DOCTORAL THESIS

Comparative corporate governance: a Chinese perspective

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STATEMENT

This thesis is submitted to Bond University in fulfillment of the requirements for the Degree of Doctor of Philosophy.

This thesis represents my own work and contains no material which has been previously submitted for a degree or diploma at the University or any other institution, except where due acknowledgment is made.

Signature: Yuwa Wei

Dated: May 16, 2002
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ABSTRACT

In 1997, the Fifteenth National Congress of the Communist Party of China clarified the direction of the enterprise reform of the country. It was decided that the reform of establishing a modern enterprise system should be speeded up, and large and medium sized state-owned enterprises should be reformed into corporations. Since then, the speed of corporatisation in China has been accelerated. With more and more enterprises are converted into companies, the issue of corporate governance becomes the focus of the enterprise reform.

This thesis carries out research into the development of the corporation and corporate governance in China. It mainly concerns itself with the following important issues: (1) How has the system of corporate governance developed in the context of the enterprise reform in China? (2) How do corporate theories and corporate practice in other systems influence current Chinese thinking and practice? (3) What are the problems existing in China's corporate governance system? (4) What is the best arrangement of corporate governance for China?

Corporate Governance and Its Significance to the Enterprise Reform in China

Corporatisation of state-owned enterprises is the last resort of the enterprise reform in China. Before corporatisation, many strategies were tried and gained limited success. The final decision as to corporatisation is based on years of reform experiment and deliberation. The decision has its solid theoretical and practical grounds.

It has been widely acknowledged that the governance structure of a state-owned enterprise does not encourage profit maximizing behaviour. This has been thoroughly discussed by Chinese policy makers and scholars. In their discussions, modern enterprise and governance theories were applied to analyse the problems of Chinese enterprise system. What took a long time to be debated in the
early years of enterprise reform were the reform policies and measures. The Chinese were aware of the fact that simple privatisation would not achieve the reform purpose. The political, social and economic conditions in China determined that such an approach would increase social costs and jeopardize the prosperity of the whole economic reform program. The Chinese were also uncertain about whether corporatisation without privatisation could bring much improvement on enterprise performance. As a result, instead of corporatisation, China introduced less radical measures of enterprise reform such as increasing enterprise autonomy and introducing a director responsibility system.

However, state-owned enterprises continually delivered unsatisfactory economic performance. Furthermore, these reform programs produced new problems. A severe problem was insider control. These problems persisted and began to have an impact on all important economic sectors and areas. The Chinese saw no alternative but to take profound measures to reform their enterprises. It was agreed that China must introduce modern corporate governance structure into its enterprises so as to build a modern enterprise system. Thus, corporatisation was carried out in steps, from initial trials to full scale reforms.

Today, many enterprises take the corporate form. However, the corporate form does not automatically bring high economic efficiency and performance. What decides the outcome of the enterprise reform is whether these enterprises are effectively governed to produce high economic performance and to benefit all interested groups. At this point, more efforts need to be made by Chinese policy makers, enterprises, investors, managers, and entrepreneurs.

**Designing a Practicable Model of Corporate Governance for China**

Just as the economic efficiency of an enterprise does not necessarily improve simply because it adopts the corporate form, merely introducing modern corporate governance mechanisms into a
company does not necessarily guarantee the company is better governed. This is because a good governance model may have little to do with practicability. An economic model is usually built on the assumption that society and individuals, based on perfect information about the costs and benefits of alternative choices, can make rational decisions. However, the reality is that we live in a society of incomplete information, with a complex environment, and where individuals hold their own subjective perceptions of the external world. Hence, there are gaps between a model based on rational choice and efficient market hypotheses, and the practicability of the model. A model of little practicability amounts to a mere scrap of paper. Furthermore, divergent corporate governance models adopted by different systems illustrate the fact that the development of a model in a particular system is shaped by social, ideological, economic, historical and cultural conditions of that particular system.

Therefore, to select a system of corporate governance requires balancing a number of considerations. The vitality of a corporate governance system lies in both its economic rationality and practicability. To adopt a model giving insufficient consideration to the special social situations of a particular society will increase the cost of the institutional change and the cost of reception of the model. Consequently, its adoption becomes undesirable. The most desirable choice is a choice that represents the best economic efficiency after balancing the economic benefits and the cost of reception. Hence, in the process of designing a suitable model of corporate governance for China, important situations that influence corporate behavior should be taken into account. This model has to give adequate consideration to China’s current economic situation and political system, the Chinese people’s ideological and cultural preferences, the developing path of corporate practice in China, and the significance of the model relating to sustainable development of the nation’s economy.
Object of This Thesis

This thesis therefore seeks to:

1. Identify important concepts of the corporation and corporate governance
2. Examine the trend of corporate development
3. Assess important factors that shape corporate development
4. Evaluate the regulations and practice of corporate governance in some important systems
5. Examine the development of the corporation and corporate governance in China
6. Analyse the problems existing in the current Chinese enterprise system and propose solutions
7. To put forward a suitable model of corporate governance for China
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I must thank my husband, Kewu, and my son, Kuo, for their constant support and encouragement.
INTRODUCTION

This thesis sets out to investigate the law and the development of the corporation and corporate governance in the People’s Republic of China. The evolution of the corporate system in China happens in the context of the economic reforms, which started in the late 1970s and are in full swing currently. This grants greatest significance to the research on this topic. This thesis firstly examines the fundamental theories of the corporation and corporate governance and their reception and development in China, then proceeds to discuss why and how the Chinese apply corporate mechanisms to reform their state-owned enterprises. It gives a glance at some important corporate systems of the world, so as to distinguish the rationality of the corporation and corporate governance from a comparative perspective. Finally, it attempts to put forward an opinion about a rational system of corporate governance in China, as well as to speculate on the future development of the corporate system in China.

