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

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2012 January

(S. J. D., University of Pennsylvania Law School and Assistant Professor of Law, National Chiao-Tung University, Taiwan. Earlier version of this article was elected as the winner of Worldwide Young Corporate Law Scholar Forum Competition by Columbia University School of Law in 2008. I am grateful to Prof. Edward Rock, Katherina Pistor, Jeffrey Gordon, Wen-Yeu Wang for their helpful comments and discussion on the ideas and drafts of this article. All errors, of course, remain mine.)
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I. INTRODUCTION

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

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

Though some might wonder how the independent director mechanism could be successfully transplanted in China, it has in fact been part of the law and mandatory for all listed companies in China since 2001, which is one year earlier than its introduction in neighboring Japan. To look at this issue from a broader angle, it took just three decades for China to transform itself from “non-existent” in the world economic order to jump to
the second largest economy, and many novel governance structures and corporate law concepts accompanied these shifts.

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

In most legal mechanisms transplanted from one country to another, it is too optimistic to expect that good governance can be easily achieved by a single legal transplant without necessary supports from other institutions and constituencies. As conditions evolve, the possible changes in the design of the independent director, as well as its observations and explanations, must link to the changes in the relevant socio-economic conditions. From a practical sense, those structural changes may create new dynamics to overcome the seeming mismatch between the independent director and its environment, or provide an opportunity to completely re-design this mechanism to fit the whole structure better.
Before the correct course can be concluded, a careful examination and analysis of the current rule and environment are needed. The structure of this article is as follows: Part II will provide a brief history of Chinese Economic Reform and the basic structure about Chinese company law, and then discuss the legal framework about independent directors in Chinese corporate law. Part III will focus on structural issues of Chinese corporate governance and recent changes, which include the modernization of state-owned enterprises, the banking sector and the stock market. It will highlight the difficulties, as well as the possibilities, this mechanism faces in a broader picture. Part IV will include several different surveys of the result of this new legal design. This section will provide a more comprehensive view on the implementation after its first decade in China. Also, the critiques toward this new mechanism will be examined and assessed. Part V starts with an analysis of the core governance issues China is dealing with today and to what extent the current independent director mechanism is helping to solve those issues. After discussing its current ineffectiveness, this section will propose two possible models in which the independent directors can play a role as the social, economic, and political conditions continue to evolve in China. The purpose of this analysis is to help answer the question whether the independent director is a reasonable choice in light of the current conditions in China and the possible strategies to maximize its efficacy. Part VI will briefly conclude this article.
II. CHINESE CORPORATE LAW AND THE LEGAL SETTING OF INDEPENDENT DIRECTOR

1. The Forming of the Modern Corporate Mechanism

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

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

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

A. Historical Roots of Economic Reform in China

Before the mid-1980s, most of the production of goods and services in China had been controlled and conducted by state-owned enterprises (SOEs). At that time, there were no private property rights in the strict sense. The government held all property ownership and managerial rights in state-owned enterprises, and the state was the only dominant actor in economic activities. Under that regime, the concept of state ownership not only depressed the growth of the private sector in China, but also concurrently deprived state-owned enterprises of economic and legal independence. The state-owned enterprise executives were required to fulfill the production plans of the government and the terms “corporation” or ”legal person” did not exist at all.1

China’s market-oriented economic reform started in 1978. In the process of economic reform, the major task was to transform the planned economy, which was previously

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1 Cindy A. Schipani & Junhai Liu, Corporate Governance in China: Then and Now, 2002 COLUM. BUS. L. REV. 1, 5-6 (2002).
dominated by state-owned enterprises, into market-oriented, privately owned and run productivity units. Based on the literature discussing Chinese economic reform, on the enterprise level, the reform is divided into four stages. Each of the stages represents a gradual shift to the modern concept of the corporation.

a. Stage One: 1979-1983

The first stage of reform started in 1979. The main purpose of this stage was to set up a profit retention system that allowed state-owned enterprises to retain part of their profits to use at their own disposal. Before that, state-owned enterprises needed to hand in all profits to the state authorities. State-owned enterprises were also permitted to exert discretion or autonomy when they met state planning targets. This represented a first step of departure from the central planning system where enterprises operated under state

\[\text{\textsuperscript{2}}\text{ The classification here is based on the observation of the emergence of the modern western-style company. The emphasis is on the enterprise level but does not necessarily coincide with the view from macroeconomics. Other classifications have been introduced based on different viewpoints. For example, Gao divides the Reform Era into three stages: the first stage was from December 1978 (the third Plenary Session of the 11th National Congress of the Communist Party of China) to September 1984, which focused on rural area and established household responsibility system and township enterprises. The second stage was from October 1984 (the third Plenary Session of the 12th National Congress of Communist Party of China) to December 1991, and it expanded the reform from rural areas to urban area and focused on the reform of state owned enterprises. The system of contracts on enterprise leasing was introduced, and management responsibility was set up in this period. The third stage was from January 1992 to the present, and aimed at establishing a socialist market economy. Its core purpose was to replace fiscal contract systems with a tax-sharing system, and many other structural adjustments were implemented. GAO SHANQUAN, \textsc{Two Decades of Reform in China} 19-21 (1999).}\]
mandatory planning and were in nature just like divisions of the state administrative apparatus.³

b. Stage Two: 1984-1986

The second stage was the tax-for-profit reform from 1983 to 1986. Its objective was to gradually substitute a uniform income tax system for the case-by-case bargaining regime of profit remittance. In this design, all enterprises should be responsible for their own profits and losses and to engage on an equal footing in competition. This reform was a clear indication of an effort to distinguish state from enterprise and pursue a more market-oriented economy.⁴

c. Stage Two: 1987-1993

The third phase of reform was the adoption of the “Contract Management System.” This system abandoned the pursuit of a standardized, generally applicable rate of the state-enterprise division of enterprise profits. Instead, its aim was to allow SOEs to keep all of the above-base profits (in which the base was adjustable), and then endow more autonomy to SOEs’ managers. The essence of this stage of reform was to further separate ownership and control but at the time keep the bargaining process formal rather than ad hoc. In most cases, the state will represent all outside interested parties through a unified contract-issuing committee and negotiate a contract with all inside members represented


⁴ Id.
by management. In the bargaining process, quite understandably, serious problems occurred, such as exploitation by informational asymmetry. Moreover, management tended to take more risks and over-expand in good times and ask for re-negotiation when the situation turned in the opposite direction. In short, while trying to conceive a more reasonable division of profit sharing between SOEs managers and the state, the state still remained ultimately responsible (legally and economically) for rescuing SOEs, a need which became more frequent after a decade of reform.5

From 1984 to 1993, the SOE reform was shaped by the wish to encourage the expansion of production and profit. This was obviously a reaction to the low productivity of traditional SOEs and the corresponding shortage of merchant supply. In this period, the government set the goal of SOE reform to make SOEs responsible for their gains and losses in the market. To achieve this goal, policy makers devoted much effort to separate ownership from management rights in SOEs, allow managerial independence and allow the state to transform itself as a major shareholder. This effort combined the desire to promote productivity and retain the ultimate control over large SOEs. This process was institutionalized by two major pieces of legislation.

In 1988, China promulgated the “Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People”, also known as *State-Owned Industrial Enterprises Owned by the Whole People*, also known as *State-Owned Industrial Enterprises Owned by the Whole People*, also known as *State-Owned Industrial Enterprises Owned by the Whole People*, also known as State-Owned Industrial Enterprises Owned by the Whole People*, also known as *State-Owned Industrial Enterprises Owned by the Whole People*, also known as State-Owned Industrial Enterprises Owned by the Whole People*.5

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Enterprises Law of China, or shortened as “SOEs Law”. Before the enactment of
Company Law 1993, the SOEs Law of 1988 was the main governing law on the issues of
business organization and the operation of state enterprises in China. The basic idea of
SOEs Law of 1988 is that it delegated overall responsibility of managing SOEs to factory
managers. In this regard, managers became the legal representatives of the enterprise.
Additionally, the law required the establishment of a management committee or other
consulting bodies to assist the factory manager in making decisions on important issues.
The SOEs Law also provides that the local organization of the Chinese Communist Party
should guarantee and supervise the implementation of the guiding principles and policies
of the Communist party and the state. Enterprise is allowed, through the employees'
congress and other forms, to practice democratic management. Trade unions are
permitted to represent and safeguard the employees' interests, and employees may
organize and participate in democratic management and supervision. From a broader
view, the SOEs Law in fact was the experimental, and primitive, form of the general
Company Law of 1993. It represented the first attempt to put the relationship among
managers, the state and employees into the form of legal rule.

6 Quanmin suoyouzhi gongye qiye fa[Law of the People's Republic of China on Industrial Enterprises
Owned by the Whole People](promulgated by Nat’l People’s Cong., April 13, 1988, effective August 1,
1988). For an introduction on SOEs Law, see Cindy A. Schipani & Junhai Liu, supra note 1, at 9-12.

7 Law on Industrial Enterprises Owned by the Whole People, art. 47.

8 However, as an interim legislation which covered state owned enterprises only, it was incapable of
laying a foundation for future business development in China since there were still much inconsistency and
confusion. After the enactment of Company Law 1993, many SOEs have transformed themselves to
corporations with legal person status and are no longer subject to SOEs Law.
During this period of SOE reform, the contracting system and the notion of contract were gradually adopted in many SOEs to govern the relationship between the state and the factory director/manager. Government agencies and factory managers are the parties of this contract. This system was operated in a way that allowed the factory to keep all of the remaining profit after they paid the fixed (as agreed by the contract) amount of profit to the state.

However, for a number of reasons, the contracting system and the transitional model it represented failed to provide much in the way of SOE reform. First, it was very difficult to identify a reasonable minimum amount of profit for the SOEs to pay to the State. Second, although most SOEs enjoyed benefits when they were profitable, they were unable to pay the fixed amounts required to the State when they sustained losses. Third, there was a fair amount of exploitation of the assets of SOEs for personal use.

Finally, too minimal an amount of SOE profits were retained for development purposes, leaving insufficient resources for future expansion. With these problems in mind, SOE reform in 1993 reflected a desire to build a modern enterprise system compatible with the market economy. To achieve this goal, Chinese policy-makers began to look to the modern corporate model in the Western world for possible solutions.

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

The impact of the introduction of the modern company in China is multifaceted. With the goal of transforming SOEs into companies with modern organizational form, the Company Law 1993 sets up a new group of relationships among state, managers along with workers. From the legal perspective, the status of independent legal entity provided the foundation for increased managerial freedom. The formation of the separate legal enterprise entity also helped to strengthen the confidence of general investors about state neutrality, which in turn helped to increase the influx of new outside capital.

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In fact, the *Company Law 1993* brought not only legal reforms but an influx of private capital. The socialist state is owned by the people and thus there existed an implicit contract in which state was obliged to guarantee job security and a certain level of social welfare. But with the corporatization of SOEs and the delegation of managing power, the dynamics had changed dramatically. Especially under the drive for profit, a large number of former SOEs started substantial downsizing and lay-offs. This trend in turn reshaped the role of the state and triggered social discontent. Many scandals were reported in the process of corporatization of the SOEs, and the selling of state asset cheaply, misuses of the fund from the sale of assets, and political corruption presented severe challenges to the Chinese government.

In this light, the demand that the state oversee those newly-created companies has been repeated since the enactment of Company Law. In fact, both central and local government in China are still cautious about to those former SOEs and continuously exert their influence to curb (although not always successfully) unwanted corporate behaviors. Specifically, the state maintained its influence both through regulation and its status as a shareholder. The Chinese Communist Party has exercised its control over the selection and dismissal of SOE managers through its organization department at different levels. For example, the Central Party Organization Department has the authority over appointments of the top managers of very large SOEs (the level of minister or deputy minister), as does the provincial or municipality party organization department for most large and medium-sized SOEs (the level of bureau chief or deputy bureau chief).
However, a new class of capitalists has been emerging ever since the advent of the Company Law of 1993 and it has started step by step to gain its own standing free from governmental control. In this light, the interplay between the state and companies has started inevitably to move toward a more rule-based legal form, and this leads to further dependence on the development and implementation of the Company Law and relevant business regulations.


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

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10 For an introduction to the earlier experimental legislations during the prior stage of Economic Reform, see Roman Tomasic & Jian Fu, *Company Law in China, in COMPANY LAW IN EAST ASIA* 149, 155 (Roman Tomasic ed., 1999).
dealing with the corporate form, the Company Law 1993 was generally considered to be strongly influenced by German and Japanese Company Law, although several other countries' legal systems are also referenced. From the lens of comparative law, Chinese company law has a relatively simple structure and involves many rules similar to Western company laws, but still possesses a socialist tint.

The Company Law 1993 experienced two minor adjustments in 1999 and 2004 respectively.11 On October 27, 2005, after one and half years' preparation and deliberation, the Eighteen Session of the Standing Committee of the Tenth National People's Congress promulgated a revised Company Law (hereinafter Company Law 2005 or Company Law) which came into effect on January 1, 2006. In Company Law 2005, the general frame and rules of the previous version were preserved, roughly forty articles were modified, and the total number of articles slightly downsized to 219 articles. These changes mainly include the lower legal capital requirement, improvement of corporate governance structure (especially strengthening the power of the board of supervisors), a more clearly defined directorial fiduciary duty, and rules concerning shareholder suits. The aim of this revision is to adjust the previous laws to fit current needs. But in general, as mentioned earlier, the Company Law 2005 is considered an adjustment or refinement of the Company Law 1993 but not presenting any fundamental change either in structure or to the rules themselves.

11 The first amendment was promulgated on Dec 25, 1999 and became effective on the same day. The second amendment was promulgated on Aug. 28, 2004 and became effective on the same day. As all amendments are incorporated into the original text, all articles are cited according to the latest version unless noted otherwise.
This section will provide an overview of the *Company Law 2005*, and the significant differences between *Company Law 1993* and *Company Law 2005*, if needed, will be particularly indicated.

C. General Feature

The Company Law keeps a high degree of similarity to many modern corporate laws. Fundamental characteristics such as independent legal entity status, shareholders’ limited liability, shareholders’ right to choose managers and central management, are stipulated.\(^{12}\)

D. Types of Companies

Chinese Company Law recognizes only two types of corporations: closely held corporation (*you xian ze ren gong si*) and publicly held corporation (*gu fen you xian gong*

\(^{12}\) *COMPANY LAW*, art. 3. However, in terms of free transferability, the Chinese Company Law encountered much on this point when *Company Law 1993* was enacted. The reason for this predicament was partly due to the ideological restrictions on the concept of private property in China, which had been a socialist country and was still struggling to transform itself to a market economy at the time when Company Law was enacted. Another reason for this was the existence of extensive state owned capital in China and the difficulty in accommodating it to a market economy. This background led to the unique split share structure as a compromise. For further discussion, see *infra* III, 1, D.
The principal differences between these two types of companies are: (1) the former is limited to 50 members and the latter does not have upper limit; (2) the former is limited for the transferability of shares; (3) the former is limited in its ability to raise funds from the general public.

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

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13 COMPANY LAW, art. 2. This categorization varies according to different translators. Some refer them as “Limited Liability Company” and “Joint Stock Limited Company.” See, e.g., Roman Tomasic & Jian Fu, supra note 9; LIN FENG ET AL., COMPANY AND SECURITIES LAW IN CHINA, 11, 31 (2001). According to the official translation provided by National People’s Congress, they are referred as “company with limited liability” and “company limited by shares” respectively. For official English translation of Company Law, see National People’s Congress, Database for Laws and Regulations, http://www.npc.gov.cn/englishnpc/Law/Frameset-page.html (follow “Civil And Commercial Laws” hyperlink; then follow “Companies Law of the People's Republic of China” hyperlink).

