sup> Hence, foreign investors may have to rely upon Chinese courts that are not experienced with corporation matters.

The potential difference between the interests of these two types of shareholders gives the extensive powers allocated to shareholders' by the Company Law an ominous thread. For instance, shareholders making the decisions regarding the company's operation principles and investment plans has a completely different meaning when the majority shareholder is the Chinese government. Examining these conditions simplistically a reasonable conclusion would be that China has kept centralized economic planning, but is pursuing it under a different implementation regime.

This conclusion is supported when one reviews the other decision that are made only by shareholders at shareholders' meetings. Recall, both boards are chosen by the shareholders; the compensation for the members of both boards is set by the shareholders; the company's fiscal budget is decided on by the shareholders; and extraordinary transactions, such as mergers or dissolutions, must be approved by the shareholders.

Hence, if the government, as majority shareholder, decided to pursue an objective other than the maximization of profits, the American shareholder would be at the mercy of the government's agenda. For

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108. "Under the [Company] Law, the capital of a [limited stock corporation] must be divided into shares with equal value for each share." Lin, *supra* note 3, at 356.

109. Lin, *supra* note 3, at 356. It is important to note that the Company Law does not specifically provide definitions of registered shares or bearer shares.

110. *Id.*

111. *Id.*

112. *Id.* at 374.

113. Art & Gu, *supra* note 7, at 301.

114. *Id.* at 356.

115. Spencer, *supra* note 100, at 208.

example, the government might sacrifice a corporation's profits to achieve another state objective, such as higher employment in the region.<sup>116</sup>

#### F. *Shareholders Under the Company Law*

"The idea that . . . [owners] operating a business should be entitled to enjoy profits if [the business] succeeds, but be insulated from liability for losses if it fails, is neither intuitively appealing nor obvious" in China.<sup>117</sup> In fact, not long ago "the Chinese government prohibited even discussion about establishing corporations or private ownership of stock because it deemed such concepts inconsistent with . . . China's political and economic system."<sup>118</sup> In short, until recently, the fundamental concept of limited liability that the Company Law endorses was explicitly against the socialist ideology and the law in China.

An example of China's dramatic change in regards to private enterprise is evidenced by the changing concept of profits and dividends. Previously these words were synonymous with "exploiting the working class,"<sup>119</sup> the antithesis of the Chinese socialist system. However, it must be remembered that limited liability companies in the West, in part, stand on the fundamental presumption that the benefits to society through encouraging commerce outweigh the possible inability of individual claimants to recover for the wrongs done to them by a corporate entity. This fundamental concept does not directly conflict with the socialist ideology.

Nonetheless, considering its history and ideology, China's grafting the legal concepts of Western corporations law onto its powerful economy is an amazing step toward bringing China in line with international business practices. This grafting of Western law includes extensive powers being given to corporate shareholders. In fact, the Company Law states that the "shareholders' meeting is the most powerful authority" within the corporation.<sup>120</sup>

##### 1. *Shareholder Meetings*

The shareholders' meeting being the most powerful authority in a corporation is more than simple sloganism or rhetoric. The shareholders of Chinese companies actually exercise considerable control over a company. For instance, the first shareholders' meeting is called and presided over by the majority shareholder.<sup>121</sup> Generally, subsequent shareholders' meetings

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116. Latimer, *supra* note 107, at 1107.

117. Art & Gu, *supra* note 7, at 293.

118. *Id.* at 281. China began the journey to a market economy in 1978.

119. *Id.* at 282.

120. Company Law, art. 102

121. *Id.*, art. 42.

are "called by the board of directors and presided over by the chairman of the board of directors"<sup>122</sup> who themselves have been elected by the shareholders.

The Company Law ensures the shareholders are active participants by requiring a regular annual shareholders' meeting.<sup>123</sup> Additionally, the Company Law requires an interim shareholders' meeting to convene within two months if one of the following events occur: "(1) less than two-thirds of the directors required by Company Law or company constitution are serving;" (2) if unrecovered losses equal one third the total equity capital; (3) a shareholder holding ten percent or more of the shares proposes a meeting; and (4) if the board of directors or board of supervisors considers a meeting necessary."<sup>124</sup>

Most significantly, the Chinese Company Law requires that many crucial decisions be made only at shareholders' meetings. Specifically, the following decisions can only be made by the shareholders. First, the shareholders must decide the company's "operational principles and investment plans."<sup>125</sup> Second, the directors and supervisors must be elected or removed, and their compensation must be determined.<sup>126</sup> Third, reports from the board of directors and the board of supervisors must be examined, discussed and approved by the shareholders at the meeting.<sup>127</sup> Fourth, there must be an examination, discussion and approval of the "company's annual financial budget plans and final accounting plans, and the company's profit distribution plans and loss recovery plans."<sup>128</sup> Next, resolutions must be made regarding the increase or reduction of the company's registered capital, as well as the issuing of corporate bonds.<sup>129</sup> Further, the shareholders must approve extraordinary matters, such as corporate merger, division, transformation, dissolution and liquidation.<sup>130</sup> Any necessary amendments must be made to the corporation's articles of association.<sup>131</sup> Additionally, "the changes in registered capital; decisions regarding the division, merger, or dissolution of the corporation; and amendments to the company's articles of incorporation must be passed by two-thirds of all shareholders holding voting rights."<sup>132</sup>

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122. Lin, *supra* note 3, at 366.