Research of such a nature has to be carried out beyond the sphere of law, as corporate development demands economic, political, and cultural explanations and corporate governance “transcends the law and takes into varieties of non-law or self-regulation and other business practices”.1 Furthermore, as the research involves observations and

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1 See John H Farrar, Corporate Governance in Australia and New Zealand (forthcoming in 2001), 2.
generalisations about the corporation and corporate governance in more than one historical period and more than one system, it has to be made by comparison. As Professor John H Farrar observed in his book *Corporate Governance in Australia and New Zealand*:

In the case of corporate governance research we are necessarily going beyond law and looking at varieties of self-regulation and practice. In the area of comparative corporate governance we are looking at comparative cultures and there are lessons to be learned from anthropology and political science. This is particularly true when we attempt to get to grips with post modernism and globalisation.²

The economic reforms in China have come to a stage of reforming and reconstructing its enterprises. It is a key step toward the final success of the entire economic reforms. This point has been made clear by the Chinese leadership. The Fifteenth National Congress of the Communist Party of China (1997) pointed out that further economic reforms should focus on reforming large and medium-sized state-owned enterprises into conventional corporations, so as to set up a modern enterprise system in China. Hence, to build up an efficient corporate system becomes a historical duty for today’s China. The main factors that contribute to the decision are: Firstly, the need to improve the productivity and performance of state-owned enterprises. Secondly, the need to end government capital injection into state-owned enterprises. In this process, “Corporate governance”, as a study of improving enterprise performance, will inevitably become a center of attention.

² Ibid.
In the past, the productivity and profitability of state-owned enterprises in China have been constantly low. The major defect inherent in the state-owned enterprise system is widely understood to be that the ownership structure existing in the enterprises is incompatible with the managerial structure of modern firms. Here, a modern firm refers to a corporation in the Western system. Corporations have prevailed and become the most common business structure in the Western world since the 19th century. The predominance of the corporate system is due to the fact that the corporate structure allows a business to be independent from its investors. Consequently, the investors of the corporation are free from unlimited liability. This enables the corporations to pool funds from an ever-large amount of investors and to operate on an ever-large scale. The corporate success results in the emergence of a number of gigantic companies in the world. The growth in size and the development in technology result in the separation of ownership and management in companies. Agency costs arise as a side product of the separation of ownership and control. Hence, the main task of corporate governance in a modern firm is to maximally reduce agency costs so as to increase productive and managerial efficiency. This includes dealing with the divergence of interest between investors and managers and increasing management accountability. A modern corporation achieves these goals by dividing and balancing corporate powers among its internal organs, namely, shareholders’ meeting, board of directors (or supervisory board) and managers. In other words, this is a process of balancing powers and interests among

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corporate constituents. It is on this base that the system of modern corporate governance stands.

The ownership structure and managerial arrangement in state-owned enterprises do not follow the logic of the governance in a modern firm. Theoretically, the owner of a state-owned enterprise is the state, or the people as a whole. However, there is not an appropriate form for “the people as a whole” as the owner to appear in such an enterprise. In practice, the state ownership rights in a state-owned enterprise are exercised by administrative departments of different levels. From the viewpoint of modern corporate governance, this type of state ownership in a state enterprise amounts to de facto absence of ownership. This is because the power of controlling and supervising the enterprises invested in “the people as a whole” in such a firm is impotent. The owner has no opportunity to use stock market mechanisms on the one hand, and has no real presence in the decision-making organ on the other. Recently, reports about the assets of state-owned enterprises being misappropriated and depleted through neglect and depredation have increased. This illustrates that the organisational structure of the state-owned enterprise has hindered China from improving its economic performance at the micro-economic level. It is clear that agency costs relating to this type of governance structure

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5 Ibid.

6 See On Kit Tam, The Development of Corporate Governance in China (1999), 50.

7 See Mei Shenshi, Research on the Structure of Modern Corporate Organs’ Power: A Legal Analysis of Corporate Governance (1996), 34-35.
are high, and it is impossible to reduce the costs without a fundamental change in the system.

In some former socialist countries, the problem was solved (theoretically) through a rapid process of privatisation and corporatisation. In the former Soviet Union, the change was made nearly overnight. However, the drastic reforms in these countries have brought many problems at the macro-economic level including high inflation and unemployment. Their enterprise reforms were achieved at a high social cost. So far, this type of reform is not regarded as the desirable solution to the Chinese.8 Foreseeing the above problems, China has pursued a gradualist strategy for its economic reform. Starting from delegating more powers to state-owned enterprises, carrying out experiments with corporatisation, building up stock markets, and completing the corporate legislation, the country is now ready for a nation wide movement of corporatisation and reform.