14 COMPANY LAW art. 24.

15 Id. art. 72.

16 Id. art. 9.

17 Within each category of the corporation there are special provisions applicable to subcategories, organized according to the corporation's ownership structure. They include: (1) wholly foreign-invested enterprises; (2) Chinese-foreign equity joint ventures; and (3) Chinese-foreign contractual joint ventures. These types of foreign-invested corporations are governed by three separate laws: the “Wholly Foreign-invested Enterprises Law” of 1986 (also called “Law of the People's Republic of China on Foreign-Capital Enterprises,” enacted on April 12, 1986), the “Chinese-foreign Equity Joint Ventures Law” of 1979 (also called as “Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures,” enacted by
E. Basic Corporate Organs

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

a. Shareholder Meeting

First, article 4 of Company Law lays the foundation for corporate governance by
stating that the shareholders are empowered to make major decisions and select
management personnel. Further in article 38 and 100, the power endowed to the

the National People’s Congress on July 1, 1979), and the “Chinese-foreign Contractual Joint Ventures Law”
of 1988 (also called as “Law of the People's Republic of China on Chinese-Foreign Contractual Joint
Ventures,” enacted on April 13, 1988). The relationship between Company Law and these three statutes is
still unclear. Generally, it is believed that these three legislations will prevail. But as China has joined the
WTO since 2001, it becomes obligated to provide national treatment to foreign investors coming from
other WTO member countries. It is also expected that the statutes regulating foreign investments will be
repealed and Chinese-invested corporations and foreign-invested corporations will be governed by the
same corporate governance norms. Schipani & Liu, supra note 1, at 19-21. However, all these three
legislations are still effective up to this date.

18 In fact, the word used in Article 4, on its face, is to allow shareholders to “participate” in major
decisions but not “make” major decisions. The interpretation of “make major decisions” is based on the
stipulation of Article 38 (which is also applied to public-held company according to Article 100). However,
this difference in the wording in these two articles still implies a possible uncertainty in terms of dividing
the decision-making power between shareholders and board of directors.
shareholder meeting mainly include the power to: (1) decide the management policy and investment plan, company elections, and the removal of directors and supervisors;\(^\text{19}\) (2) amend corporate charters;\(^\text{20}\) (3) approve the annual budget\(^\text{21}\) and directors’ and supervisors’ report,\(^\text{22}\) and the plan of profit distribution;\(^\text{23}\) and (4) make other important decisions such as mergers, divestiture, liquidation, and dissolution/other structural changes,\(^\text{24}\) increasing or decreasing corporate legal capital\(^\text{25}\) and the issuance of corporate bonds.\(^\text{26}\)

In terms of voting, the assignment of voting rights is accorded to the amount of capital invested in a privately-held company,\(^\text{27}\) and in a publicly-held company (joint stock company), one share one vote is the default rule.\(^\text{28}\) Shareholder meetings should be held annually and are subject to interim meetings if certain conditions are met.\(^\text{29}\)

\(^{19}\) COMPANY LAW, art.38, para. 1, no. 1.

\(^{20}\) Id. art.38, para. 1, no. 10.

\(^{21}\) Id. art.38, para. 1, no. 5.

\(^{22}\) Id. art.38, para. 1, no. 3, 4.

\(^{23}\) Id. art.38, para. 1, no. 6.

\(^{24}\) Id. art.38, para. 1, no. 9.

\(^{25}\) Id. art.38, para. 1, no. 7.

\(^{26}\) Id. art.38, para. 1, no. 8.

\(^{27}\) Id. art.43. However, proportionate voting power in privately-held companies is subject to change by amending the articles of incorporation. Id.

\(^{28}\) Id. art.104.

\(^{29}\) Id. art. 40, 101. For privately-held company, one tenth of shareholder, one third of directors or supervisor/board of supervisors can demand an interim shareholder meeting. Id. art. 40. For publicly-held
b. Board of Directors

The board of directors is responsible to the shareholders meeting in terms of carrying out the company’s business, and bears the ultimate responsibility to the shareholder meeting.\(^{30}\) In article 47, Company Law stipulates that the authority of the board of directors mainly includes to “carry out the resolution made by shareholder meeting”, \(^{31}\) and decide the business management as well as investment plan\(^{32}\) and choose managers.\(^{33}\) Also, board of directors is responsible for preparing proposals for the shareholder meeting. The subjects of proposal include company’s annual budget,\(^{34}\) profit distribution,\(^{35}\) increase or decrease company’s capital,\(^{36}\) issuance of corporate bond,\(^{37}\) setting up internal departments\(^{38}\) and company’s internal management systems and company, in addition to the conditions mentioned above, an interim shareholder meeting should be convened if (1) the number of incumbent directors is less than two third of the stipulated number; or (2) accumulated loss reaches one third of the received capital. \textit{Id.} art. 101.

\(^{30}\) \textit{Id.} art.47, para. 1.

\(^{31}\) \textit{Id.} art.47, para. 1, no. 2.

\(^{32}\) \textit{Id.} art.47, para. 1, no. 3.

\(^{33}\) \textit{Id.} art.47, para. 1, no. 9.

\(^{34}\) \textit{Id.} art.47, para. 1, no. 4.

\(^{35}\) \textit{Id.} art.47, para. 1, no. 5.

\(^{36}\) \textit{Id.} art.47, para. 1, no. 6.

\(^{37}\) \textit{Id.}

\(^{38}\) \textit{Id.} art.47, para. 1, no. 8.
regulations,\textsuperscript{39} and other major structural changes including merger, divestiture and company dissolution.\textsuperscript{40}

In general, directors and manager of a company shall abide by the provisions of the articles of association, faithfully perform their duties, protect the interests of the company and may not exploit their positions and powers to seek personal gains.\textsuperscript{41} This is generally interpreted as the source of “duty of loyalty” and “duty of diligence” in Chinese company law. These duties also apply to supervisors and managers and the breach of these duties will incur civil liability.\textsuperscript{42}

The number of directors is 3 to 13 in closely held company,\textsuperscript{43} and 5 to 19 and publicly held company respectively \textsuperscript{44}, and the term of director is up to three years.\textsuperscript{45} It is also required by law to have at least two board meetings a year in publicly-held company.\textsuperscript{46} One thing of particular interest concerning board of directors in Chinese company law is the employee representative in board. According to current rule, it is encouraged to have employee representative on board as director in both publicly- and privately-held

\textsuperscript{39} Id. art.47, para. 1, no. 10.
\textsuperscript{40} Id. art.47, para. 1, no. 7.
\textsuperscript{41} Id. art. 148.
\textsuperscript{42} Id. art. 150.
\textsuperscript{43} Id. art. 45.
\textsuperscript{44} Id. art. 109 para. 1.
\textsuperscript{45} Id. art. 46 and art. 109 para. 3.
\textsuperscript{46} Id. art. 111. The same requirement does not apply to privately-held company.
company.\footnote{id. art. 45, para. 2 and art. 109 para. 2.} If the privately-held company is formed by more than two SOEs, it becomes required to have employee representative as board member.\footnote{id. art. 45, para. 2. Please note the same requirement does not apply to publicly-held company.} In addition, smaller privately-held company can have only one executive director, instead of a whole board, to carry out its duty if the corporate charter considers it appropriate.\footnote{id. art. 51.}

c. Board of Supervisors

According to article 52 and 118 of Chinese company law, the board of supervisors is made up of at least three supervisors.\footnote{id. art. 52 para. 1 and art. 118 para. 1. However, it is permissible for privately-held company to avoid forming a board of supervisors and have one or two supervisors instead. Id. art. 52 para. 1.} The board of supervisors should have at least one third of its members from representatives of employees and workers,\footnote{id. art. 52, para. 2 and art. 118, para. 2.} as the remaining members are elected by shareholder meeting. The specific proportion of worker representative shall be provided for in the articles of association.\footnote{id. para. 2 and art. 118, para. 2.} The representatives of workers shall be elected by workers through employee meeting or union, or other democratic processes.\footnote{id.}

The function of supervisors, according to article 54 and article 119 of Chinese company law, is to supervise the board of the directors. The details of its power include:
(1) to investigate the company’s financial affairs;\textsuperscript{54} (2) to supervise acts undertaken by directors and managers during the performance of their duties and propose to remove directors or managers when serious breach occurs;\textsuperscript{55} (3) to request directors or managers to rectify conduct which is harmful to the interest of the company;\textsuperscript{56} (4) propose to call an interim shareholder meeting;\textsuperscript{57} (5) bring forth motion in shareholders meeting;\textsuperscript{58} (6) file derivative suits against directors when director breach the duty to abide the law, administrative rules and articles of corporate charter;\textsuperscript{59} (7) other power stipulated in the corporate charter.\textsuperscript{60} Based on article 55, supervisors can present in the board of directors' meeting, and make recommendation or challenge the decisions of the board of directors.\textsuperscript{61} Also, the board of supervisors has the right to conduct investigations when irregularity is spotted.\textsuperscript{62}

The term of supervisor is three years.\textsuperscript{63} Concerning the convening of the meeting of board of supervisors, in closely-held company, it is mandatory for supervisors to meet at

\textsuperscript{54} Id. art. 52, para. 1, no. 1.
\textsuperscript{55} Id. art. 52, para. 1, no. 2.
\textsuperscript{56} Id. art. 52, para. 1, no. 3.
\textsuperscript{57} Id. art. 52, para. 1, no. 4.
\textsuperscript{58} Id. art. 52, para. 1, no. 5.
\textsuperscript{59} Id. art. 52, para. 1, no. 6.
\textsuperscript{60} Id. art. 52, para. 1, no. 7.
\textsuperscript{61} Id. art. 55, para. 1.
\textsuperscript{62} Id. art. 55, para. 2.
\textsuperscript{63} Id. art. 53, para. 1 and art. 118, para. 5.
least once a year.\textsuperscript{64} In publicly-held company, supervisors are bounded to meet at least every six months.\textsuperscript{65} Supervisors are subject to all duties and liabilities that are applicable to directors and managers, such as duty to abide the law and regulations, good faith and diligence, and the restraints on self-dealing.\textsuperscript{66}

F. Divisions of Power among Corporate Organs

Despite the seemingly clear-cut nature of the corporate powers of the different corporate organs, two somewhat blurred areas are the division of business decision power between the shareholders and directors and the reach of the oversight powers of the supervisors. These two issues are haunting Chinese company law, as they do in many other countries adopting the two-board structure, and the situation turned even worse after independent director became part of the balancing game inside the company in 2001.

a. Management Power Division between Shareholder Meeting and Board of Directors

Shareholders in China are invested with more power from a comparative perspective. Article 4 of Company Law stipulates that shareholders are empowered to make major decisions and select management personnel in proportion to the amount of capital that they have invested in company. In Article 38, paragraph 1, no. 1, it also empowers the

\textsuperscript{64} Id. art. 56, para. 1.
\textsuperscript{65} Id. art. 120, para. 1.
\textsuperscript{66} Id. art. 148.
shareholders meeting to “decide on the management policy and investment plan of the company.”\textsuperscript{67} Based on the language expressed explicitly in these articles, it appears that Chinese company law tips the balance of the corporate decision power toward shareholders and endows a greater range of participation in business decisions for shareholders, which weakens the power of the board of directors.

However, Article 47 of Company Law, which concerns the power of the board of directors, shows a somewhat different picture. Under Article 47, paragraph1, no.3, the board of director has the same managing power to “decide the management plan and investment project”.\textsuperscript{68} Further in no. 8 and 10 of the same paragraph, it also stipulates that it is the role of board of directors to set up internal organs or departments and other management systems and regulations.\textsuperscript{69} Simply observing the language used for describing the power of the board of directors, it seems as though Article 47 provides a general and extensive managing power to the board of directors.

But this interpretation might bump against Article 47 no. 1 and 2 of the same article. As Article 47, paragraph1, no. 1 and 2 indicate, it is clear that the primary tasks of the board of directors is to “convene the shareholder meeting and report the execution of its work to the shareholder meeting” and “carry out the resolution of shareholder meeting.”\textsuperscript{70} Following this line and pulling all pieces together, it appears that Chinese company law

\textsuperscript{67} Id. art. 38, para. 1, no. 1.

\textsuperscript{68} Id. art. 47, para. 1, no. 3.

\textsuperscript{69} Id. art. 47, para. 1, no. 8 and 10.

\textsuperscript{70} Id. art. 47, para. 1, no. 1 and 2.
has adopted an approach that provides less managerial discretion to directors and requires board of directors to defer to the extensive decision-making power of shareholders if shareholders explicitly use it. In this sense, the managerial power board of directors has is more supplementary and restricted in Chinese company law, and it can be fairly said that management power is divided at its best. However, the exact dividing line in real life is more complicated and is still unclear under current rule. Noticeably, this debate is largely limited to a theoretical level now, as the unique capital structure in many Chinese public companies effectively reduces the possibility of disagreement between board of director and shareholder meeting. But this issue is likely to come back with severity when the current capital structure is no longer stable or gradually changes in time.

b. The Overseeing Power of Supervisors and Its Limit

The line between the directors’ managing power and supervisors’ oversight power is another issue that is not clearly answered in Chinese law. This is an issue commonly encountered by countries who adopt a two-board structure. Compared to many other countries, however, Chinese Company Law has a mixed method, intentionally or not, for handling this issue and has a quite unique attribution to its supervisors as a result.

To begin with, in Chinese Company Law, it is stipulated that a supervisor cannot be a manager or a director at the same time. This rule is aimed at increasing the segregation between management and the body responsible for oversight of the same company, at the

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71 Id. art. 58, para. 4; art. 118, para. 4.
same time as a usual assertion which can be found in many countries using dual board structure. However, this stipulation has left much uncertainty. In Article 54 paragraph 2, which is the main article about the authority of the board of supervisors, it only says that the power of supervisors includes the power to “oversee the behaviors of directors and managers in connection to their performing of duties, (and) file motion (to shareholders meeting) to remove directors or managers when they violate laws, administrative regulations or articles of incorporation.” However, Article 54 paragraph 2 does not provide a clear delineation about the range of the items that are subject to supervisors’ oversight. According to the text, the plain interpretation is that the range of the supervisors’ oversight power covers everything related to “performing directorial and managerial duties.” If this text works as its plain language indicates, the oversight power of supervisors in China is in fact almost unlimited, and it will in turn decrease the breadth of the discretion of directors, blur the line between directors and supervisors, and make supervisors the ultimate decision makers in a company.

This confusion is exacerbated by another unusual rule in Company Law. Article 55 provides supervisors the right to attend the meeting of the board of directors and make

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72 For example, Japanese Companies Act article 335 paragraph 2 stipulates that supervisors (“Kansayaku,” also often translated as “corporate auditors”) cannot be held by directors or employees of the same company (including its subsidiaries). Shoho [Commercial Code] art. 335, para. 2 (Japan). For a general introduction on Japanese supervisors system, see e.g., Chien-Chung Lin, The Japanese Independent Director Mechanism Revisited: The Corporate Law Setting, Current Status, and Its Explanations, 24 TEMP. INT'L & COMP. L.J. 65, 84-5 (2010).
direct inquiry or recommendation to anything concerning board resolutions. But there is no further detail provided in Chinese company law or relevant regulations about what will happen if the disagreements between directors and supervisors occur and the effect or applicable procedure to solve it. From a comparative perspective, this rule is noticeable as both directors and supervisors are directly elected by shareholder meeting, and further compounds the already blurred line of power allocating the duties of directors and supervisors.

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

73 Id. art. 55, para. 1; art. 119.

The aforementioned discussions suggest that Chinese Company Law collectively reveals a mentality in China that includes a strong sense of caution and distrust toward corporate directors and managers, as director and managers (or more precisely, including controlling private shareholder) have successfully accumulated great wealth and power over the past economic reforms and privatization. Partly due to the historical socialist roots and social problems triggered in the course of transforming state capital into private control, this perception effectively changed the formation of Chinese Company Law. However, the issue of how to divide different power among these corporate organs is an issue unsolved and might need to be decided on a case-by-case basis. This in turn will beg for more court decisions to substantiate this field in the future.

G. Shareholder Suits

The shareholder suit in Chinese Company Law is arguably a dual-track design. There are only two articles about the shareholder suits, and both are newly added in the 2005 Amendment. Before the 2005 amendment, minority shareholders could bring matters to the supervisors’ attention and request their intervention. But due to the limited performance of supervisors in China, shareholders’ only resort is to appeal to the shareholders’ meeting to stop any illegal or improper conduct by directors or managers. But this resort does not have much meaning when shareholders are in minority position.