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.* at 368. Normally, shareholder decisions are passed by a simple majority.

"[T]he right to inspect the company's articles of association, [the] minutes of shareholders' meetings, and financial accounting reports,"<sup>133</sup> aid the shareholders in exercising their power. The shareholders also have "the right to raise inquiries into, and offer proposals [regarding] the operation of the company."<sup>134</sup>

Examining this list of powers held by the shareholders, one is impressed by the extent of control shareholders exercise over the corporation. The most striking result of these extensive powers is the substantial inroads made into the powers delegated by the Company Law to the corporation's board of directors. First, the board of directors' responsibility to determine the company's operation and investment plans is qualified by the requirement that the shareholders must decide upon both plans at shareholders meetings. Second, the board of directors responsibility to formulate annual financial budgets must be approved at the shareholders' meeting. Third, although the board of directors must decide the distribution of profits to shareholders via dividend, this distribution must be approved by the shareholders. Fourth, the board of directors must formulate plans to satisfy the budget deficits, but if there is a loss of one-third or more capital, an interim shareholders' meeting must be called (i.e., the owners are brought in to review things). Fifth, registered capital adjustments made by the directors apparently will be provided by a resolution from the shareholders. Sixth, although the board of directors must draft plans regarding mergers, separations and dissolutions of the corporation, shareholders' must approve of such extraordinary transactions. In short, most of the major powers allegedly held by the board of directors originates from or must be approved by the shareholders at a shareholders' meeting.

At first glance, the U.S. holders of a Chinese company's stock should have few complaints about being a shareholder exercising great control over the company. However, as has been foreshadowed throughout this note, the fellow shareholders are themselves a potential problem.

## 2. *Big Brother: The Majority Shareholder*

The potential problem with shareholders' rights in China is not that they are insubstantial. To find the potential trouble for American shareholders of a Chinese company stock, one must look behind the Company Law to the other participants in the market.

"The extraordinary power accorded to shareholders is consistent with the Corporation[s] Law's overall approach to managing state-owned enterprises."<sup>135</sup> The Chinese government in structuring the shareholders'

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133. *Id.*

134. *Id.*

135. Art & Gu, *supra* note 7, at 297. This reemphasizes the fact that the Company Law is not an effort to promote privatization.

rights did so with the intent of being the majority shareholder in most large limited liability stock companies. By holding the majority of a corporation's shares the government maintains control over a corporation from a non-regulatory position. The government, thereby, frees itself of micro-management but retains a not-so-invisible hand in corporate affairs. This not-so-invisible hand can be used to ensure that the company does not deviate from the governmental objectives. The potential difficulty for foreign investors in a Chinese company's stock is apparent: a shareholder's interests (i.e., maximization of profits) probably will not match the ultimate interests of the Chinese government, the majority shareholder. Therefore, although the Company Law provides for substantial shareholder control over the corporation via shareholders' meetings, the predicate for this substantial power is that the Chinese government remains the majority shareholder.<sup>136</sup>

The conflict between an American shareholder's interest and the Chinese government's interest is different from the plight of minority shareholders in the United States. In China, as in United States, the American shareholder must be concerned about her minority shareholder's interest not being adequately represented when it conflicts with the interests of the majority shareholder. However, in China, the majority consists of the community (i.e., employees and their families), which is represented by the government. From the perspective of the foreign minority shareholder in China, this situation is similar to a corporate constituency-type problem. In the United States, the concern is that the community (i.e., the company's employees) will suffer in the corporation's pursuit of profits. Conversely, in China, the concern of the foreign minority shareholder is that the corporation will suffer in pursuit of supporting the community. For example, a Chinese corporation could be used simply to manufacture raw components for other Chinese corporations.<sup>137</sup> The "[p]rofitability of the supply[ing corporation] may not be as important to the [Chinese government] as the allocation of enough components to the other enterprises."<sup>138</sup> The government could simply make evaluations of the "costs and benefits and make a decision, [as majority shareholder], on pricing, payment, and production costs."<sup>139</sup> Obviously, this evaluation may not take the interests of the foreign minority shareholders of the supplier corporation into account.<sup>140</sup>

In short, although the Company Law dictates a duty of care and a duty of loyalty running from the board of directors, board of supervisors and managers to the corporation, it does not dictate any fiduciary duties between shareholders. Since the Company Law does not address the duties among

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136. For example, Chinese companies have not issued shares available to a foreigner in excess of "30 percent of the company's share capital." Spencer, *supra* note 100, at 208.