Since the beginning of corporate practice, China has constantly transplanted corporate notions and practice from the Western systems. The 1994 Company Law is a combination of western influences with an attempt to innovate. For example, it imports two types of companies, limited companies and stock companies (private companies and public

8 See the remarks made by the Chinese scholars Yang Deming and Wu Jinglian in Zhang, Wenmin et al (eds), The Great Economic Debate in China (1997), 131-132. Some Western scholars also made useful discussions about the relationship between economic productivity and the improvement of social welfare. In Australia at the Crossroads, Radical Free Market or A Progressive Liberalism (1998), Fred Argy discussed the changing economic policies of the public sector and governmental intervention of the economic life in Australia during the past decades. He argued that to use GDP as the welfare indicator is inadequate. He pointed out that apart from GDP, the ingredients of a decent society also include the availability of work, quality of life and distribution of welfare. He went further to point out that Australia is now at the crossroads of economic policy. It can continually move down the free-market road and allow the traditional welfare society to be replaced by one of harsh, competitive individualism of the kind, or it can take a more pragmatic consensual approach, ie, while carrying out market-related economic reform, it allows the basic ingredients of a decent, consensual society to be preserved. He suggested that the current
companies) from Anglo-American systems, and adopts the two-tier board structure of the German system. However, the transplantation and innovation at the early stage came as a patchwork. This resulted in lack of efforts to systematically and consciously address some major issues of corporate governance. At a time when enterprise reforms are at a stage of focusing on improving micro-economic performance, the Chinese are increasingly interested in issues of corporate governance and are enthusiastic about promoting the best corporate practice.

Corporate governance has been an object of attention in developed countries since the 1980s. Some countries have developed comparatively effective systems of corporate governance. Some systems are generally accepted as the models of corporate governance. It was first thought that China would build up its own corporate governance system by following an existing model. However, many doubt whether such a system will work in China. The experience of different countries tells that the development of corporate governance is shaped by the ideology, economic circumstance, political preference, and social ethos of the time. When talking about transplanting an existing model, more study must be done in relation to whether the economic, political and social environments in today’s China are ready for the reception of an imported model. It is true that the best law is a law that can be justified by usual practice. If a model on paper is too far from


10 See On Kit Tam, *The Development of Corporate Governance in China*, 50

reality, its influence will be reduced to a minimum. The corporate development in Japan is an example. After the Second World War, the corporate legislation in Japan has been under the influence of the USA.\textsuperscript{12} During the American occupation, Japan enacted antitrust, securities and exchange laws and brought in the rules of takeovers similar to those in America. These laws aimed at confining the growth of corporate groups and preventing financial institutions and companies from holding the stocks of other companies. However, resulting from the general rejection by the Japanese society, the laws have only existed as mere scraps of paper.\textsuperscript{13} Hence, importing a model is one thing and importing a workable model is another. Creations are needed when there is no such a workable model to transplant. Even when a model is adopted, there is still work needed to be done, because there are always gaps between theories and practice.\textsuperscript{14} These gaps have to be filled by informal rules and norms shaped by tradition, culture and customs. In fact, people’s social relationship and behavior are better influenced by those informal rules and norms.

The current economic reforms in China follow a top-down process. Government’s guidance and promotion are important. A rational model of corporate governance can generate better economic efficiency and reduce certain unnecessary economic costs. Hence, the Chinese now are in a stage of facing two tasks. One is to find an advanced,


\textsuperscript{13} See Zhu Yikun, \textit{Corporate Governance} (1999), 79.

\textsuperscript{14} Any law cannot hundred percent reflect reality, cannot predict all foreseeable and unforeseeable events, and cannot extinct language obscurity. Moreover, a law usually lags behind the social development. See Xu Guodong, \textit{Explanations of Basic Principles of Civil Law} (1992), Publishing House of China University of Political Science and Law, Beijing, 137-143.
workable model of corporate governance for the existing and future enterprises. The other one is to physically build up such a corporate governance system within the legal framework. It is a complicated and strenuous project to complete. It requires both theoretical and practical rationality. The academic research on corporate governance in China has just begun. Some recent works are outstanding. However, there is no single volume with the focus of searching for a model of corporate governance for the current economic reforms. Outside China, Professor On Kit Tam at Monash University in Australia carried out a study of the development of corporate governance in China. He developed a model of corporate governance for China, which was based on the idea of "corporate senate".

This thesis attempts to carry out a research that sets out to find the answers for the questions including: How are the Chinese going to shape their corporate governance system? Has the corporate governance system been influenced and will it be influenced by any existing corporate governance theories and practice? How should a practical corporate governance system with Chinese characteristics evolve? Then, based on these discussions and analyses, it proposes a practicable model of corporate governance for China. It proceeds with the analyses and discussions in the following order:

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15 For example, Dou Jianmin, Research on the History of Corporate Ideology in China (1999); Mei Shenshi, Research on the Structure of Modern Corporate Organs' Power: A Legal Analysis of Corporate Governance (1996); Xu Xiangyi et al, Organisation and Management of Modern Companies (1999); and Zhu Yikun, Corporate Governance (1999).
Part One: THE CONCEPTUAL ASPECTS OF CORPORATE GOVERNANCE

Part one investigates the nature of corporations. This leads to analyses of the objectives and the rationality of corporate governance. Although there have been many arguments on the nature of the corporation, legal science has not provided a satisfactory answer to the nature of corporations yet. Various theories interact and influence each other. Among them, there are some influential theories, which have imposed a significant impact on the development of corporate law and practice. If we are determined to identify their imperfections while appreciating their contribution, we can find out the limitations of each theory.