However, the language used in these two articles about the shareholder suits does not provide a clear picture to understand how the shareholder suit mechanism can or should
work. Company Law Article 152 is about derivative suits. According to Article 152, any shareholder in a closely-held company, or shareholder who holds more than one percent of the outstanding stock in a publicly-held company, can demand the board of supervisors to file a suit against directors or managers if they breach the their duty described in Article 150.\textsuperscript{75} Qualified shareholders can only bring the suit directly if the board of supervisors refuses to file the suit, or fails to file the suit within thirty days, or when emergent situation or irreparable damage exists.\textsuperscript{76} Shareholders can use the same rule to bring suit against supervisor, as shareholder should demand board of directors to bring the suit instead.\textsuperscript{77}

As of the cause of action, article 150 is a rather simple rule itself and stipulates that directors, supervisors and managers are subject to civil liability when they violate a law, relevant administrative rules or corporate charter and incur damage to company thereby.\textsuperscript{78} In Article 148 and 149 of Company Law, a rather detailed list of the legal obligations that directors, supervisors and managers should observe is provided. In Article 148, it provides that directors, supervisors and managers should assume the duty to obey law and regulation, duty of loyalty (good faith) and duty of diligence (care).\textsuperscript{79} It also prohibits them from taking bribes and misappropriating company property.\textsuperscript{80} In Article 149, it

\textsuperscript{75} Company Law of the People's Republic of China, art.152, para. 1.

\textsuperscript{76} Id. art. 152, para. 2.

\textsuperscript{77} Id. art. 152, para. 1.

\textsuperscript{78} Id. art. 150.

\textsuperscript{79} Id. art. 148, para. 1.

\textsuperscript{80} Id. art. 148, para. 2.
proscribes directors, supervisors and managers from conducting any of the following: (1) misappropriating corporate funds; (2) placing corporate funds in private accounts; (3) lending corporate funds or provide corporate assets as collaterals to any third party without the provision of the articles of incorporation, prior consent from board of directors or consent from shareholders; (4) conducting any transaction involving self dealing without the provision of the articles of incorporation or prior consent from shareholders; (5) exploiting corporate opportunity or assuming any positions in other similar business without the prior consent from the shareholders; (6) taking commission from another company which transacts business with the company; (7) leaking confidential business information; or (8) performing any other breach of loyalty to the company. In short, Article 148 is about the duty to abide the law and the duty of diligence, and Article 149 is a general provision about the duty of loyalty.

Article 153 is about shareholder direct suits. Unfortunately, this is an article that in fact triggers more confusion than clarity. Article 153 says: “If directors and managers breach the law, regulations or corporate chapter and cause damage to shareholders,
shareholders can bring suit to court.” On its face, Article 153 talks about exactly the same cause as mentioned in Article 152 but applies a different procedure. Due to the limited amount of time since the implementation of the 2005 Amendment of Chinese Company Law, there is not much academic discussion available concerning the direct shareholder suit and its application.89

89 Shareholder suits in China in the last decade were mostly arising from misrepresentation in stock market cases based on the Securities Law Article 69 (formerly Article 63 before the 2005 amendment). In fact, in addition to the limited occasion of shareholder suits provided in Company Law, Securities Law permits two causes of action for shareholders to institute suits, which are Article 47 (the rule about short-swing and speculative share trading) and Article 69 respectively. Securities Law Article 69 prohibits misrepresentation in the prospectus, financial and accounting reports, and annual report. It reads: “If the share prospectus, measures for offer of corporate bonds, financial and accounting statements, listing report document, annual report, interim report, ad hoc report or other disclosure materials announced by an issuer or listed company contain any false record, misleading statement or major omission, thus causing losses to investors in the course of securities trading, the issuer or the listed company shall be liable for the losses; the directors, supervisors, senior executives and other personnel directly responsible for of the issuer or the listed company, the sponsor, and the underwriting securities company shall be jointly and severally liable for such losses.”

One study conducted by Royal Institute of International Affairs (now Chatham House) in 2003 compiles a list of 12 companies involved as defendants in the first wave of private securities litigation in China, which includes ST Shandong Bohai, ST Shanghai Tongda Innovation Investment, ST Yantai Dongfang Electronic Information, ST Shanghai Jiabao Shiyi, ST Fujian Jiuzhou Group, Xian Shengfang Keji, ST Yi An Technology, Shenzhen Sanjiu Medical, ST Guangxia (Yinchuan) Industry, Hubei Tianyi Science and Technology, Daqing Lianyi, and ST Chengdu Boxun Shuma Technology. Eleven of the twelve are about account falsification and misrepresentation, and the remaining one is about tax evasion and other breaches of law. Stephen Green, Better than a Casino: Some Good News from the Frontline of China’s Capital Market Reforms, ASIA PROGRAMME WORKING PAPER, NO. 6, CHATHAM HOUSE, 13-15 (2003)
H. Supplementary Note

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

However, the problems created by an inadequate statute are not solved simply by relying on the administrative supplement of explanatory rules. The lack of experience among legislators in conceiving the kinds of situations the law needs to deal with, along

(available at: http://www.chathamhouse.org.uk/researchasia/papers/view/-/id/142. Last visited July 7, 2011). Interestingly, no damages have been awarded by the courts, and settlements have ranged from USD 97 to USD 27,000 (for 11 investors). Furthermore, courts are rumored to be forcing larger group suits to be split up into smaller group suits to bolster court fee income. See Id. at 13, 15. For some case studies in the 1990s and early 2000s, see Donald C. Clarke, Law Without Order in Chinese Corporate Governance Institutions, 30 NW. J. INT'L L. & BUS. 131, 192-95 (2010).
with the lack of techniques for drafting its formulation with precision, has created a huge barrier among practitioners to understanding of how company law applies in certain cases. Further, academic work in China, although having experienced a period of impressive progress, is still developing and not yet capable of providing the help needed in borderline cases. The lack of judicial precedents to fill the holes left by the relatively unclear language in statutes is another difficulty. Sometimes there is concern about applying extreme cases more generally especially in light of the somewhat doubtful decision quality in some lower courts. In sum, both judicial decisions and academic work in China are not helping very much to fill in the gaps created by Chinese Company Law.

3. The Introduction of Independent Directors

The introduction of independent director mechanism to China was mainly a unilateral decision of the administrative branch, rather than a result of natural evolution of corporate governance or legislative action. In 2001, China Securities Regulatory Commission promulgated “Guidance Opinion on the Establishment of an Independent Director System in Listed Companies” and independent director became mandatory internal organ for all listed companies.

A. Legal Sources of Independent Directors
The term “independent director” first appeared for the time in the “Guiding Opinion for Listed Corporations' Articles of Incorporation” issued by the China Securities Regulatory Commission (CSRC) in December 26, 1997. In article 112 of this regulation, listed companies were advised to retain independent director at their option. In terms of defining “independent director”, it provided that an independent director cannot be a current employee of the company, an employee of a shareholder, or a relative of an interested person or management. Article 112 also encouraged listed company to stipulate the duty and authority of its independent directors in its own charter.

In 2001, the “Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies” (“the 2001 Guideline” hereinafter) was introduced. In


In this new regulation, a basic framework was spelled out for an extensive implementation of the Chinese independent director mechanism. It contained various rules about the qualification and authority of independent directors for all listed companies. Basically, the 2001 Guideline requires each listed company to have at least two independent directors by June 30, 2002 and have one third of its board comprised of independent directors by June 30, 2003. By this means, independent director becomes mandatory corporate organ for all listed companies in China as the 2001 Guideline taking its full effect in 2002.

Following the introduction of the 2001 Guideline, several regulations repeatedly emphasized the determination to carry out the independent director mechanism by the CSRC. In the “Notice on Matters Regarding Further Regulations of Initial Public Offers and Listing of Shares” of September 19, 2003, it is reiterated that issuers shall set up the independent director system following the 2001 Guideline. In this notice, it is stipulated that when a company applies for the initial public offer of shares and listing, at least one-third of the members of the board of directors shall be independent directors, and among them there shall be at least one accounting professional (the accounting professional must carry the senior title of a professional accounting post or the qualification of certified

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92 Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies, art 1, para. 3.

93 For detailed discussion about the rules in the 2001 Opinion, see infra II, 3, C.
public accountant). Also in January 31, 2004, the State Council of China issued
"Several Opinions on Promoting the Reform and Opening-up and Stable Development of Capital Market." This document underscores the importance of independent directors in the reform and development of China's capital market.

Company Law 2005 (effective from January 1, 2006) Article 123 provides a new legal basis for the independent director in Company Law. According to the text, this new article simply states that a company has to set up independent directors according to applicable regulations, and it also delegates to the State Council the power to stipulate detailed rules concerning independent directors. The empty language in this new article does not mandate a broader application of the independent director mechanism in China.

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96 COMPANY LAW, art 123. The language itself only says: “Listed companies shall institute independent directors. Further detail is subject to the rules promulgated by the State of Council.”
in the future. This new article, however, officially provides the independent director a better legal basis in Company Law, and alleviates it from administrative regulation to law. In addition, the rule-making power delegated to State Council is still meaningful if utilized.

B. Reason for the Introduction of the Independent Director in China

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

According to the preface of the 2001 Guideline, the purpose of implementing independent director is to “further improve the governance structure of listed companies and standardize their operation, China Securities Regulatory Commission (CSRC) formulates the Guidelines for Introducing Independent Directors to the Board of Directors in Listed Companies. All listed companies are required to act in accordance with the Guideline.” In article 1 paragraph 2, it states that “….An independent director should protect the interest of its company as a whole (as required by this Guideline and Articles of Association). They also have to pay special attention to protecting the legitimate interest of small and medium shareholders from undue harm. An independent director should fulfill his/her duty independently, without being influenced by major

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97 Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies, preface.
shareholders, persons who exert control over the company, or the (governmental) units and persons who have a relation of interest with other listed companies.” 98

Based on the language used in the 2001 Guideline, the purpose of the introduction of the independent director in China can be generally interpreted as providing more protection to minority shareholders, at the same time protecting the company itself from looting by its managers (referred to “persons who exert control over the company”). To alleviate the problems controlling shareholders bring, by which the minority shareholder is usually harmed, seems to be the major reason the independent director mechanism was imported. To put it in a different way, the controlling/non-controlling shareholder agency problem seems to be the core issue which the 2001 Guideline attempts to address.

However, several facts compound this reasoning. In theory, the traditional agency problem (manager/shareholder agency problem) should have been limited in the Chinese context because the controlling shareholder effectively controls the management as well as the board of the company. But in reality, managerial stripping emerged and remains a serious problem in China. Further, if the controlling shareholder is the government as many SOEs appear to be in China, the problem becomes the potential looting by high-ranking governmental officers (who are appointed as managers in companies themselves, or collaborate with company managers as government officials). Controlled transactions such as self-dealing become an issue despite the highly concentrated capital structure. In this sense, the goal of protecting minority shareholders bumps up against both types of

98 Id. art. 1, para. 2.
agency problems (manager/shareholder; controlling shareholder/non-controlling shareholder), and introducing the independent director mechanism in China seems to be one wished cure for two mixed corporate issues which differ fundamentally from each other.

C. Substantive Rules

a. Definition and General Requirement

First of all, an independent director of the listed company shall mean a director who does not assume any other office except director in the company, and has no relationship, either between him and his company or between him and the main shareholders of this company, that may hinder his independent and objective judgment.\(^{99}\)

Second, the independent director shall fulfill his duties independently; shall not be influenced by the main shareholders, the actual controllers of the company, or other units or individuals with interest relationships with the listed company; and shall prevent the legal rights and interests of small to medium shareholders from being damaged.\(^{100}\)

\(^{99}\) Id. art. 1, para. 1.

\(^{100}\) Id. art. 1, para. 2.
Independent directors should also have five years or more of working experience in law, economics, finance or other relevant field.\textsuperscript{101} Companies must have at least one accounting professional among its independent directors.\textsuperscript{102} Independent directors should also meet the general qualifications requirement for ordinary directors, which are stipulated in Company Law article 147\textsuperscript{103} and an independent director can work as an

\textsuperscript{101} Id. art. 2, para. 4.

\textsuperscript{102} Id. art. 1, para. 3.

\textsuperscript{103} Id. art. 2, para. 1. Company Law article 147 paragraph 1 reads: “None of the following persons may hold the position of director, supervisor or senior executive of a company: (1) A person without capacity or with restricted capacity for civil acts; (2) A person who was sentenced to criminal punishment for the crime of embezzlement, bribery, seizure of property or misappropriation of property or for undermining the socialist market economy order, where not more than five years have elapsed since the expiration of the enforcement period; or a person who was deprived of his political rights for committing a crime, where not more than five years have elapsed since the expiration of the enforcement period; (3) A director, or factory head or manager of a bankrupt and liquidated company or enterprise who was personally responsible for the bankruptcy of the company or enterprise, where not more than three years have elapsed since the date of completion of the bankruptcy liquidation; (4) A legal representative of the company or enterprise that had its business license revoked for violating the law, where such legal representative bears individual liability therefore and not more than three years have elapsed since the date of revocation of the business license; and (5) A person with relatively large amount of personal debts that have fallen due but have not been repaid.”

Paragraph 2 and 3 reads: "Where a company elects or appoints a director or supervisor or engages senior executives in violation of the preceding Paragraph, such election, appointment or engagement shall be invalid. Where any director, supervisor or senior executive of a company during his term of office occurs any circumstance as listed in Paragraph 1 of this Article, the company shall remove him from office.”
independent director for five listed companies at most.\textsuperscript{104} In addition, articles of incorporation may impose additional requirements for independent directors, both in terms of qualifications and code of conducts.\textsuperscript{105}

b. Exclusion

(1) Those who hold posts in a listed company or its subsidiary enterprises, the lineal relatives (spouse, parents, and children, etc.) of those aforementioned persons, and those with significant social relations (sisters and brothers, parents-in-law, daughters-in-law and sons-in-law, spouses of sisters and brothers, sisters and brothers of spouse);\textsuperscript{106}

(2) In the situation of a natural person shareholder, any shareholder who directly or indirectly holds more than 1\% of the shares issued by the listed company or is ranked as one of the top ten shareholders of this company, he/she and their lineal relatives cannot be an independent director;\textsuperscript{107}

(3) In the situation of a corporate shareholder, if it directly or indirectly controls more than 5\% of the shares issued by the listed company or is ranked as one of the top five shareholders of the listed company, employees and their lineal relatives of those corporate shareholders cannot assume the position of independent director;\textsuperscript{108}

(4) Those who once fell into the previous three categories within the last year;\textsuperscript{109}

\textsuperscript{104} Id. art. 1, para. 2.

\textsuperscript{105} Id. art. 2, para. 5.

\textsuperscript{106} Id. art. 3, para. 1.

\textsuperscript{107} Id. art. 3, para. 2.

\textsuperscript{108} Id. art. 3, para. 3.

\textsuperscript{109} Id. art. 3, para. 4.
(5) Persons who provide financial, legal, consulting or similar services for the listed company or its subsidiary enterprises;\textsuperscript{110}

(6) Other personnel as stipulated by the articles of association;\textsuperscript{111} and

(7) Other personnel as determined by CSRC.\textsuperscript{112}

c. Procedure of Selection

(1) Nomination: dependent directors are to be nominated by any of the following, jointly or individually: (a). incumbent members of the board of directors; (b). the board of supervisors; or (c). shareholder who owns more than one percent equity interest.\textsuperscript{113}

(2) Pre-filing to CSRC and CSRC maintains the right to dissent within fifteen days after filing.\textsuperscript{114}

(3) Approved by the resolution of shareholders meeting.\textsuperscript{115}

In reality, independent directors are often selected by controlling shareholders, not by themselves or through the board. Controlling shareholders and management try to select those with some connection to them and who will side with them.\textsuperscript{116}

\textsuperscript{110} Id. art. 3, para. 5.

\textsuperscript{111} Id. art. 3, para. 6.

\textsuperscript{112} Id. art. 3, para. 7.

\textsuperscript{113} Id. art. 4, para. 1.

\textsuperscript{114} Id. art. 4, para. 3.

\textsuperscript{115} Id. art. 4, para. 1.

\textsuperscript{116} For further discussion about the implementation and its critics, see infra IV, 1.
d. Term of Office

The term of independent director is the same as ordinary director (which means it is subject to stipulation in the articles of incorporation and with a maximum of three-year a term)\textsuperscript{117}. Also, the cap of the maximum term of six years applies.\textsuperscript{118}

e. Powers and Obligations

(1). Major related transactions ratification: Major transaction (referring to those of an amount of more than RMB 3,000,000 [roughly 461,538 USD by the exchange rate 6.5/1] or exceeding 5\% of net assets of the listed company) have to obtain ratification from the independent directors before being submitting to the board of directors for discussion.\textsuperscript{119}

(2). Power to request a convention a meeting of board of directors.\textsuperscript{120}

(3). Power to request the board of directors to convene an interim shareholder meeting.\textsuperscript{121}

(4). Power to put forward the proposal to the board of directors relating to the appointment or removal of the accounting firm.\textsuperscript{122}

(5). Power to retain independent counsel.\textsuperscript{123}

\textsuperscript{117} COMPANY LAW art. 46.