137. Latimer, *supra* note 107, at 1106 n.59.

138. *Id.*

139. *Id.*

140. *Id.*

shareholders, there are none. Therefore, the Chinese government as, majority shareholder, can pursue any objective when exercising its control over the corporation, provided the objective is legal.

### 3. *Protecting Shareholder Rights*<sup>141</sup>

The Company Law does provide methods for protecting the rights assigned to shareholders. If a shareholder finds that "a shareholders' meeting or the board of directors pass[ed] a resolution in violation of . . ." the law or administrative regulation, or the resolution "invades legal interests [of] shareholders," the shareholder has a right to file a law suit in the People's Court.<sup>142</sup> The shareholder has "the right to sue for an injunction and damages."<sup>143</sup> "The [Company Law] does not provide expressly for derivative actions" thus, a shareholder's suit must be brought by the shareholder on her behalf.<sup>144</sup>

A purchaser of shares in a Chinese corporation is statutorily protected if a corporate resolution invades the legal interests of the shareholder or is illegal. As an American holder of Chinese corporate stock the power to sue if a law is violated is comforting and appears to provide added protection.<sup>145</sup>

Although these provisions allowing shareholders to sue are comforting, they do not assure vindication of violated rights. "China has traditionally followed a disciplinary model of rule enforcement, its legislation typically has not provided rights to its citizens that may be privately enforced."<sup>146</sup> Thus, determination of damages for business malfeasance is, for the most part, a relatively new concept to the courts.<sup>147</sup> The Company Law

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141. In this section it is important to note that overlaps exist between the Company Law and various local securities regulations currently found in China.

142. Art & Gu, *supra* note 7, at 297. The Chinese court system is made up of four levels of People's Court.

143. *Id.*

144. *Id.*

145. Although outside the scope of this paper, a major concern for the holder of Chinese stocks is the difficulty of getting a favorable judgment enforced. "Chinese courts have been notoriously inconsistent in enforcing awards, particularly when an award would harm an interest of a major contributor to the regional economy." Latimer, *supra* note 108, at 1107. "Although in theory China's court system is independent from other government institutions, in reality a court's power to enforce its judgments depends upon cooperation from local banks . . . and political leaders." *Id.* at 1109.

146. *Id.* at 1108. Although Latimer is not speaking strictly within the context of the Company Law, his comments are still correct and informative.

147. [A] final problem confronting those who hold shares in Chinese enterprises is the fundamental conflict between a system of stock ownership and the [socialist] ideals perpetuated in China's most recent constitution. . . . If the constitution declares public ownership to be the basis of China's economic system, it appears, in theory at least, that the measures enacted by the national and local governments vesting private

provides no guidance to the courts in this area. For instance, although the meaning of the term "damages" is self-evident to Americans, a corporation's violation of Chinese law resulting in damages to a shareholder is an unfamiliar concept. Additionally, the determination of such damages is difficult, even with more experienced courts.

Finally, as has been discussed, there is no provision in the Company Law that forces a majority shareholder to maximize corporate profits. Thus, the conflicts with the Chinese government being the majority shareholder are still completely applicable with the power to sue being of no consequence.

### III. CONCLUSIONS ON THE CORPORATION LAW AND SHAREHOLDERS

Obviously, the Company Law is an extensive piece of legislation intended to address the structural needs of Chinese companies so that they will have access to capital via stock exchanges. On the surface, the Company Law appears to provide a great deal. It promulgates how to set up a corporation; the rights and responsibilities of shareholders, and responsibilities of the board of directors and the board of supervisors. The Company Law codifies duties of care and loyalty under which corporate management must operate, albeit with varying degrees of success. However, the primary question remains, how will these Western structures, with their unique Chinese characteristics, be applied given the underlying socialist ideology and the legal system in China.

In conclusion, the new Company Law does not provide American shareholders the protections they are accustomed to in the United States. Although, at first glance, the rights of Chinese company's shareholders are equal to and even exceed those of the shareholders in the United States, it remains to be seen how these rights can be executed in China. The current laws of China do not offer adequate levels of foreign shareholder protection because they do not ensure that shareholders can oversee and direct the governance of the Chinese company.<sup>148</sup>

*John D. Osgathorpe\**

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individuals with the right to own shares of enterprises are per se unconstitutional.

*Id.* at 1113.

148. *Id.* at 1097.

\* John Osgathorpe is a J.D. Candidate, 1997, at Indiana University School of Law - Indianapolis. He holds a Certificate in Chinese Law from the East China Institute of Politics and Law. He received his B.A. from Indiana University, and his A.S. from Vincennes University.