They all have the tendency of focusing on one aspect with no compromise to other forms of rationality. The organic theory sees a corporation as a real being in society, irrespective of whether the law recognizes it or not. The theory has been troubled by the inquiry of how a corporation can be real from the beginning. It is bogged down by the questions such as what is the soul and what is the brain of the corporation. The fiction theory regards a corporation as a creation of law, and presumes that a corporation is an artificial or a fictional creature. It possesses only those properties and rights which are

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16 See On Kit Tam, The Development of Corporate Governance in China.

17 See Martin Wolff, “On the Nature of Legal Persons” (1938) 54 Law Quarterly Review 494, 496. Wolff estimated that there were at least 16 theories about corporate personalities existed in History. Also see Phillip I Blumberg, The Multinational Challenge to Corporation Law (1993), 25.
conferred upon it by law or are incidental to its existence.\textsuperscript{18} This theory has the advantage of being flexible in terms of rejecting some undesirable consequences of legal personality. However, it is criticized as evasive, as it bypasses the question of what a legal person really is and treats a legal person as an artifice at the very beginning.\textsuperscript{19} Today, the two theories are still influential in the Western systems, although neither of them has definitely answered the question of what a corporation is.

Although taking totally different approaches, the two share a common theme. They both focus on the corporation instead of shareholders.\textsuperscript{20} This is in contrast with another influential theory, the contract theory, which emphasizes that a corporation is a private arrangement of incorporators. The theory has developed to simply deem a corporation to be a “nexus of contracts”.\textsuperscript{21} Hence, it supports the view that the State should interfere with corporate activities as little as possible and the law should only intervene where people do not act rationally. The theory of “nexus of contracts” is still a metaphor. It cannot be true to say that a corporation is merely a bunch of contracts. Therefore, the theory is also insufficient to answer the question what is the nature of a corporation.

Recently, people try to fill the gap by referring to economics. This has resulted in the emergence of a number of economic theories on the nature of the firm. Since the 1930s,
there has been a growth of the law and economic literature. The literature started the
inquiry from the most essential question - what is the nature of the corporation? It treats a
corporation as a species of firm. The firm exists because economic transactions use the
price system and there are costs of using price system. The firm provides a means of
internalising market transactions, which reduces the transaction costs. The reason that
the corporation prevails is because, as a type of firm, it has the capacity to accommodate
large scale and highly specialised trade and production. Limited liability enables the
corporation to raise funds from the general public and makes the separation of ownership
and control possible. Therefore, the corporation is the choice of economic development.

The economic explanation of the nature of the corporation sounds straightforward.
The next step is to inquire how a corporation should be governed. At this point, it is
helpful to identify economic efficiency as the main criterion of measuring corporate
performance. The object of corporate governance is to improve the economic efficiency
of the corporation. However, if we want to make a comment on how a corporation should
be governed, we need to find out what is the second criterion, the criterion for judging

American Economic Review 777-795. Also see Jeffrey Gordon, “The Mandatory Structure of Corporate


23 This is the mainstream theory. Marx and some other writers had different views. They held that the firm
was created for the need of reducing production costs. Nevertheless, all these theories agreed on one point
that the firm exists for the need of increasing economic efficiency. See Chapter 13 in Karl Marx, Capital
(1867). Also see Harold Demsetz, “The Firm of Theory: Its Definition and Existence”, in Harold Demsetz,

Law and Economics 301, 302. Also see John H Farrar, “Frankenstein Incorporated or Fools’ Parliament?
Revisiting the Concept of Corporation in Corporate Governance” (1998) 10 Bond Law Review 142, 152-
153.
corporate economic efficiency. That is: for increasing whose economic efficiency a
corporation should be governed. In Anglo-American systems, it is the predominant view
that the corporation should be directed to maximise the economic interests of the
owners. In other systems such as Germany and Japan, corporations are understood as
economic entities that advance social welfare and serve the public good.

If we see the corporation as a social or state creation, it should logically exist for the
good of society, or at least not contradict the public interest. If we see the corporation as a
nexus of contracts, it is logical that attention should be given to the overall relationship
among contractors including shareholders, managers, creditors, debtors, employees,
suppliers and consumers. In other words, a corporation may pursue many goals.