\textsuperscript{118} GUIDELINES FOR INTRODUCING INDEPENDENT DIRECTORS TO THE BOARD OF DIRECTORS OF LISTED COMPANIES, art. 4, para. 4.

\textsuperscript{119} Id. art. 5, para. 1, no. 1.

\textsuperscript{120} Id. art. 5, para. 1, no. 4.

\textsuperscript{121} Id. art. 5, para. 1, no. 3.

\textsuperscript{122} Id. art. 5, para. 1, no. 2.

\textsuperscript{123} Id. art. 5, para. 1, no. 5.
(6). Power to solicit proxies.\textsuperscript{124}

(7). If committees of salary and remuneration, auditing, nomination, and so on are established within the board of directors of the listed company, the independent directors shall make up more than one half of the members of these committees.\textsuperscript{125}

(8). Obligations to deliver independent opinions: Independent director has the obligation to deliver independent opinion to the shareholder meeting or board of the directors concerning the nomination and termination of directorship,\textsuperscript{126} the appointment and dismissal of important managing positions,\textsuperscript{127} compensations of directors and high-rank managers,\textsuperscript{128} major loans to related party,\textsuperscript{129} and other proceedings that could damage the interests of minority shareholders.\textsuperscript{130}

(9). Equal right to corporate information. When two or more independent directors determine that the materials presented are not sufficient, they have the right to request a deferment of the related discussion in the meeting of the board of directors or the meeting as a whole.\textsuperscript{131}

\footnotesize{\textsuperscript{124} Id. art. 5, para. 1, no. 6.}
\footnotesize{\textsuperscript{125} Id. art. 5, para. 4.}
\footnotesize{\textsuperscript{126} Id. art. 6, para. 1, no. 1.}
\footnotesize{\textsuperscript{127} Id. art. 6, para. 1, no. 2.}
\footnotesize{\textsuperscript{128} Id. art. 6, para. 1, no. 3.}
\footnotesize{\textsuperscript{129} Id. art. 6, para. 1, no. 4. A Loan over RMB 3,000,000 or 5% of net assets of the listed company is considered as a “major loan” here. Id.}
\footnotesize{\textsuperscript{130} Id. art. 6, para. 1, no. 5.}
\footnotesize{\textsuperscript{131} Id. art. 7, para. 1.}
(10). Enhanced power in ratifying management buyout: In “Administration Measures on Administration of Takeover of Listed Companies”, it prescribes that in the case of management buyout, company should have no less than half of its directors as independent director. In terms of resolution, first the takeover plan shall be carried out upon the resolution of the non-affiliated directors only, and has to obtain approval from two thirds or above of the independent directors, and then be submitted to the shareholders meeting for consent.

(11). Company needs to disclose the relevant information when the requests or proposition of independent directors (including convene) are denied. It should be disclosed when independent director cannot exercise their mandatory power listed above.

(12). When exercising the task, the independent directors shall obtain consent of at least one half of the independent directors. However, if the opinions among the independent directors differ, the board of directors shall separately disclose the opinions of each independent director.

132 SHANG SHI GONG SI SHOU GOU GUAN LI BAN FA [MEASURES ON ADMINISTRATIVE ON TAKEOVER OF LISTED COMPANIES], China Securities Regulatory Commission, Order No.35 [2006] of the China Securities Regulatory Commission, July. 31, 2006 (Promulgated on July 31, 2006; came into effect on September 1, 2006).

133 Id., art. 51, para. 1.

134 Id.

135 Id. art. 5, para. 3.

136 Id.

137 Id. art. 5, para. 2.

138 Id. art. 6, para. 3.
On its face, much is entrusted to the Chinese independent directors and the general ideas and design underlying the whole legal framework basically mimics that of the United States. However, simply looking at these rules is not enough to provide a clear picture of how the independent director in China is implemented, what it means and what changes it brings to corporate China. Before moving toward the discussions of implementation and impacts, however, it is necessary to start with the landscape of the Chinese economy and its structural background. By doing so, the rules and their effects can be more clearly understood and assessed.

III. THE STRUCTURAL CHALLENGES OF CORPORATE GOVERNANCE IN CHINA

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

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

A. Incorporation of SOEs

Back to the early days in the 1990s, the enactment of the Law on Industrial Enterprises Owned by the Whole People (the SOEs Law) and the Company Law of 1993 marked the first step toward solving the problem of state ownership by means of legal reform. Generally speaking, the SOEs law only required the separation of management and state ownership and promoted more efficient management techniques and the
implementation of the *Company Law of 1993*, similarly pushing for corporatization and even privatization of SOEs. In some successful cases, some SOEs were transformed into independent legal entities and started to be responsible for themselves financially. Some SOEs were even successfully transformed into listed corporations or parent corporations of listed subsidiaries and raised large funds from overseas securities markets in the years following the implementation of the *Company Law*. But not all aspects of this transformation are positive, however. In most of the cases, SOEs were simply reorganized as wholly State-owned corporations with various subsidiaries.¹³⁹

As a result of several decades of China’s highly centralized economy, SOEs and their transformation created many complicated social, cultural as well as economic implications for Chinese society.¹⁴⁰ Politically, despite some successful cases, many SOEs were generally regarded as government branches even after acquiring an independent legal entity status. The situation was further compounded by the fact that government agencies exerted various influences over those former SOEs. For this reason, many former SOEs did not really enjoy legal independence even after incorporation as

¹³⁹ Survey Team of Reform in 100 Pilot SOEs & Cheng Yuan, *Enterprises Demand Supportive Reforms*, JINGJI RIBAO [ECONOMIC DAILY], Jan. 10, 2000, at 5.

companies. This problem became more pressing by the impressive progress achieved by private-owned corporations after the opening of the economy in the 1990s.

B. Remaining Problems of State Ownership

Incorporation of the former SOEs, and their expansion and consolidation soon thereafter, were only part of the Economic Reform. The ultimate goal of the Economic Reform was to foster a modern market economy. With a modern market economy, a real competition can be achieved and thus better efficiency. Allowing former SOEs to become independent entities and their shares to be traded on the stock market did not deal with the fundamental question of how to ensure managerial accountability while allowing them more freedom to enhance efficient production.

Financially speaking, the Chinese government still acts as a majority shareholder in many listed corporations even one decade after the enactment of the Company Law of 1993. At the end of 1995, state shares made up 54 per cent of the total shares of listed

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141 Schipani & Liu cited that as of June 2000, there were 999 A or B Share listed companies, with a total market capitalization of 4069 billion Chinese Yuan (RMB, about 500 billion USD), negotiable market capitalization of 1322.909 billion Chinese Yuan (about 160 billion USD). Schipani & Liu, supra note 1, at 56 n 215. In fact, most non-negotiable shares were held by other SOEs or central as well as local governments. Schipani & Liu cited CSRC statistics in 1999 that about 90 percent of non-negotiable shares are state-owned or indirectly controlled. Id. at 64.
Chinese companies. The number declined to 47.7 per cent by the end of 2001.¹⁴² Many state shares appear in the form of share interests in the listed public companies held by their parent SOEs. This situation occurred often as SOEs first partitioned better quality assets to the subsidiary and received shares of these subsidiaries in return. The tactic allows those subsidiaries to be more easily listed on the stock market and to raise more money from it than their parent companies could. However, parent SOEs still remain in control over those publicly-traded subsidiaries, and sometimes demand excessive interest from their controlling position at the expense of other shareholders. The dominance of the state as a shareholder in most of the listed firms remains more than large enough to seriously compromise the independence of company management.

According to another study conducted by one Japanese think tank, in the mid-2000s Chinese SOEs still accounted for almost 34 percent of the national capital in China.¹⁴³


¹⁴³ Ken Imai, Institute of Developing Economies Discussion Paper No. 64, Explaining the Persistence of State-ownership in China 7 (2006). Available at http://hdl.handle.net/2344/130. In fact, however, determining on the exact numbers of either state capital or state-controlled companies is both
The power of remaining state capital and its impact on company law and economic development are still extensive. As could be expected, their dominance creates a dilemma. For example, the government may be concerned whether the state is sufficiently protected as a shareholder from managers’ discretion. But minority shareholders and potential investors may be similarly concerned about the potential misuse of corporate assets or priority-setting by the state as a controlling shareholder.\textsuperscript{144} To solve this dilemma, a more aggressive move toward privatization and further dissolution of state ownership, through the establishment of a soundly functioning capital market, are necessary.

C. Attempt to Address an Insufficient Monitoring Mechanism

According to the basic structural setting in Chinese corporate law, the supervisor or board of supervisors possesses the authority as well as duty to monitor and demand directors or the manager to make corrections if any of their acts are found to have damaged the interests of the company.\textsuperscript{145} It is anticipated that the governing corporate bodies should assert claims whenever the corporate interest is damaged or threatened by directors' or executives' breach of duties. But this type of monitoring is only theoretically difficult and controversial. That is the reason sometimes numbers come out with very different results. For the statistics about state-controlled companies in general and different methods of calculations, \textit{cf. supra} note\textsuperscript{142}.

\textsuperscript{144} Schipani & Liu, \textit{supra} note 1, at 56.

\textsuperscript{145} \textsc{Company Law of 1993}, art. 126 para. 1, 2 and 3.
possible. In reality, the board of directors in China may refuse to assert claims against offenders due to the amicable relationship between the culpable directors or managers and the remaining directors. The same situation may also occur with respect to the board of supervisors when supervisors are close to the culpable director, or when both are under control of the same controlling shareholder.

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

The fact that Chinese corporate governance has been haunted by different types of problems caused by having controlling shareholder in the past decades clearly indicates that the transformation of state ownership to private ownership is the linchpin of understanding today’s governance issues in China. Surely directorial accountability cannot be achieved only by policy or government actions. Rather, it is co-determined by the market, business actors and legal/judiciary mechanisms. The question of how to improve the role of the board of directors and increase its accountability is inevitably linked to a more political question: whether or how to transform single state ownership into dispersive, private ownership. If the move toward more dispersive ownership
continues in the future, the independent director in China may play a more important role than it has in the past ten years.\textsuperscript{146}

D. Stock Market Establishment and Reform in 2005

a. Establishing Stock Market

Along with the march toward the enactment of the \textit{Company Law 1993}, the establishment of the Chinese stock market also began in the late 1980s. In light of several attempts to implement a share-holding system within certain types of companies since the early period of Economic Reform, the effort to establish a stock market was understandable since a market in which investors can trade their investments is pivotal to a continuing willingness to invest.\textsuperscript{147}

\textsuperscript{146} The political control, or the monitoring by governmental agency, rather than any other intra-corporation monitoring mechanisms conceived by company law, is another means to control managers in China. In other word, administrative power also plays a determining role in Chinese corporate governance. For detailed discussion, see e.g., Clarke, \textit{supra} note 89, at 169-80 (discussing the role of China Securities Regulatory Commission and its tools in disciplining corporate governance.)

In November and December 1990, China set up her two stock exchanges, the Shanghai Stock Exchange and Shenzhen Stock Exchange respectively. In the first several years after the establishment of these two stock exchanges, the stock traded on both was limited. The main reason for this was the small number of companies that had successfully completed their transformation as share-holding companies. This was attributed to the fact that the full implementation of the corporatization of former state-owned enterprises, as well as the legislation of company law that provided a basic modern corporate structure, were still absent.

The early efforts to encourage trading on stock market were mostly in vain. The large size of state capital and limited amount private capital both contributed to this slow development. In the past, economic reform started with the government trying to transfer the control to enterprise managers. The government started only selling some enterprises as a whole or some assets to domestic as well as foreign investors as a process of privatization. As this strategy rolled out in its preliminary stage (roughly from mid-1980s


to mid-1990s), the government gradually recognized that continuing privatization is necessary for further economic development. As the privatization slowly spread out and gained its hold in equity market throughout the 1990s, this effort encountered the existing split-share structure and led to the reform of the split share system in 2005.

b. Share Ownership Reform in 2005

The split share system was a unique product from the very early stage of the Chinese stock market. By its very nature, it was the result of a compromise between the need to privatize SOEs and the healthy, gradual development of the stock market. In the beginning, the split share structure was the result of the transition from the socialist economy to capitalism, which required transforming the ownership of collectively-owned enterprises (along with all its assets) into segmented structure. What the split share system meant was basically a lock-in system which prohibited most shares from being traded but allowed a portion of ownership to be freely-transferable. The idea of this design was, in the early stage of SOEs reform, to set up a modern stock market with appropriate amount of equity in the market, attract both domestic and foreign investors to invest their money, and help transform SOEs into partially private companies. Certain large shareholders (state and other legal entities) were prohibited from trading. For this

reason, most SOEs only issued a small portion of their shares to the public market. In the meantime, a great portion of the total shares were retained by state or other legal entities (such as local governments and other related SOEs), and those shares were required to be non-tradable.

The rationale behind this design, at the time when it was first conceived, was two-fold. First, the Chinese authorities worried there might not be enough willing capital available to invest in the Chinese market if all shares were later allowed to be dumped in the market all at the same time. The fact that only limited shares were available in the market was targeted to maintain the price of shares and avoid price crash. The second reason was that Chinese government was still somewhat bounded by socialist ideology, which remains embedded in the Chinese constitution. That made it difficult psychologically for the government to transform all state assets to private, disproportionate ownership. Also, the retention of the majority of SOEs shares was intended to maintain the absolute control over large enterprises. Additionally, the desire to create a stock market gradually and at a steady pace, as well as concern over the possibility of serious market speculation, were also important reasons for this mechanism.

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

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151 Wang & Chen, *id*, at 305.
market.\textsuperscript{152} However, the distinction of tradable and non-tradable shares also created several serious issues. For example, the limitation of the tradability of shares controlled by state meant that the state was locked in many enterprises, and the state still was responsible for their management and financial performance. This is against the general policy to encourage the state to play a smaller role in many SOEs. On the flip side, the split-share structure also created a great uncertainty for private investors since their minority position was always subject to majority’s mistreatment and hence was inevitably vulnerable. Being unable to obtain majority position to a certain extent deterred investors from further investing a larger amount in the capital market, and a sound development of capital market and the participation of well-experienced foreign partners is necessary for further development of Chinese industry. Furthermore, the limited tradable shares also helped to create a perfect environment for market speculation and manipulation.\textsuperscript{153}

In general, this approach was mostly successful because the government, as the largest shareholder, due to its inability to run modern corporations efficiently, silently forwent some of the most important rights that shareholders in a similar position in the western world would have exercised. However, the need to deepen the degree of

\textsuperscript{152} The legal attribute of this non-trading feature has been debated severely among Chinese legal scholars. Some maintain that this feature is a part of the (implicit) contract implied in the prospectus when new shares were first introduced to the stock market. But other scholars deny the very existence of this implicit contract. Wang & Chen, \textit{Id.} at 312-18.

\textsuperscript{153} A more economic approach to the analysis of the deficiency of the split share structure focuses on its price-distortion effect, see Wang & Chen, \textit{Id.} at 305-08.
privatization becomes clearer as the economy develops. Gradually, the Chinese government considered to change this “minority dominance” (implying excessive risk-taking, and other opportunistic behaviors), as this traditional approach faced a critical point as the development of the stock market and privatization proceeded.