From an economic point of view, efficiency should logically be the overall increase in
the wealth of the community. The key is whether the increase in the owner's wealth
represents the overall gain of society. Apparently, this does not contradict basic economic
theory, where individuals are assumed as rational maximisers of their self-interests and
society's interests are promoted by the self-interested individuals. However, in a
corporation, there are other players who are also rational beings. Their interests may not

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25 See John Kay & Aubrey Silberston, "Corporate Governance", in Fiona Macmillan Patfield (ed),
Perspectives on Company Law: 2 (1997), 58. Also see Margaret M Blair, Ownership and Control:

26 See Article 14(2) of the German Constitution. Also see Chapter 8 in James C Abeggien & George Stalk,
Governance", in Klaus J Hopt & Eddy Wymeersch (eds), Comparative Corporate Governance, Essay and

27 See Arthur A Thompson, Jr & John P Formby, Economics of the Firm: Theory and Practice (1993, 6th
dfn), 262.

coincide with those of investors. The fact that corporations cannot prosper if economic inequities imposed on certain interested groups persist, suggests an unfavorable response to the supposition that corporations exist only for shareholders' interests. In reality, most corporations in developed countries pursue multiple goals. These developed countries have experienced more than thirty years' economic growth and prosperity. This enabled the corporations of those countries to satisfy the basic demands of all corporate actors. This story also happens in the countries such as the USA, which is the stronghold of the shareholder interest theory. This further reminds us that a corporation is an organisation comprised of the individuals with different interests. They cooperate for their common interests. A good system of corporate governance should be a system that pursues the goal of increasing total wealth and avoids the emergence of economic losers among corporate actors.

To keep the common goal alive, attention must be given to corporate direction and management. This is a game of balancing power. To continue the game, agency costs are inevitable. Firstly, we need to identify who are the players, the rules of the game, and the incentives for each player to continue the game. From a narrow view, corporate governance, as a system of directing and controlling the corporation, involves shareholders, the board of directors (or supervisory board), and managers. From a broad sense, corporate governance should involve all stakeholders including shareholders, directors, managers, employees, creditors, and consumers. Although the separation of

30 This can extend to include general public.
ownership and control has diluted their controlling strength, shareholders are still in the best position to supervise management, as they have the crucial power: to vote and to sell. A malfunctioning shareholders' meeting may probably produce an incompetent board of directors. The rise of the German and Japanese corporate economies has shown the importance of employees' participation in corporate governance. The Japanese case has also shown how far human beings can move away from the rational being model. Hence, economic modeling may not be sufficient to explain all matrices relating to corporate governance.

One thing should always be borne in mind, the corporate world is in a stage of rapid development, the rise of new economic powers and the increased domination of corporate groups and multinationals create new complexities for corporate governance. We need to use an evolutionary approach to define corporations, and the role of the State and each corporate actor. The present trend of the development of corporate governance is marked by cross influences and interactions between different corporate systems.

Since the economic reforms, a literature introducing and promoting corporate concepts and theories has grown rapidly. The Chinese have been trying to apply corporate theories and practice to attack some difficult issues and obstacles relating to the enterprise reform. With the deepening of the enterprise reform, a workable system of corporate governance will be built up and corporate concepts and ideologies will begin to take their roots in China.

Part 2: THE CHINESE EXPERIENCE OF THE CORPORATION AND CORPORATE GOVERNANCE
Part 2 examines the development of the corporate system in China with some special attention to some issues relating to corporate governance. China played a role of a world leading economy for a considerable time prior to modern history. However, it ceased to be innovative and vigorous by the 17th century. Up to the 1800s, China was well behind the western economic powers of the industrial world. This caused China’s recent history to be subject to commercial and political turmoil. Chinese scholars have been reflecting on the causes that brought China the misfortunes from different angles. To many of them, the significance of studies on this topic not only lies in teaching the Chinese a historical lesson but also lies in providing dynamic and applicable ideology for China’s future development. There are people who attribute China’s economic stagnation at the last stage of its feudal system to the non-development of corporations at that time.\(^{31}\)

As early as the late nineteenth century, some Chinese intellectuals began to introduce corporate concepts into the Chinese society. They enthusiastically praised the function of companies and promoted the adoption of a corporate system in China by attributing the rise of western economies to the practice of corporate activities.\(^ {32}\) They believed that the corporate system could enhance a nation’s strength and increase the wealth of a society. They saw the corporate system as the all-powerful method of developing a nation and considered it was the only way that could lead China move to modernisation.\(^ {33}\) For example, there were the following remarks:

\(^ {31}\) For example, famous scholars including Chen Chi, Ma Jianzhong, Wang Tao, and Xue Fucheng all made this kind of comment.  


\(^ {33}\) *Ibid.*
Industry and commerce cannot progress if a corporate system is not developed. Then China will never become rich and strong.\(^{34}\)

The corporation is one of the decisive factors that enable British merchants to dominate the world. As a result, although other countries including France, Spain and Germany have spared no effort in competition, they are no match.\(^{35}\)

Some Qing officials also had the desire of industrialising China by corporate activities. They initiated the “foreign affair movement”,\(^{36}\) which resulted in the establishment of the earliest Chinese corporations and the birth of the first Chinese *Company Law* (1904).\(^{37}\) Since then until 1949, the corporate concept together with the notion of legal personality and limited liability were well received by the Chinese, and corporate law was gradually completed. However, corporate practice did not develop at a vigorous pace. The reasons were many. The social instability, weak and uneven economic development structure, political corruption and foreign economic monopoly were the external causes.\(^{38}\)

Internally, there was a gap between western corporate experience and Chinese culture. Although China transplanted the corporate system from the West through establishing it in law, in reality, people dealt with corporate matters in their own way. There were


\(^{36}\) This is a campaign of modernising China and establishing national industries through learning from the West.

\(^{37}\) The first company was established in 1873.

abundant reports of abuse of power by directors, managers and promoters and on inability of shareholders' meetings and malfunction of the stock markets. This illustrates the fact that legal acceptance does not amount to social acceptance.

A particular feature of corporate development during this period was that the State showed a strong desire to interfere in corporate practice. At the early stage, the Qing government attempted to control corporate practice by establishing a number of government controlled companies. In these companies, the government, as a shareholder, had the rights to dispose of the corporate assets and to appoint directors and managers. Other shareholders only had the right to receive dividends. The companies had to distribute dividends to its shareholders according to fixed rates, no matter whether they made profits or not. Shareholders, except the government, were in fact, like a kind of perpetual debenture holder or creditor. Through these companies the government gained monopoly over certain trades. On the other hand, some businessmen tried to get the government's protection by inviting the government to be the supervisor of their companies. This resulted in the existence of the companies that were invested in by businessmen but managed by the government (guandu shangban companies).

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39 A report in newspaper Shenbo (December 25, 1883) provided an example. It described a common situation of shareholders' meeting: The Chinese followed Western system to set up companies. All processes including prospectus, board arrangement and the constitutions were close to Western experience, only the practice was different. When a shareholders' meeting was held, there must be a banquet. Even female entertainers were called. When the air filled with joy, the proposal and other documents were produced by the directors and were passed without questioning.


41 Ibid.
Later, the Guomindang government promoted state capitalism. The initial purpose of promoting state capitalism was to restrict private enterprises from monopolizing important economic sectors such as banks, railway, electricity and water supply.\textsuperscript{42} However, the subsequent implementation brought a dismal result. The state monopoly and the state-controlled companies had nurtured the most corrupt government in the world. The state-controlled companies became the arenas for the government officials making their personal gains, where they misappropriated public assets by using their authority, creating their own personal shareholdings, taking the positions of directors or managers and appointing their trusted associates.\textsuperscript{43} Furthermore, these companies were filled with bureaucracy.\textsuperscript{44} These factors severely undermined the healthy development of the corporate system in China and brought disastrous consequences to the nation’s economy. These past experiences may serve as a lesson for today’s enterprise reforms in China.

In 1949, the communist government gained power in China. The country started to adopt the planned economic system where there was little place for market mechanisms and private ownership. The old enterprises were subject to nationalisation. Up to 1956, all enterprises with private ownership were transformed into state-owned enterprises.\textsuperscript{45} This marked the extinction of traditional corporate species in China. In the coming two

\begin{itemize}
\item \textsuperscript{43} See Xu Dixin, The Road of the Chinese Economy (1946), 106-107.
\item \textsuperscript{44} Ibid, 103-104.
\end{itemize}
decades, China, as all other former socialist countries, experienced economic stagnation. The underperformance and inefficiency experienced by state-owned enterprises were clearly perceived by the Chinese leadership. A few attempts at reforming the enterprises were made but with no consequence. The problem lay in the fact that all these reforms had to be made within the orthodox framework of state ownership.46

Since 1978, China initiated economic reforms aimed at transforming the planned economy into a market economy. The reforms starting from the agricultural sector extended to the private sector and foreign investment. Although the outcome was remarkable, the government clearly understood that the core or the main task of the reforms was far from complete. The reform over state-owned enterprises was still at its dawn. The fundamental obstacle was the ideology. It was not only the government’s preference but also the general sentiment of the Chinese society that public ownership over the nation economy was superior to private ownership.47 It was the majority’s wish that the economic reforms should lead China to reach a destiny of common enrichment. Public ownership was regarded as important in ensuring the delivery of such an outcome.48 The reforms in the countryside have not shaken the ideology, because the Chinese land system allows the country to retain the ownership over land on the one hand and confers the right to use the land to farmers on the other. It has been clear that the enterprise reform does not challenge the foundation of public ownership. Some


47 This is reflected in many publications of this period.
experiments including increasing enterprise autonomy, introducing responsibility for factory directors, contracting out and leasing were carried out. However, no obvious improvement in economic efficiency was achieved.\(^{49}\)

The thought of reforming state-owned enterprises through corporatisation came as early as in the early 1980s.\(^{50}\) The discussions pointed out that no current reform strategies could solve problems such as rationally distributing and effectively using capital in state-owned enterprises, and bringing incentive mechanisms into enterprise management.\(^{51}\) Corporatisation was the only resort of solving the problems. In the mid-1980s, some cities began the trial of establishing share companies. The Chinese government also encouraged the trials in official documents and regulations. However, not until 1994, did a national company law appear. Not until very recently, did the government finally clarify that state-owned enterprises should be reformed into corporations. The main reason for such long circumspection and discretion was that the Chinese were puzzled by the question whether state ownership could be retained after the reforms. Many thought that corporatisation would dilute state ownership in state-owned enterprises.\(^{52}\) Some

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\(^{51}\) Ibid.

believed that corporatisation would inevitably cause the expansion of privatisation. Fortunately, the Chinese have retained a sense of flexibility after all the ideological and theoretical debates. What China needs is to introduce a mechanism or a managerial system that can increase the economic efficiency of its enterprise system. From this viewpoint, bringing modern corporate mechanisms into China's enterprise system is essential. Therefore, the character of corporatisation finally becomes determined. Public ownership is regarded as tenable by establishing state-owned companies or state-controlled companies.