Under the split share structure, the key difficulty is how to overcome the alignment problem of ownership, residual claims and control. Without this alignment, a successful equity market and modern corporate governance are nothing but an illusion. As a result, the split share system, as a transitional design, started to face challenges from the outside as well within. In the summer of 2005, Chinese security authorities started an initiative to repeal the split share system. As of December 25 2006, 94.49% of listed companies on the Shanghai and Shenzhen stock exchange had completed their transformation and successfully repealed the non-trading restriction of non-tradable shares, while 74 companies remain in process.¹⁵⁴

Basically, the issue of repealing split share structure is how to pacify (or compensate) the current transferable shareholders for their loss caused by the increase in outstanding shares and their dilution effect on shareholders control power. This repeal was achieved through a private negotiation among non-tradable shareholders and tradable share owners. By providing certain forms of compensation to tradable share owners by non-transferable share holders (generally a certain number shares previously owned by non-tradable share owners), non-tradable share owners can reach an agreement with tradable share owners, and based on this agreement, securities authorities may lift the non-trading restriction of the non-tradable shares and allow those shares to be traded on the stock exchange. In terms of the agreement among tradable and non-tradable shareholders, shareholders representing both two third of tradable and non-tradable shares must consent. Also, some agreements contain a time/amount restriction on the trading of the previously non-tradable shares.155

Generally speaking, the split share reform was a tremendous success, a conclusion derived from the booming stock market both in China and globally during the period from 2006 to 2007. With the various reforms implemented and foreign investment inflow, the Chinese stock market is gradually moving closer to a normal structure comparable to those in many other successful economies. However, it is still early to call the Chinese stock market mature, both from the viewpoints of companies and investors. For example, although the legal restriction of non-trading was repealed, the capital

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155 For a detailed discussion about the steps involved in carrying out this negotiation, see Kister, supra note 150, at 335-43.
structure of most of the public traded Chinese companies is still concentrated. Furthermore, some historical relics such as the distinction of A shares and B shares remains to this day, despite the fact that it is generally expected to be abandoned eventually.\(^{156}\)

c. Current Situation

As of January 2007, according to the statistics provided by the Chinese Securities Regulatory Commission, the total number of listed companies is 1445, the total market capitalization of companies in China is 10564 billion RMB, and negotiable market capitalization is 3041 Billion RMB. Total capital is 1524 billion shares (943.6 billion shares are nonnegotiable and 580.6 billion are negotiable).\(^{157}\) For the Shanghai Stock

\(^{156}\) Traditionally, the Chinese government has dealt with the problem by classifying shares into several classes. Different shares are under different restrictive covenants, such as resale, holding period, voting right, profit-sharing or to whom these shares can be sold. Shares are classified accorded to who owns these shares. In this way, the government had successfully attracted the first group of foreign and local private investors and started on its way to a modern securities market. The A share is owned by domestic investors, and the B share is by foreign investors, and they are traded on different boards of the stock exchange with different prices. In addition to this distinction, there are H shares, which are issued for and traded on the Hong Kong Stock Exchange. For more discussion about the historical development of B share and H share, see Quain, *Why Does Not the Rising Water Lift the Boat? Internationalization of the Stock Markets and the Securities Regulatory Regime in China*, supra note 149, at 617-26.

Exchange, the total market capitalization is about 6500 billion RMB by December 15, 2006 and the Shenzhen Stock Exchange has 1779 Billion RMB, with an annual growth rate at 90.61 percent. In terms of negotiable market capitalization, Shanghai and Shenzhen have 3183 and 858 billion RMB, with 121 percent annual growth rate. In light of the data of 2011 April, the numbers indicate how the split-share reform has transformed the Chinese stock market.

<table>
<thead>
<tr>
<th></th>
<th>Total Market Capitalization (Bn, in RMB)</th>
<th>Total Listed Companies</th>
<th>Total Capital (Bn, Shares)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Negotiable Shares</td>
<td>Total Shares</td>
<td>Negotiable Shares</td>
</tr>
<tr>
<td>2007 Jan</td>
<td>3041</td>
<td>10564</td>
<td>1445</td>
</tr>
<tr>
<td>2011 Apr(^{158})</td>
<td>20751</td>
<td>27464</td>
<td>2175</td>
</tr>
</tbody>
</table>

*Table 1: Market Capitalization and Shares in China: Comparison between 2007 and 2011*

**Source:**


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\(^{158}\) CHINA SECURITIES REGULATORY COMMISSION, *Statistical Information, 2011 April Securities Market Monthly Data, available at*


Despite the fact that privatization in China has been continuing and the government has been selling its stock in SOEs through various channels after the repeal of the ban on non-tradable state shares, the Chinese government is still the biggest shareholder in many large enterprises through direct or indirect holding.\(^\text{159}\) But undeniably, the repeal of the split share system represents a successful removal of legal barriers to the further release of government-owned stock and a move toward further normalization of the Chinese stock market and related corporate governance. To say the least, it is only when state-owned shares are privatized or at least go to a relatively low number and the differential

\(^{159}\) Currently all shareholding owned by state is charged by State-owned Assets Supervision and Administration Commission (SASAC), which is under the direct command of State Council. SASAC is the product of “The Law on the State-Owned Assets of Enterprises,” which was promulgated on Oct 28, 2008 (effective Jan 1, 2009). By creating a unified, centralized organization, its main purpose is to supervise and manage the state-owned assets of the enterprises and to enhance the management of the state-owned assets. STATE-OWNED ASSETS SUPERVISION AND ADMINISTRATION COMMISSION, Main Functions and Responsibilities, http://www.sasac.gov.cn/n2963340/n2963393/2965120.html(last visited on July 11, 2011). But interestingly, article 1 of The Law on the State-Owned Assets of Enterprises specifically stipulates that to “enhance the protection of state asset” is one of the main reasons of bringing this new law. The latter expression exemplifies the problem of asset tunneling in China. Qi ye guo you zi chan fa [THE LAW ON THE STATE-OWNED ASSETS OF ENTERPRISES] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 28, 2008, effective May 1, 2009), art. 1.
treatment among shares and shareholders are eliminated, will more meaningful corporate governance or independent director mechanism function in China.

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

Instead of direct finance provided by equity market, the role of financial intermediaries, mostly in the form of bank loan, has been proved to be another determining factor in shaping the landscape of corporate governance at the national level.\(^{160}\) However, compared to the relatively liquid equity market, the banking system is dominated by fewer players, and often has a stronger tint of governmental involvement or intervention.

Generally speaking, Chinese banking system has been dominated by several features: concentration, large-size, and state influence. Prior to economic reforms and until the 1980s, the banking system was wholly state-owned or heavily controlled by state bureaucrats. Before the Economic Reform Era, the banking system in China did not perform the function of creating credit as most financial institutions do in many other countries. The major function of banking system then was much like a clearing house, to

\(^{160}\) For the general discussion of the relationships between corporate governance and corporate finance, see, e.g., *Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* 51-102, 169-87 (1994). A more recent discussion, see *Raghuram G. Rajan & Luigi Zingales, Saving Capitalism from Capitalists* 201-74 (2003).
transfer capital to and from managers in state enterprises to satisfy administratively mandated costs of production.\textsuperscript{161}

Until the mid-1980s, more than 90 per cent of total financial assets were concentrated in the People’s Bank of China (Chinese central bank) and the objective of financial institutions were to move money from one account to another to meet the financial obligations of the enterprises. However, as the Economic Reform was being carried out in the 1980s and the 1990s, four major state banks—Agricultural Bank of China, Bank of China, China Construction Bank and Industrial and Commercial Bank, customarily shortened as “the Big Four”---were established. The People’s Bank of China started to shift all commercial accounts to those special purpose banks based on the types of accounts and began to perform as a central bank, acting as other central banks in the world with functions such as issuing currency, implementing monetary policy, regulating and supervising financial institutions.\textsuperscript{162}

As those newly-created special purpose banks (now generally referred as state-owned commercial banks) started to take over the commercial accounts formerly owned by People’s Bank of China, however, their roles in the field of commercial banking were still to a certain extent obscured. On the one hand, those newly-created banks in China were still owned and are controlled by the state and their operations were hence bounded


\textsuperscript{162} RAPHAEL SHEN, CHINA’S ECONOMIC REFORM: AN EXPERIMENT IN PRAGMATIC SOCIALISM, 177 (2000).
by state policy. Policy-lending forced Chinese state-owned banks to accumulate a large amount of non-performing loans that are directed to other SOEs for political reasons. Until the early to mid-2000s, state-owned commercial banks still extensively extended policy-directed credits to special clients, which were mostly SOEs or former SOEs. As a result, policy lending, which still prevails today, has caused a heavy, unnecessary burden and loss for those state-owned commercial banks.

On the other, the large size and limited number of banks and their lending priority makes it difficult for healthy private enterprises to access bank loans in a normal way, which in turns hinders development. Contrary to the gradual easing of the problem of bad loans, which has been lessened during the past decade due to the economic success in

163 According to The Economists (which cites a report by Ernst & Young May 2006, a company that does plenty of work on the mainland), China's stock of non-performing loans added up to $911 billion US dollar and is more than five-and-a-half times the latest government estimate of $164 billion, published in March 2006. Also, the report found the country's big four state-owned banks, which are trying to attract international investors, to be carrying $358 billion of bad loans, almost three times the official tally. A Mulled Report; Chinese Banks, ECONOMIST (U.S. EDITION) 78, May 20, 2006. Another estimate appeared is between 350 to 550 billion US dollars. US-China Economic and Security Review Commission, 2005 Rep to Congress, 109th Cong. 1st Sess., 53 (2005), available online at <http://www.uscc.gov/annual_report/2005/annual_report_full_05.pdf> (visited January 28, 2008).


165 IMAI, supra note 143, at 5.
China,\textsuperscript{166} the problem of market concentration is still unsolved. For example, the so-called Big Four dominate more than 50 percent of the total assets of banking institutions according to the statistics published in late 2006 by the China Banking Regulatory Commission.\textsuperscript{167} Three of them (Bank of China, China Construction Bank and Industrial and Commercial Bank) are publicly traded and listed in Shanghai and Hong Kong separately.\textsuperscript{168} The market capital of these three banks was valued at 4.48 trillion RMB

\textsuperscript{166} However, due to the growing strength of China's economy since 2002, the non-performing loans in Chinese state-owned banks have significantly reduced in recent years. According to the statistics published in 2007, the NPL ratio for the “Big Four” is 9.22%, which equals 105 billion RMB and is 1.26%, or 18.83 billion RMB, lower than early 2006. On the other hand, the same ratio for 12 major stock Commercial Banks in early 2007 is 2.81%. \textit{Asian Wall St. J.}, Chinese Edition, Jan 19 2007. A different statistic published by Chinese Banking Regulatory Commission shows that in 2007, the aggregate NPLs ratio of Chinese banking industry is moving between 6.63 to 6.17 percent. Chinese Banking Regulatory Commission, \textit{NPLs of Commercial Banks as of end-September 2007}, available at \texttt{http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=2007051774830DBD1F20010BFFD7F4A6791F6F00} (Last visited July 11, 2011).

\textsuperscript{167} China Banking Regulatory Commission, \textit{Total Assets & Total Liabilities as of End-September 2006 (of Chinese Banks)}, available at \texttt{http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=2885} (Last visited July 11, 2011). One phenomenon needing particular attention is the dramatic drop from roughly 90 percent in 2001 to roughly 50 percent since mid of the 2000s. See infra Table 2 for more recent comparison.

(roughly 574 Billion U.S. dollars based on the exchange rate of January 2007) by January 2007.169 This figure is about half of the total market capital of all traded companies on the Shanghai and Shenzhen Stock Exchanges. In addition to the Big Four, there are Joint Stock Commercial Banks, which are comprised of twelve commercial banks,170 most of which are smaller banks that have transformed to a stock ownership structure and take up to 15 percent of total banking institutions assets. Although they are transformed to a stock ownership structure, the state still controls most of their shares. If including postal saving and city and rural cooperative credit unions in the calculation, the percentage of banking

2006 --- Investors Place Bets Globally -- and Reap the Rewards --- India and China Lead Asia Higher; Japan Rally Fizzles, WALL ST. J., Jan 2, 2007, at R6. However, these IPOs are possible with significant help from the government. Since 1998, Beijing has injected $95 billion into the "big four banks," and carved out $305 billion of bad loans. ICBC itself received a $15 billion state capital injection last year, plus a government-financed nonperforming-loan carveout of $85 billion. Foreign banks added an additional $20 billion; Goldman Sachs, Allianz Capital and American Express own 10% of ICBC’s equity before its IPO. Editorial, Great China Bank Sale, WALL ST. J., Oct 18, 2006, at A20.


assets under Chinese government control would exceed 65 percent. This degree of concentration has not showed any sign of easing yet.\footnote{The Chinese banking regulatory agency has adopted several measures to open its market gradually to encourage competition. Its basic strategy differs according to the target bank’s size. For those state owned or state controlled banks, the idea is to corporatize them first and then issue their stock and make it available to sell to foreign investors. For mid-size banks (stock commercial banks), the Chinese banking agency encourages them to bring in foreign banks as strategic investors and cooperate extensively on a business level. The hope is that those second level banks can learn modern financial know-how more efficiently and hence meet the needs of both business and customers.}

<table>
<thead>
<tr>
<th>Year (end of)</th>
<th>Asset, by number, BN (RMB)</th>
<th>Liability, by number, BN (RMB)</th>
<th>Ratio</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>State-Owned Commercial Banks</td>
<td>All Banks</td>
<td>State-Owned Commercial Banks</td>
<td>All Banks</td>
</tr>
<tr>
<td>2007</td>
<td>28007</td>
<td>52598</td>
<td>53.2%</td>
<td>26433</td>
</tr>
<tr>
<td>2010</td>
<td>45881</td>
<td>94258</td>
<td>48.7%</td>
<td>43032</td>
</tr>
</tbody>
</table>

*Table 2*

*Market Concentration Comparison Between 2007 and 2010: State-Owned Commercial Banks to All Banking Institutions*

*Source: China Banking Regulatory Commission*

*Date Collected: July 11, 2011*
Communications (BOCOM). BOCOM was newly added to the traditional Big Four as SOCBs in 2007.

<table>
<thead>
<tr>
<th>Year (end of)</th>
<th>NPLs Owned by State-Owned Commercial Banks</th>
<th>NPLs Owned by All Banking Institutions</th>
<th>Major Commercial Banks to All Banking Institutions Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>By number, BN (RMB) 1115, 8.05% to Their All Loans</td>
<td>By number, BN (RMB) 1268, 6.17% to Their All Loans</td>
<td>87.9%</td>
</tr>
<tr>
<td>2010</td>
<td>308, 1.31% to Their All Loans</td>
<td>429, 1.14% to Their All Loans</td>
<td>71.8%</td>
</tr>
</tbody>
</table>

Table 3

NPLs Status Ratio Comparison Between 2007 and 2010: State-Owned Commercial Banks to All Banking Institutions

Source: China Banking Regulatory Commission

Date Collected: July 11, 2011

Note: According to China Banking Regulatory Commission, the SOCBs include the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC), the China Construction Bank (CCB) and Bank of Communications (BOCOM). BOCOM was newly added to the traditional Big Four as SOCBs in 2007.

Partly due to the state’s control over bank and limited market competition, the range of innovation and the service provided still lag behind the need. From a corporate law
perspective, the conservative (or sometimes, on the contrary, speculative) attitude posed a threat to the adequate and stable supply of funds that companies need. In this sense, the banking system in China today performs a relatively weak role in corporate financing and, thus, some Chinese companies meet their needs instead through direct financing, i.e., the security market.

To sum up, China’s banking system still plays a pivotal role in the Chinese economy today. It was the main mechanism for financing the country’s high levels of investment, which made up 45 percent of China’s gross domestic product (GDP) in 2005. Despite the pressure caused by the need to provide funds to inefficient SOEs, the growing economy in general and hence the infusion of domestic deposit, which is evidenced by an extraordinary deposit rate of about 47 percent and derives from limited investment channels in recent years, have been helping to keep the banking system in China liquid enough, and even capable of developing.\footnote{Harry Harding, Think Again: China, FOREIGN POLICY, Mar/Apr Issue, at 28, 2007.}

From the perspective of the corporate sector, the importance of the banking system is reducing in recent years as companies start to be financed by means other than bank loans, such as bond issues, corporate profits, or stock offering. Moreover, a gradual process of mergers, acquisitions, and privatization is increasing the profitability of formerly state-owned enterprises. In this sense, the reliance on the banking system is decreasing and as is the risk of managing banks in China. Understandably, internal recapitalizations, the transference of non-performing loans to management companies,
and partial foreign ownership of major banks are partly responsible. In addition, the banks’ portfolios are being broadened through greater reliance on home mortgages and fee-generating services. In addition, China’s low level of foreign indebtedness and more than 1 trillion foreign exchange reserves give the government the tools to improve the health of banks and contain the economic consequences of a financial crisis, if it should happen.