Today, all Chinese companies are bound to organise their productive activities according to the rules established by the *Company Law*. The law provides for two types of companies with different governance structures. In a stock company, the governance organs include shareholders' meeting and two-tier board system. In a limited company, there may be only one board with one or more supervisors. The law is more like a general guideline, with more principles and less details. This has attracted considerable criticisms from the academics and practitioners. However, in the writer's opinion, the present Chinese *Company Law* follows the current trend of developments in corporate legislation and the established corporate standard by mainstream practice. It may be too early to require the law to set out all the details relating to incorporation at this stage. Having a sophisticated law does not amount to having a sophisticated corporate system in


54 See Article 102, 112 & 124 of the 1994 *Company Law*.

55 *Ibid*, Article 52,
real life. This is particularly true when we talk about transplantation and reception of law. This has also been confirmed by the history of corporate development in China. Hence, the major task for today’s Chinese is to build up an efficient corporate governance system in practice within the current legal framework. The experience will provide valuable data and reference for the work of improving the law. For instance, the law has stipulated that the shareholders’ meeting is the organ of primary authority. However, in many cases, shareholders’ meetings do not function as expected. The law has introduced the co-determination system. However, in reality, it is not a confident statement that employees have effectively participated in corporate decision making in many companies. Therefore, more work needs to be done in relation to implementing the law and physically establishing a workable system of corporate governance. This does not mean that the work of improving the current law is less important. In fact, the two processes should always complement each other. With the development of corporate practice, the law will develop constantly.

The variety of existing corporate governance systems offers rich sources to inspire the Chinese to discover a suitable model of corporate governance. The experience of corporatisation and varied use of the corporate form in other countries provide valuable information for the investigation. If the Chinese can take the advantage of this experience, they may be able to get the best result of the enterprise reforms within the shortest time.

Part Three: IMPORTANT MODELS OF CORPORATE GOVERNANCE
In part three, UK, German, USA and Japanese models of corporate governance are discussed as the dominant overseas models. This is not only because these countries have created the most powerful corporate economies in the world, but also because their corporate systems have made important contribution to the development of corporate governance in the world and imposed a strong influence to the rest of corporate systems. All of them have their influence on China's corporate law and practice.

1. The UK

The UK was the first country of industrialisation and sustained the strongest corporate economy for a very long period. Before the end of World War II, its corporate system and corporate law provided models for other systems especially those of its colonies, and therefore, had a far-reaching influence in the world. Its corporate philosophy was inspired by the belief in individualism and freedom of contract. The British viewed the creation of public stock companies as a means of increasing individual wealth by investment. It was a source of profit. Therefore, companies were shareholders' companies. They should be run for, and only for, the interests of shareholders. The delegation of the controlling power to directors was based on the belief that a director can be trusted as a steward, a just and honest man acting for the good of others. Later, the stewardship theory was

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replaced by the agency theory. The agency theory has treated that the relationship between shareholders and directors as one between principals and agents.\textsuperscript{59} An agent will act with self-interest and cannot be expected to behave in a manner assumed in the stewardship model.\textsuperscript{60} Hence, the basic institutions of corporate governance have been designed to minimize agency costs. The UK formally adopts a one-tier board structure. The accountability of the board to shareholders is ensured by elected non-executive directors and independent auditors. In terms of industrial relations, it has always been a prevailing view that the interests of employees and the interests of shareholders are basically in conflict.

The ownership structure in the public companies of the UK reflects the pattern of the separation of ownership and control.\textsuperscript{61} Although theoretically the shareholders are placed at the centre of corporate arrangements, the voting power of a large amount of dispersed shareholdings has virtually left in the control of management.\textsuperscript{62} Hence, restricting the power of management has been a task of corporate governance. Apart from increasingly imposing more requirements on directors' duties of care and skill, the UK has developed efficient securities markets and a body of laws and self-regulation. Recently, there has been an increase in the numbers of institutional investors. Institutions are expected to


\textsuperscript{60} Ibid.

play the role of large shareholders in monitoring managers so as to improve shareholders' status in large companies.\textsuperscript{63}

Insular geography and long time stability in politics have given the English people the confidence in a preference for gradual evolution.\textsuperscript{64} The development of corporate law and practice has followed the same pace. Not until recent years, have the British realised that the slow response to the changing environment and the hesitation in taking a significant step to reform the existing corporate system, have made the UK corporate system and the company law appear to be out-dated.\textsuperscript{65} Since the mid-19th century, the development of UK company law has been a process of constant addition of new rules to the existing legal framework. While the law grew in bulk and complexity, no attempts were made to re-examine the fundamental principles and policies.\textsuperscript{66} The government is criticised for not having done enough to provide stable macro-economic conditions and to mobilize industry.