The problems that Chinese banks are dealing with are those governance problems experienced by most state-owned enterprises in China, namely strong governmental intervention and insufficient involvement from other shareholders and infra-governance. In this sense, even though banks provide a large proportion of funding to Chinese companies, the expectation that those financial relationships will result in greater participation or an effective governance relationship is still somewhat immature.

3. The Dual Role of State in Corporate Governance

This background on the Chinese corporate environment allows for the institution of independent director and its implementation in China to be more carefully observed and evaluated. One main difference in the Chinese corporate world, as mentioned, has been the large portion of state-owned shares in equity. As a product of a former socialist idea, this peculiarity still presents a strong barrier to the development of a market economy and to those standard designs of corporate governance. Further, the Chinese government also
heavily uses its regulatory power to influence various actors in the Chinese securities market. The double role of state, in many aspects, produces mixed results.

Based on the discussions above, the following section will begin with the implementation of the Chinese independent director and the general response from the community. Then it will go to the specific issues arising from its implementation. Combining the general background of corporate governance and the implementation of independent director mechanism, we may be in a better position to understand and assess the future prospects of this imported legal mechanism.

IV. THE IMPLEMENTATION OF INDEPENDENT DIRECTOR AND ITS CRITICS

1. Implementations

   A. 1999

   In an earlier survey covering all the newly listed companies in the period from 1997 June to May 1999, there are several basic statistics that provide a basic picture of the
public companies in China. In terms of ownership, in more than 74 percent of the companies in this survey, the directors own more than 50 percent of the outstanding shares of their companies, and directors own more than two third of the shares in about 44 percent of total companies. In contrast to the strong alignment of ownership and directorship in those companies, however, there is another group of companies at the opposite end of the spectrum in which directors only own nominal shares or even none at all. The second group of companies is mostly owned by the government or under indirect governmental control, and the directors in these companies are either professional managers or people with strong government ties, so-called “insiders.”

In terms of board composition, about 40 percent of the surveyed companies have a majority of insiders or managers as directors. In contrast, about 36 percent of the

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174 See COMPANY LAW art. 109, para. 1.

175 Li & Deng, supra note 173.
companies have a majority of directors appointed by substantial shareholders. That means a polarized situation: over three quarter of companies their boards are either controlled by insiders/managers or controlling shareholders.

In terms of ownership concentration, in about 54 percent of surveyed companies substantial shareholders control over half of the total shares, and substantial shareholder control two third of total shares in about 30 percent of surveyed companies. In contrast, in only 14 percent of companies do substantial shareholders control less than 30 percent of the total shares.

Noticeably, among surveyed companies, 18 percent of them already have independent director/outside directors. Half of the surveyed companies have a majority of supervisors who are elected by employees. The number is higher than what the law requires, which is that one third of supervisors or more to be elected by employees. However, whether elected by shareholders or employees, the general perception is that supervisors are not functioning effectively.

B. 2001

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176 Substantial shareholder, according to the Hong Kong listing regulation, means shareholders who are entitled to exercise, or control the exercise of, ten percent or more of the voting power at any general meeting of the company. Rule 1.01, Main Board Listing Rules, Hong Kong Exchanges, available at http://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_1.pdf (Last visited July 11, 2011).

177 COMPANY LAW art. 118
Another survey\textsuperscript{178} conducted in 2001 covering 1135 listed companies in China provides several interesting findings, especially about the constitution of the board of directors.

In terms of state ownership, 65.64 percent of listed companies have more than 30 percent of their shares owned by state or government controlled entities; 40.62 percent of companies have more than 50 percent of their shares owned by state or government controlled entities; and 9.25 percent of surveyed companies have more than 70 percent of their shares owned by state or government controlled entities.\textsuperscript{179}

In addition, 57.73 percent of the directors are appointed by state or other government controlled entities. Or to put in a different way, 730 of the surveyed companies have half of their directors appointed by state or government controlled entities, which is about 64.32 percent of the total surveyed companies. Furthermore, 226 companies (equals to 19.91 percent of the surveyed companies) have all their directors appointed by state or government controlled entities.\textsuperscript{180}


\textsuperscript{179} Id. at 29.

\textsuperscript{180} Id. at 30.
In terms of the number of directors, 77 percent (878 companies) of the surveyed companies have 7 to 11 directors. The average number of directors is 9.42 for all surveyed companies.\textsuperscript{181}

The survey shows 348 companies (30.66 percent) have installed independent directors. Independent directors take 6.67 percent of total directorship for all surveyed companies. 248 companies have more than two independent directors, and in 53 companies, independent directors make up more than 1/3 of the board.\textsuperscript{182}

About 89 percent of independent directors have backgrounds in technology, finance or management. The source of independent directors includes academic professionals, technological experts or government officials (incumbent and retired), and academia is the important source of independent director.\textsuperscript{183}

The survey found 28.83 percent of directors who are not independent are also managers in the same company. In addition, more than 44 percent of directors are appointed by shareholder companies. In most of cases, they serve also as employees or managers in those shareholder companies.\textsuperscript{184} These numbers reflect the intensive network among companies and corporate groups in China, which were built on inter-company equity investment and mutual monitoring,

\begin{itemize}
  \item \textsuperscript{181} Id. at 37-38.
  \item \textsuperscript{182} Id. at 60.
  \item \textsuperscript{183} Id. at 63-64.
  \item \textsuperscript{184} Id. at 147.
\end{itemize}
C. 2002

Another survey in 2002 provided some details of the background of independent directors in China.\textsuperscript{185} In 500 randomly-pick Chinese listed companies, there are 1044 independent directors in total and 39 percent of them are professors in universities or colleges. In addition, 28 percent of them are from business circles; 14 percent of them are professionals, such as lawyers and accountants; 13 percent are retirees who are former Communist party or governmental officials; 6 percent of them are from other research institutions.

About 85.6 percent of independent directors in this survey work on the part-time basis. Only 14.4 percent of them are retirees, which number is substantially lower than generally perceived. Most independent directors work for only one company as an independent director. Only 6.2 percent of them work as independent directors in two or more companies at the same time.

D. 2010

Independent directors became mandatory in the 2001 Guidelines, it is generally expected that most listed companies in China maintain one third of their directors as

\textsuperscript{185} Yue Qing tang, \textit{Dui Wu bai Jia Shang shi Gong si Du li Dong shi Nian ling Zhuan ye deng Gou cheng de Shi zheng Yan jiu} (Empirical Survey on the Age, Professional and Other Characteristics of The Independent Directors in Five Hundred Listed Companies), \textit{JING JI JIE} (ECONOMIC AFFAIR), Feb. 2003, at 86, 89.
independent after 2002. However, to observe its implementation, it is worthwhile to see how this newly-transplanted design functions in light of its relation to the whole board and supervisors. The following charts tables summarize the number of independent directors, its ration to the whole board, and the number of supervisors in top financial companies listed on the Shanghai and Shenzhen stock exchanges and top 25 companies in China.

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186 See supra note 92 and accompanying text.
<table>
<thead>
<tr>
<th>Name</th>
<th>Contributed Capital (thousand)</th>
<th>Board of Directors</th>
<th>Number of Independent Directors</th>
<th>Term (year)</th>
<th>The Ratio of ID to the Board</th>
<th>Number of Committee</th>
<th>Number of Supervisors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial and Commercial Bank of China</td>
<td>334,019,000</td>
<td>15</td>
<td>6</td>
<td>3</td>
<td>40.00%</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Agricultural Bank of China</td>
<td>270,000,000</td>
<td>12</td>
<td>3</td>
<td>3</td>
<td>25.00%</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Bank of China</td>
<td>253,839,000</td>
<td>15</td>
<td>4</td>
<td>3</td>
<td>26.67%</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>China Construction Bank</td>
<td>233,689,000</td>
<td>17</td>
<td>6</td>
<td>3</td>
<td>35.29%</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>Bank of Communications</td>
<td>48,994,000</td>
<td>14</td>
<td>6</td>
<td>3</td>
<td>42.86%</td>
<td>5</td>
<td>11</td>
</tr>
<tr>
<td>China Citic Bank</td>
<td>39,033,000</td>
<td>15</td>
<td>5</td>
<td>3</td>
<td>33.33%</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td>China Everbright Bank</td>
<td>33,434,790</td>
<td>15</td>
<td>5</td>
<td>3</td>
<td>33.33%</td>
<td>6</td>
<td>11</td>
</tr>
<tr>
<td>China Life</td>
<td>28,265,000</td>
<td>11</td>
<td>4</td>
<td>3</td>
<td>36.36%</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>China</td>
<td>22,262,000</td>
<td>18</td>
<td>6</td>
<td>3</td>
<td>33.33%</td>
<td>6</td>
<td>8</td>
</tr>
</tbody>
</table>
Table 4: Board Composition in Top 10 Financial Companies (Shanghai Stock Exchange)

Source: Shanghai Stock Exchange (2010 October)

<table>
<thead>
<tr>
<th>Name</th>
<th>Contributed Capital (thousand)</th>
<th>Board of Directors</th>
<th>Number of Independent Directors</th>
<th>Term (year)</th>
<th>The Ratio of Independent Directors to the Board</th>
<th>Number of Committee</th>
<th>Number of Supervisors</th>
</tr>
</thead>
<tbody>
<tr>
<td>MinSheng Bank</td>
<td>19,119,000</td>
<td>15</td>
<td>5</td>
<td>3</td>
<td>33.33%</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>China Merchants Bank</td>
<td>19,119,000</td>
<td>15</td>
<td>5</td>
<td>3</td>
<td>33.33%</td>
<td>6</td>
<td>9</td>
</tr>
</tbody>
</table>

Top 8 Financial Companies (Shenzhen Stock Exchange)

<table>
<thead>
<tr>
<th>Name</th>
<th>Contributed Capital (thousand)</th>
<th>Board of Directors</th>
<th>Number of Independent Directors</th>
<th>Term (year)</th>
<th>The Ratio of Independent Directors to the Board</th>
<th>Number of Committee</th>
<th>Number of Supervisors</th>
</tr>
</thead>
<tbody>
<tr>
<td>ShenZhen Development Bank</td>
<td>3,105,434</td>
<td>15</td>
<td>5</td>
<td>3</td>
<td>33.33%</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>Bank of Ningbo</td>
<td>2,500,000</td>
<td>17</td>
<td>6</td>
<td>3</td>
<td>35.29%</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>ChangJiang Securities</td>
<td>2,171,234</td>
<td>12</td>
<td>4</td>
<td>3</td>
<td>33.33%</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>GF Securities</td>
<td>2,057,045</td>
<td>7</td>
<td>3</td>
<td>3</td>
<td>42.86%</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>GuoYuan</td>
<td>1,964,100</td>
<td>15</td>
<td>5</td>
<td>3</td>
<td>33.33%</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Securities</td>
<td>Contribute d Capital (ten thousand shares)</td>
<td>Board of Directors</td>
<td>Number of Independent Directors</td>
<td>Term (year)</td>
<td>The Ratio of Independent Directors to the Board</td>
<td>Number of Committees</td>
<td>Number of Supervisors</td>
</tr>
<tr>
<td>-------------------------</td>
<td>-------------------------------------------</td>
<td>--------------------</td>
<td>--------------------------------</td>
<td>-------------</td>
<td>-----------------------------------------------</td>
<td>----------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>HongYuan Securities</td>
<td>1,461,204</td>
<td>10</td>
<td>4</td>
<td>3</td>
<td>40.00%</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>North East Securities</td>
<td>639,312</td>
<td>13</td>
<td>5</td>
<td>3</td>
<td>38.46%</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>ShaanXi International Trust</td>
<td>358,413</td>
<td>11</td>
<td>3</td>
<td>3</td>
<td>27.27%</td>
<td>4</td>
<td>3</td>
</tr>
</tbody>
</table>

Table 5: Board Composition in Top 10 Financial Companies (Shenzhen Stock Exchange)

Source: Shenzhen Stock Exchange (2010 October)

<table>
<thead>
<tr>
<th>Name</th>
<th>Contribute d Capital (ten thousand shares)</th>
<th>Board of Directors</th>
<th>Number of Independent Directors</th>
<th>Term (year)</th>
<th>The Ratio of Independent Directors to the Board</th>
<th>Number of Committees</th>
<th>Number of Supervisors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial and Commercial Bank of China</td>
<td>33,401,885</td>
<td>15</td>
<td>6</td>
<td>3</td>
<td>40.00%</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Agricultural Bank of China</td>
<td>32,479,412</td>
<td>12</td>
<td>3</td>
<td>3</td>
<td>25.00%</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Bank of China</td>
<td>25,383,916</td>
<td>15</td>
<td>4</td>
<td>3</td>
<td>26.67%</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Company Name</td>
<td>Shares</td>
<td>Industry</td>
<td>Region</td>
<td>Nature</td>
<td>Percentage</td>
<td>Code</td>
<td>Level</td>
</tr>
<tr>
<td>--------------------------------------------</td>
<td>----------</td>
<td>----------</td>
<td>--------</td>
<td>--------</td>
<td>------------</td>
<td>------</td>
<td>-------</td>
</tr>
<tr>
<td>China Construction Bank</td>
<td>23,368,908</td>
<td>17</td>
<td>6</td>
<td>3</td>
<td>35.29%</td>
<td>5</td>
<td>8</td>
</tr>
<tr>
<td>China National Petroleum Corporation</td>
<td>18,302,098</td>
<td>14</td>
<td>5</td>
<td>3</td>
<td>35.71%</td>
<td>4</td>
<td>9</td>
</tr>
<tr>
<td>China Petrochemical Corporation</td>
<td>8,670,253</td>
<td>15</td>
<td>5</td>
<td>3</td>
<td>33.33%</td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>Bank of Communication s</td>
<td>5,625,964</td>
<td>14</td>
<td>6</td>
<td>3</td>
<td>42.86%</td>
<td>5</td>
<td>11</td>
</tr>
<tr>
<td>China Everbright Bank</td>
<td>4,943,479</td>
<td>15</td>
<td>5</td>
<td>3</td>
<td>33.33%</td>
<td>6</td>
<td>11</td>
</tr>
<tr>
<td>China Citic Bank</td>
<td>3,903,334</td>
<td>15</td>
<td>5</td>
<td>3</td>
<td>33.33%</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td>China State Construction Engineering</td>
<td>3,000,000</td>
<td>7</td>
<td>4</td>
<td>3</td>
<td>57.14%</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>China Life</td>
<td>2,826,471</td>
<td>11</td>
<td>4</td>
<td>3</td>
<td>36.36%</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>China MinSheng Bank</td>
<td>2,671,473</td>
<td>18</td>
<td>6</td>
<td>3</td>
<td>33.33%</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>China Merchants Bank</td>
<td>2,157,661</td>
<td>15</td>
<td>5</td>
<td>3</td>
<td>33.33%</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>China Railway</td>
<td>2,129,990</td>
<td>9</td>
<td>5</td>
<td>3</td>
<td>55.56%</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Company</td>
<td>Shares</td>
<td>Dir</td>
<td>dep</td>
<td>Dom</td>
<td>Chair</td>
<td>CEO</td>
<td></td>
</tr>
<tr>
<td>---------------------------------------------------</td>
<td>--------</td>
<td>-----</td>
<td>-----</td>
<td>-----</td>
<td>-------</td>
<td>-----</td>
<td></td>
</tr>
<tr>
<td>China United Network Communications Group</td>
<td>2,119,660</td>
<td>8</td>
<td>4</td>
<td>3</td>
<td>50.00%</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Shanghai International Port Group</td>
<td>2,099,080</td>
<td>9</td>
<td>3</td>
<td>3</td>
<td>33.33%</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>China Shenhua</td>
<td>1,988,962</td>
<td>8</td>
<td>4</td>
<td>3</td>
<td>50.00%</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>China Metallurgical Corporation</td>
<td>1,911,000</td>
<td>9</td>
<td>5</td>
<td>3</td>
<td>55.56%</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Baoshan Iron &amp; Steel Co.</td>
<td>1,751,205</td>
<td>10</td>
<td>4</td>
<td>3</td>
<td>40.00%</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>China Yangtze Power Co.</td>
<td>1,650,000</td>
<td>13</td>
<td>4</td>
<td>3</td>
<td>30.77%</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Zijin Mining Group Co.</td>
<td>1,454,131</td>
<td>11</td>
<td>4</td>
<td>3</td>
<td>36.36%</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Aluminum Corporation of China Limited</td>
<td>1,352,449</td>
<td>10</td>
<td>4</td>
<td>3</td>
<td>40.00%</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>China National Coal Group Corp.</td>
<td>1,325,866</td>
<td>7</td>
<td>5</td>
<td>3</td>
<td>71.43%</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>Daqin Railway Co.</td>
<td>1,297,676</td>
<td>11</td>
<td>4</td>
<td>3</td>
<td>36.36%</td>
<td>4</td>
<td></td>
</tr>
</tbody>
</table>

*Table 6: Board Composition in Top 25 Companies of China*

*Source: Shanghai Stock Exchange and Shenzhen Stock Exchange (2010 October)*
Based on the survey above, several observations can be tentatively drawn. First, it seems that the independent director mechanism has taken root in China. As major listed companies successfully meet the compulsory one-third threshold as required, the persistent presence of independent director on boards of listed companies creates a possible, even favorable environment for them to perform intended functions. Second, the committee within the board of directors has been extensive utilized in many large Chinese listed companies. The non-required nature of the committee structure and its acceptance provide an interesting topic for future study. Third, a similar degree of acceptance of independent director mechanism has been shown across different sections of industry. One reason for this phenomenon could be attributed to the manner that the Chinese independent director mechanism was implemented. But whether or how different types of companies or businesses adopt this new mechanism differently is another topic requiring more in-depth research, and it may be early to jump to any conclusion at this point.

As a legal transplant with a clear aim, the survival of this mechanism in China after a decade of experiment is a fact rather than mere. But similarly understandable, to have an independent director on board, in many cases, does not equal good corporate governance. The role of the Chinese independent directors and the actual difference they make are still subjects of further observation and discussion. But one thing can be sure is that the future of the independent director in China will be a function of political, economic, and social environments as well as public opinions.
2. Critiques and Phenomena

A. Question about Effectiveness

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

Within academia, the reviews are mixed. Some show a positive attitude toward the introduction of independent directors in Chinese listed companies and believe it will help alleviate the problem of concentrated ownership structure (and hence the mistreatment of minority shareholders from controlling shareholder) and prevailing “insider-dominance” by providing a better check-and-balance mechanism within the board and facilitates the board of directors’ monitoring function. Also, independent directors are considered to be helpful in improving the quality of the board of directors and broadening its perspectives.

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188 Zhu, id. at 53.
On the contrary, reservations about independent directors are easily found in Chinese academic circles. One common critique is the issue of false independence and its effectiveness. The concentration of ownership in China often results in a strong tie between ownership and management. The existence of sole owner, either state or private, makes the desired independence difficult to attain. Because independent directors are most likely friends of incumbent management, many critics consider independent directors to be either not independent enough in reality or unable to make any difference. All these leave effective monitoring dubious.

B. Question about Power Division with Supervisor

On the face, with the similar focus on providing monitoring to management, the unclear division of power between independent director and the supervisory board is a

189 Gu Gong yun and Luo Pei xin characterize independent directors in China in the following manner: “In reality, most of the independent directors in China become independent directors as the result of the leading managers’ invitation. They accept simply due to the personal relationship with these managers. In fact, their responsibility and power are both obscure and the only purpose is to enhance the public image of that company or for advertisement, or even to meet the requirement for foreign stock exchanges. In short, these invitations or relationships surely compromise their independence.” Gu Gong yun & Luo Pei xin, Lun Wo guo Jian li Du li Dong shi Zhi du de Ji ge Fa la Wen ti (Some Legal Issues on Establishing the Mechanism of Independent Directors in China), Zhong Guo Fa Xue (CHINA LEGAL SCIENCE), June 2001, at 67.

190 See, e.g., Yi Xian rong, Du li Dong shi Xu yao Du li (Independent Director need to be Independent), 99 XIN WEN ZHOU KAN (CHINA NEWSWEEK), 45, (2002); Su Xiang hui, Du li Dong shi Zhi du Ying gai Huan xing (Independent Directors Mechanism Should be Postponed), ZHONG GUO SI FA (JUDICATURE OF CHINA) 36, (2003).
legal issue under much debate and criticism. In the Chinese context, this issue is slightly different from other two-board system countries such as Japan.\textsuperscript{191} Contrary to Japan’s case, supervisors in China do not have a deep historical root and have not formed a powerful cross-industry institution. The short history of company law in China makes this institution less resistant to other competing institutions which might share authority or reset the power structure. Also, supervisors in China face similar challenges to their ability to perform their function adequately.\textsuperscript{192}

In discussing this issue, some Chinese academics consider these two institutions to be serving different purposes and can successfully co-exist and function in a supplementary fashion.\textsuperscript{193} In opposition to this opinion, some attack independent directors for being redundant and believe company law should go back to the supervisory board and enhance

\textsuperscript{191} For how Japanese corporate auditors/supervisors resist the implementation of independent directors and use strong cross-industry lobbying associations to defend the position of corporate auditors/supervisors in corporate law, see Lin, supra note 72, at 105-06.


\textsuperscript{193} \textit{E.g., id.} at 84. In this opinion, it is generally proposed that supervisors should be in charge of financial auditing, representing employees’ interest and having the right to file derivative suits against directors. Independent directors should focus on strategic decision and enhancing the quality of board’s decision, especially participating actively in situations such as self-dealing and protecting the interest and minority shareholders. \textit{See also} \textit{LI JIAN WEI, GONG SI ZHI DU, GONG SI ZHI LI YU GONG SI GUAN LI (CORPORATE SYSTEM, CORPORATE GOVERNANCE AND CORPORATE MANAGEMENT)}, 162-65, (2005).
its monitoring authority.\textsuperscript{194} Other than these two opinions, there are also opinions positing that the independent director mechanism needs more time to fit itself into Chinese corporate environment, and probably some revisions are needed for it to perform its function.\textsuperscript{195} In any event, the uncertainty created by the power overlap of the supervisor and independent director in China may develop a new gridlock or an obstacle for the further implementation of the independent director mechanism in China, and a final settlement of this disagreement may require a detailed analysis and comparison of how both institutions function.\textsuperscript{196}

C. Insufficient Support

Another usual critique is that the independent director in China is insufficiently equipped. Though the law provides legal basis to institute independent directors in companies and requires companies to provide necessary assistance to help independent

\textsuperscript{194} See, e.g., Su, supra note 190.

\textsuperscript{195} See, e.g., Gu & Luo, supra note 189, at 75.

\textsuperscript{196} Basically, the opinion of this article, similar to the opinion held in another article discussing Japanese independent director by author, is that independent director should be a better choice in terms of monitoring power allocation. It is because independent directors in a single board structure possesses better simplicity as an organizational design, and this simplicity will lead to a clearer sense of command/follow relationship. Lin, supra note 72, at 109-12. This position is strengthened by the fact that there is not guidance on how to perform the function of a supervisor under current company law in China.
directors perform their job, but in reality, they in most cases do not have enough resources to conduct effective monitoring in their companies.\(^{197}\)

D. Scarcity of Eligible Personnel

The third problem with the current implementation of the independent director mechanism in China is the scarcity of eligible personnel. As mentioned above, academics in relevant disciplines are often invited to serve as independent directors in China. Professionals such as accountants, financial advisors, lawyers or ex-governmental officers are also usual candidates.\(^{198}\) However, many observers have expressed their reservation on the effectiveness of academics serving as independent directors in modern companies. Lack of former executives from other companies or industries makes the pool of independent detectors in China small.\(^{199}\) Even qualified personnel are found, concerns about double roles and conflict-of-interest arise.


\(^{199}\) This can be attributed to the relatively short modern business development history as many successful businessmen focus only on their own companies. The fast-changing business environment in China and “manager as owner” structure also contribute to the scarcity of eligible personnel.
E. Resignations as Protests

All these difficulties mentioned above explain the high rate of resignation among independent directors in China. Especially in smaller companies, resignations of independent directors were more often observed, and in many cases resignation is the way independent directors protest and also an important sign that serious corporate corruption was spotted. Several anecdotal incidents suggested that many outside directors in China chose to resign when they spotted illegality or other highly suspicious behaviors in the board.\textsuperscript{200} One possible reason for this phenomenon is that most independent directors in China are minority only. They often encountered that the rest of the board (most are managers/inside directors) have decided things before the board met without consulting them. Sometimes those inside directors even colluded in some inappropriate decisions without bringing them to the board’s meeting at all. As a result, out of fear of being charged with personal liability, many independent directors choose to resign when they sense there might be something wrong. This phenomenon reflects the vulnerability of the independent director as a minority on boards and the prevalent lack of respect they receive in the practice of Chinese corporate governance.\textsuperscript{201}

\textsuperscript{200} Wang, supra note 178.

\textsuperscript{201} In his article “Du li Dong shi Xu yao Du li” (Independent Director need to be Independent), a researcher in Chinese Academy of Social Science Yi Xian rong cited more than ten independent director resignations occurring between 2001 and 2002 and attributed these resignations as the result of an inability to detect corporate misconduct and the fear of bearing liability for these misconducts in the future. Yi, supra note 190, at 45.
F. Variables for Further Observations

a. The Increasing Importance of Institutional Investors

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

202 There has been a substantial increase of institutional investors in the Chinese securities market in the last decade. The China Securities Regulatory Commission noted that there were only five securities investment funds in 1998, and the number grew to 218 by end of 2005 and 557 by end of 2009. By end of 2009, the total net asset value under management by investment funds was 2.68 RMB. That equals to 17.69% of the market capitalization of Shanghai and Shenzhen Stock Exchanges combined. CHINA SECURITIES REGULATORY COMMISSION, CHINA’S SECURITIES AND FUTURES MARKETS 2005, 27(2006), available at http://www.csrc.gov.cn/pub/csrc_en/Informations/publication/200812/P0200902225568825932596.pdf; CHINA SECURITIES REGULATORY COMMISSION ANNUAL REPORT 2009, 22 (2010), also available at http://www.csrc.gov.cn/pub/csrc_en/about/annual/201011/P020101105493830315968.pdf.
b. The Trend of Foreign Listing

Foreign listing is an important feature providing impetus for some Chinese companies to embrace the idea of independent directors more willingly. Due to various reasons, there has been a trend since the late 1990s of Chinese companies issuing their stocks and listing them on foreign stock exchanges.\footnote{Conceivably, the most important reason was the limited funds available domestically especially during the early decade when the Chinese stock market started to develop. However, a recently emerging and possibly more important reason is that being able to meet the stricter listing rules also increases the domestic investors’ confidence, and it in turns increases the companies’ value when these companies later sell their stock to domestic investors. For a discussion of this phenomenon, see, e.g., John C. Coffee, \textit{Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on international Corporate Governance}, 102 COLUM. L. REV. 1757 (2002). \textit{Cf.}, infra note 205.} In this trend, some companies went to the Hong Kong stock exchange and others to the New York Stock Exchange or NASDAQ.\footnote{As of the end of 2008, there were over 800 Chinese companies incorporated overseas and listed outside mainland China. Of these, 465 were listed on the Hong Kong Stock Exchange, 44 on the New York Exchange, 76 on NASDAQ, 64 on the London Stock Exchange, and 150 on the Singapore Stock Exchange. \textit{China Securities Regulatory Commission, China Securities Regulatory Commission Annual Report} 2009, supra note 202, at 17 n.1.} When they go to US stock exchanges like the New York Stock Exchange, they must meet the requirement of independent directors. This trend of foreign listing in fact helped the implementation of independent directors in China even before the mandatory rule in 2001. Lately, more and more companies chose to go public both domestically on Shanghai or Shenzhen and foreign exchanges. But it is still unclear how these newly-instituted independent directors work or are making changes due to the fact the...
operations within boards are generally not disclosed to public. However, the greater acceptance seems to provide some chance for Chinese companies to accept the idea of the independent director more openly, and enhance the level of internal monitoring, and at the same time cultivate a sense of respect for the shareholders, which is conceived as the foundational principle of modern corporate governance.\(^{205}\)

c. Corporate Misconduct

Corporate misconduct, by the lesson of history, is always an important force driving internal governance to a higher standard and triggers supplementary monitoring mechanisms like the independent director. But corporate misconduct observed in China today has mostly been solved and disciplined through the government directly issuing an order and relieving a high ranking manager of all of his posts in the company and then delivering him to criminal court. In this way, managers are mainly disciplined by

\(^{205}\) However, the contrary argument---foreign listing does not in fact enhance internal control or compliance of Chinese companies--- can be made as a series of allegedly suspicious behaviors were spotted in U.S.-listed Chinese companies in 2010 and 2011. See, e.g., Bill Alpert, SEC Reports on China Reverse-Mergers, BARRON’S, May 5, 2001; Leslie P. Norton; Michael Rapoport, SEC Probes China Auditors, WALL ST. J., June 3, 2011; David Barboza & Azam Ahmed, Muddy Waters Research is a Thorn to Some Chinese Companies, NY TIMES, June 9, 2011; Joshua Gallu, ‘Reverse-Merger’ Stocks May Be Prone to Fraud, Abuse, SEC Says in Warning, BLOOMBERG, Jun 10, 2011; Owen Fletcher, Bubble Worries Hit Tech Firms Based In China, WALL ST. J., June 16, 2011(reporting Chinese companies gain listings on U.S. exchanges through reverse mergers and some of them hire small audit firms which are unable to verify the company’s financial statements, and may be prone to fraud and other abuses. After a series of scandals at U.S.-listed Chinese firms, trading was halted of more than a dozen U.S.-listed stocks, and the Securities and Exchange Commission was investigating accounting and disclosure issues at some of the companies).
governmental intervention and criminal prosecution rather than internal governance mechanisms such as replacement by election or derivative suit.\textsuperscript{206} This is a rather different approach to solving corporate misconducts. Conceivably, it represents an inclination to prefer public enforcement mechanisms and an inadequacy of private enforcement, although the government as the largest shareholder can, at least in theory, pursue similar results via private litigation if the relevant mechanisms were installed.\textsuperscript{207}

d. Employees as Stakeholders

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

\textsuperscript{206} There are not many documented corporate law cases that have gone to trial in China. Based on an academic survey, in the period of 1992 to 1998, there were only nine cases that can be considered corporate cases involving disputes between company/directors and shareholders. Based on a different judicial decision bulletin and its digest, the number of corporate law cases in the period from 1992 to 1999 is thirteen. The reason for the low numbers is that the most common type of misconduct is false representation and these cases are generally handled through administrative procedure or criminal procedure, and rarely as civil cases. Those considered as civil corporate law cases generally involve transfer of shares among shareholders or between shareholder and company. See Jiang Tian po, Gong si fa Xiu gai Ruo gan Li lan Wen ti (Several Theoretical Issues on the Revision of Company Law), in XIN GONG SI FA XIU DING YAN JIU BAOGAO, SHANG CE (REPORT ON THE REVISION OF NEW COMPANY LAW, VOL. 1), 187, 208 (Cao Kang tai, et al. eds., 2005).

\textsuperscript{207} For a discussion of the interactive dynamics between private enforcement and public enforcement in the corporate law arena in the United States, see, e.g., Marcel Kahan & Edward Rock, Symbiotic Federalism and the Structure of Corporate Law, 58 VAND. L. REV. 1573 (2005).
board. From the demand side, employees are particularly vulnerable in today’s Chinese society as new capitalists gain more strength in the economic booms. If taking this growing gap between managers and general employees into consideration, independent directors in China may play a more active role in protecting labor. In this sense, the future development of the Chinese independent director in fact can be linked to more participation in corporate decisions by employees and at the same time easing the anger that results from profit-seeking that endangers jobs. However, this trend is still under development and is a mere possibility at this time. But if looking from a longer time-horizon, using the institution of independent directors to mitigate the tension between managers and employees is a feasible and desirable strategy, and attention must be given to the voice of employees since their concerns might well affect the attitude of central government, and in turn the corporate governance structure and its structural design through the political process.

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208 The current rule does impose a mandatory representation of employees on the board of supervisors, instead of on the board of directors. Company Law article 118 section 2 says: “The supervisory board shall be composed of representatives of shareholders and representatives of the employees of the company, and the proportion of representatives of employees shall not be less than one-third. The representatives of the employees on the supervisory board shall be democratically elected by the employees of the company through the staff and workers congress, workers’ assembly or other forms.” As noted earlier, however, the role of supervisors is obscure in the language and fails to provide enough accountability in practice. What further compounds this issue is the insufficient disclosure of the inside operation of the board of supervisors in China. Therefore, whether the mandatory representation of employees in board of supervisors brings real change is still doubtful. See Lin, supra note 72, at 112-14.

209 Employees tend to prefer more highly controlled/monitored governance models and ally with other employees (sometimes even through the political decision process). Also, due to the lower ability to
e. The Potential Hostile Takeover Wave and the Rise of Private Sector

A takeover, hostile or not, theoretically can be an important event that may trigger a more significant role for independent directors. But this could be an over-simplified estimation. First, as mentioned earlier, the derivative suit in China was not available until the 2006 amendment of the Company Law. Due to the vacant language of the article, it is difficult to bring a suit, and much of the details about the relevant procedure such as disclosure have not yet been provided. In fact, there are not any important reported cases about shareholder suits in China up to present. Under these circumstances, it is not quite clear how courts will handle a case involving breach of directorial fiduciary duty if it is

diversify their individual input in specific company, they usually are against excessive risk taking activities, similar to creditors. These features create a possibility of allying with banks and altogether seeking higher participation of decision-making within companies, which in turns leads to a possible request over the right to nominate and veto independent directors to protect their interest. See generally, MARGARET BLAIR, WEALTH CREATION AND WEALTH SHARING: A COLLOQUIUM ON CORPORATE GOVERNANCE AND INVESTMENTS IN HUMAN CAPITAL (1996); MARGARET M. BLAIR & MARK J. ROE, EMPLOYEES AND CORPORATE GOVERNANCE (1999) (especially part I).

However, it is still not clear how or whether such request will be carried out in Chinese context. Employees’ participation is generally even farther away than from the paradigm of “shareholder primacy” than participation of creditors. Its populist flavor may not easily accommodate the idea of profit maximization and the quest of economic development. These concerns inevitably cast doubts about using the independent director mechanism to solve employee issue. However, as social welfare becomes a growing problem in China, how to incorporate the need of employees will become a pressing issue which cannot be avoided, and it may well affect the political decision-making process as well as corporate governance, though when and to what extent are still issues open for further discussion.
brought, let alone whether involving the independent director in the decision making process would cure deals tainted with self-dealing and hence encourage more involvement of the independent director. Second, although tender offers are permitted in Chinese securities law, hostile takeovers are rarely seen in China, as are mergers without previous consent (implicit or explicit) by the government. Therefore, the way that the independent director functions in the United States probably would not be directly applicable to China at least in the near future.

V. TWO POSSIBLE MODELS IN THE FUTURE

Observation of the development of the independent director in China, especially its future development, must consider the broader historical context. As a corporate law design, the independent director must respond to both what is written in law and the need of actors in a changing environment. As the Economic Reform in the past thirty years has

210 See, e.g., Game On: China's Internet, ECONOMIST (U.S. EDITION) 61, March 5, 2005 (reporting an hostile bid of Sina.com, the biggest of China's three big web portals, initiated by Shanda, China's top internet company, in 2005 and describing this case as “unusually aggressive in a country where hostile takeovers among domestic firms are unheard of.” This move also triggered a swift response: Sina soon scored another first for China by putting in place a poison pill, which allows it to issue enough stock to dilute an unwelcome shareholder's stake). For similar observations, see John Armour, Jack B. Jacobs, Curtis J. Milhaupt, The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework, 52 Harv. Int'l L.J. 219, 274 (2011).
shown, the state plays a pivotal role in shaping and connecting the pieces in this puzzle in China. Analysis of the role and function of the independent director in China, both current and future, can start with the role that the state plays and may play in the future.

1. Re-identifying the Aims

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

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

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

The controlling shareholder/non-controlling shareholder agency problem, as mentioned earlier, has been a serious problem and continues to be so. However, progress has been made, and the problem is anticipated to reduce gradually in the future as state holding decreases. In the process of privatization of formerly state-owned companies, the Chinese government intentionally sold formerly state-owned shares to “strategic investors” who are often large foreign companies or capital investors. By doing this, though slowly, more companies were showered by modern production and management brought by foreign investors and had developed a sense of autonomy within corporations. But for many companies major shareholders are still persistent, which include governments, rich domestic business men, or foreign large institutional investors. Those major shareholders started to face problems such as who has the right to make the final
decision and how to monitor each other.\textsuperscript{211} In those companies, the governance issues are often solved by the capital structure and negotiation/contractual arrangement. Sometimes

\textsuperscript{211} One famous case involving French food giant Danone SA and its Chinese partner exemplifies the clash between major shareholders and the difficulties in solving this sort of issue using legal means. Groupe Danone formed a joint venture with the Chinese beverage company Wahaha Group by purchasing Wahaha’s 51\% shares from its founder Zong Qinghou in 1996. Since then, relying solely on the management of Zong Qinghou, Wahaha successfully expanded its market and became one the largest beverage producers and the largest bottled water provider in the Chinese market. As the market boomed, Wahaha’s founder Zong, a national hero who wins his reputation by establishing a country-wide brand, allegedly started parallel companies selling similar products with the same name “Wahaha” in which Zong and his family and other partners invest heavily from around 2003. After noticing this irregularity and a long negotiation process starting in 2005, Zong and his partners agreed to sell back their shares in those parallel companies to Danone for 500 million U.S. dollars in late 2006. But after signing the agreement, Danone says, Zong pulled out of the deal and began creating even more outside companies, including his own separate sales division. Zong argued that Danone officials knew about the outside companies, and in June 2007 he resigned as the chairman of Wahaha, accusing Danone of bad management, ignorance of Chinese market and culture, as well as a smear campaign against him and his family. Several suits were filed in China and U.S. over the right to use the brand name “Wahaha.” Zong successfully used this dispute to draw national attention and support, and won some of the court fights conducted in China.

In 2009, after losses in several legal proceedings that had dragged on for years, Danone decided to sell back all its shares in the joint venture to Zong for about 555 million US dollars to end this drama. See David Barboza, \textit{A Brawl Threatens a Huge Investment by Danone in China}, N.Y. TIMES, June 12, 2007; James T. Aredy & Deborah Ball, \textit{Danone’s China Strategy Is Set Back: Dispute with Venture Partner Highlights the Risks of Not Going It Alone}, WALL ST. J., June 15, 2007; David Barboza, \textit{Danone Exits China Venture After Years of Legal Dispute}, N.Y. TIMES, Sept. 30, 2009; James T. Aredy, \textit{Danone to Exit Joint Ventures with China’s Wahaha}, WALL ST. J., Sept. 30, 2009. This case clearly indicates the lack of an
smaller major shareholders may agree to concede control but have the power to appoint independent directors in substitution. In arrangement like this, managers or controlling shareholder in these companies can less easily strip their companies due to intensive monitoring from independent director on board. In short, the controlling shareholder agency problem is gradually alleviated due to the intervention of other large shareholders and unloading of state shares.\textsuperscript{212}

By contrast, the manager/shareholder agency problem has a tendency to worsen. For example, the problem of managerial stripping is a variation of the traditional agency problem between managers and shareholders. However in Chinese context, it is combined with several distinct facts which make it touchier. First, for those companies that do not have other major shareholders other than the state, managers generally have good relationships with government officials or even act as government representatives. As a result, the state is not a reliable source of monitoring in this situation, especially from the standpoint of small shareholders. Second, those managers have often also slowly accumulated a portion of shares of their company during the course of privatization and that in turn gives them better leverage to pursue their own agenda without regard to other non-managing shareholders or even the state. Therefore, what they actually represent

\textsuperscript{212} However, the problem starts to shift to bribery of governmental officers as professional managers gain more economic power and are in need of less intervention from the state. This is true when the state acts either as a regulator or a major shareholder.
here is more like a combination of the controlling/non-controlling shareholder and manager/shareholder agency problems, or both at the same time.

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

2. The Current Balance

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

However, as the economy develops, the model starts to evolve. At a practical level, the government’s roles as equity owner, loan supplier (through the control of banking system and even the exchange rate) and administrative regulator are all still decisive to
the survival and development of Chinese enterprises, especially large ones. The state continues to serve as a strong regulator that firmly controls Chinese society, and the various non-economic ways that the state can exert pressure on enterprises are powerful enough to substitute various forms of the internal governance adopted in developed economies, if the state decides to do so. In this sense, the dependent relationship (managers on government officers, or corruption as the other side of the same token\textsuperscript{213}) constitutes a strong threat to corporate governance mechanisms in the Chinese corporate landscape, though in some exceptional cases the unbelievable efficiency government demonstrates may help solve problems, such as by removing managers who commit misconduct overnight and completing the whole trial process in three months.\textsuperscript{214}

\textsuperscript{213} A recent newspaper article cites a report of the People’s Bank of China indicating official corruption with estimates that up to 18,000 corrupt officials and employees of state-owned enterprises have fled abroad or gone into hiding since the mid-1990s. They are suspected of pilfering coffers to the tune of 800 billion yuan, or $123 billion. James T. Aredy, \textit{Report: Corrupt Chinese Officials Take $123 Billion Overseas}, China Realtime Report, WALL ST. J., June 16, 2011, available at http://blogs.wsj.com/chinarealtime/2011/06/16/report-corrupt-chinese-officials-take-123-billion-overseas/ (last visited July 14, 2011); Another newspaper article, citing a private research firm based in Beijing, reports that some 500,000 corruption cases were investigated in China from 2000 to 2009, and about 64 percent of them were linked to international trade and foreign businesses. Chen Weihua, \textit{Multinationals Under Scrutiny for Corruption}, CHINA DAILY, Sept 9, 2010. For a more detailed discussion about recent cases of U.S. foreign corruption investigations involving China, see F. Joseph Warin, Michael S. Diamant, & Jill M. Pfenning, \textit{FCPA Compliance in China and the Gifts and Hospitality Challenge}, 5 VA. LAW & BUS. REV. 33, 48-57 (2010).

\textsuperscript{214} This is particularly true for many large companies in highly-regulated areas such as banking, financial service, communication, transportation, and heavy industries. Even for large manufacturers, a less intrusive measure such as land use permission, infrastructure support, tax benefits, suppression of labor
The state is strong both in terms of equity control and political control. Constituencies are comparatively vulnerable and unstable and their strategy is to exit once the management goes wrong too far, if possible. Put in a blunt way, the company law is not the only factor that determines which level of corporate governance companies adopt in China today. A complex net of political decisions and other policy/administrative reasons also play an important role, if not bigger. Since the state is a dominant player in all protests, and even criminal indictment are all common and having considerable impacts on business activities in China.
aspects relating to the arena of corporate governance, how managers respond to various corporate governance issues will largely depend on the government’s attitude. In other word, through permission or acquiescence of the government, enterprises can freely enjoy the benefit of suppressing labor, producing unsafe products, and conducting unfair market operation such as manipulation (both in the capital market such as insider trading and in the product market). Constituencies being pressed may choose to exit, or fall vulnerable due to weak legal protection and lack of experience in organizing themselves to fight for their rights.

To sum up, what is observed in China today is that when the state plus the market are enough meet the needs of various actors, there is not much left for law or corporate governance to do. The independent director, in this situation, understandably has not much say in corporate affairs, no matter how the mechanism is designed. But if the cooperation from the constituencies is a key element in supporting a long-term growth and shaping the dynamics of the whole corporate governance, the independent director could find its way. Similarly, the weakening state role may play a role in reshaping the role of the independent director in China.

3. Emerging Patterns and Two Potential Roles of the Independent Director in China
Though the current situation is that state is still in flux, the weakening of the state is expected and in fact observable in long-term developments. The Chinese government is not showing signs of quickly receding, but the growing private sectors (and to a certain extent, local governments) and their increasing economic power are not something to be ignored. An emerging managerial centrism can be seen on the Chinese corporate horizon.

While this trend gradually unfolds, a system of checks-and-balances and a new form of monitoring become necessary. The choices, as well as the problems, that the state will face are multiple. The first possible scenario is that state might become an absent equity owner. In this case, though the state may retain a certain amount of shares, in the face of growing private shareholding, the state may lose its absolute power in selecting managers and need to hand over most of the direct control. This will render it vulnerable to managerial exploitation or inefficient management as a non-controlling shareholder, and may signal a resurgence of the traditional agency problem.

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

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

The independent director mechanism could serve as an interim balancing measure as well as a long-term design. The key point in this design is to meet the needs from both sides; an indirect involvement which uses the design of independent director may function as a buffer for all actors and avoid direct conflict.
As the market economy grows, the state gradually loses its grip due to both equity dilution and the difficulty in maintaining control due to the complexity of the modern business environment. At the same time, the division of economic powers starts to become more stable as companies gain scale and constituencies become less capable to move or change their position easily. The locking in of constituencies will force them to

Figure 2: New Power Balance

(Black arrows and rectangle size indicate a dominance relationship and power)
negotiate with managers for better management, instead of the previous strategy of “voting with their feet”. In this sense, both sets of relationship (state v. managers; managers v. constituencies) need buffers or mediators to avoid direct confrontation.

In this scenario, the state starts to lose ability and/or willingness to exert direct control. In the absence of such power like appointing and removing managers via administrative decisions, the type 1 independent director, mainly appointed by the state, would serve as a representative of the state. In the meanwhile, independent directors may team up with constituencies to balance the managerial centrism and asset stripping. The main goal is to avoid traditional managerial agency problem and alleviate the problem caused by the absence of state as a regulator. The latter is especially essential when legal protection to either equity holder or the public in general (consumer in particular) is not adequate.
Figure 3: Type 1 of Independent Director under New Model---Public Control Type Governance (State controls as regulator and the independent director works as an intermediary)

Note: Vertical grey zone line indicates alignment relationship. Horizontal yellow arrow indicates control/regulation relationship. The independent director serves as a mediator which avoids director control from government.

The type 2 independent director, on the other hand, is designed to represent minority shareholders’ and constituencies’ interests. It is especially needed when government still plays an active role in directing some company’s business even in a way detrimental to
minority’s interest. In those companies, minority’s interest is less protected when managers have the strong support from the governments as equity holder.

**Figure 4**: Type 2 of Independent Director under New Model --- Minority Protection

Type Governance (State controls as a major shareholder and independent director works as representative of other constituencies)

*Note: Vertical grey zone line indicates alignment relationship. Horizontal yellow arrow indicates control/regulation relationship. The independent director serves as a mediator which unites constituencies to balance the control of government and professional managers.*
Two importance issues arise in this scenario. First, under the absolute control of the government and their delegate managers, constituencies may face random target-setting and the interference of non-economic factors. Second, which is even worse and more common in China, when the direct control of selecting managers does not function well, all governance control is lost and professional managers are free to run their companies in the way benefitting themselves only. In other word, the first case is the problem of the absence of the state as a regulator, and the second one is the problem of absence of state as am equity owner. In any event, independent director could act in the interest of constituencies and minority shareholder, which is similar to the role played by the labor director in a labor-participation regime in comparative corporate law.

4. Summary

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

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

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

The point needing to be addressed here is that in a fast-changing economy like China today, politics, as well as the change of economic structure, is a pivotal aspect, which no
one can ignore. Corporate law is not an isolated issue, but rather has to respond to what its society aggregately needs or what political decisions require. In other words, corporate law design, both in theory and practice, cannot be considered discretely. It is not only affected by politics, but is part of politics. To think from the opposite direction, the independent director as a corporate law design can then maximize its utilization if it is remodeled to suit the needs of various actors, both political and economic.

If things unfold in this way, the new governance organ will be hence needed as the power structure and environment change from the earlier pattern. But what people will need to deal with in the real world will become more obscure due to the lack of stability and norms within each institution. People conceivably need to spend time learning to reach the best compromise among their competing interests. In this sense, the independent director may function as a buffering mechanism or a mediator to ease the direct confrontation of different interests. To be more specific, the independent director may help rebuild the position of shareholder vis-à-vis managers, though many roles fall under the title of shareholder in China.215

215 The story of privatization here is a simplified version. In fact, the argument about privatization, either at the theoretical level or in practice, in the Chinese experience is a more complicated issue. However, the reason that a simplified pattern is presented is that the deviations in the process of privatization somehow are misleading because they miss the big picture, which becomes clearer when observed from a longer horizon. For a more complete discussion of Chinese experience in this regard, see Lan Cao, Public Perspectives On Privatization: Chinese Privatization: Between Plan And Market, 63 LAW & CONTEMP. PROB. 13 (2000) (particularly Part V, which discusses the state’s purpose in detail and the interaction between public/private sectors).
VI. CONCLUSION

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

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