2. Germany

\begin{footnotesize}
\begin{itemize}
\item 62 See Arthur R Pinto and Gustavo Visentini (eds), \textit{The Legal Basis of Corporate Governance in Publicly Held Corporations: A Comparative Approach} (1998), 226.
\item 64 See Jonathan Charkham, \textit{Keeping Good Company} (1995), 249-250.
\item 66 See Law Society (UK), Standing Committee, \textit{The Reform of Company Law} (July 1991), 11.
\end{itemize}
\end{footnotesize}
Corporate governance in Germany has developed along a path quite different from the UK. If the capitalist or industrial revolution in the UK was a result of a slow and inevitable process, the German achieved the goal through radical reforming legislation. The government has played an important role in shaping German corporate pattern. The industrialisation in Germany came in a far more organised manner, compared with that in the UK. Therefore, the German corporate system is not only “co-operative” but also “organised”.67 As a late industrialised country, the German government was willing to provide all possible institutional support for making Germany a strong nation of the world.68 The government promoted industry as a matter of national pride.69 The entrepreneurs relied heavily on the government for guidance. During the wartime, the degree of governmental intervention in business increased. After the Second World War recovery period, the government saw an enhanced need for its participation in corporate development.

Contrary to the diffused ownership pattern in the large public corporations in the UK and the USA, the ownership in large German companies has constantly shown the tendency of concentration.70 This is because financial institutions are the major sources of capital. In a large company, there are usually two to three big institutional shareholders,

often banks, each controlling about 10% votes. Banks as the major investors and lenders thus have developed a close tie with the industrial companies and had a significant influence over companies’ management. The role played by banks has substantially affected the ownership structure in German firms. The development of securities markets has been slow and far from maturity. Management accountability is not checked through market assessment but by institutional relations and by including a wide range stakeholders in the governance process.

The corporate development in Germany is shaped by the nation’s history. The violent political history in the past century provided more occasions for German policy makers to take extreme steps to propose drastic changes to their corporate system. The corporate law has been developed along the path of facilitating those changes. German jurists have had the chance and duty to make the most elaborate bodies of corporate laws. They tend to set their legislative activities in a broad social and economic context, and they are more likely to take a future view in the legislative process. The law is intended to cover all

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71 At the time of the industrial revolution, in order to rapidly industrialise the country and catch up with the UK as soon as possible, German industries needed a large amount of capital. The society could not supply such an amount of capital. As a result, the industries relied on banks for capitalisation. See Mark Roe, “Some Differences in Corporate Structure in Germany, Japan, and the United States” (1993) 102 The Yale Law Journal 1927, 1936.

72 Ibid.

possible instances in future practice. Hence, the company law in Germany is prescriptive and tight.74

The corporate governance system in Germany has two most distinctive features, the two-tier board system and co-determination. The two-tier board comprises a supervisory board (Aufsichtsrat) and an executive or management board (Vorstand). While the members of the executive board are responsible for the management of the company, the members of the supervisory board discharge their duties of controlling and monitoring the executive board. The supervisory board is conferred with a range of rights that are essential to its monitoring authority, including to dismiss and appoint the members of executive board, to call shareholders' meetings, to examine the annual financial statements and provide a written report on the result of the audit for the shareholders' meeting, and to represent the company in its dealings with members of the executive board.75 Supervisory independence is ensured by the explicit provision of law that the two boards have absolutely separate functions and the supervisory board cannot take over any managerial duties.76 The law requires that a public company (AG) with whatever size and labor force and a limited liability company (Gmbh) with more than 500 employees, must have a supervisory board.


75 See AktG, 111.

76 See Klaus J Hopt, "The German Two-tier board (Aufsichtsrat), A German View on Corporate Governance", in Klaus J Hopt & Eddy Wymeersch (eds), Comparative Corporate Governance, Essays and Materials (1997) 3, 6.
The co-determination system is achieved through the operation of the supervisory board. Co-determination means that a certain proportion of members in the supervisory board must be made up by employees. These employee representatives, through their influence on the composition of management board and certain decisions, make sure that the employees' interests will not be neglected. The underlying ideology is that worker participation in decision making process will promote trust, co-operation, and harmony. Germany has played an important role in an effort to harmonise EU corporate law. It has pushed hard to introduce its co-determination system into the harmonisation program.

3. The USA

As a former colony, the USA is a nation that has close historical and cultural ties with the UK. It inherited cultural, political and legal traditions from the UK. Frequently, we can notice the family resemblance of the US and the UK in corporate law and practice. However, the unique aspects of its social and economic development have shaped the corporate system of America with its own distinctive features. The vast land and the rich natural resources seemed to provide unlimited opportunities for the early settlers. Consequently, America provided a favorable social and political environment for businesses since its early settlement. On this land, the modern economy grew rapidly and soon became the world largest industrial nation until today. As a result, there have


developed a greater number of large enterprises in the USA. America has become a nation that has most exclusively exploited economies of scale. The constant and substantial growth of large US firms has resulted in a shift of the controlling power from owners to managers. This feature has marked the American capitalism as "managerial capitalism". 80

The development of managerial capitalism in the USA is partly because the increased complexity in technology operated in modern enterprises enables non-owner, professional managers to grab more powers; and partly the result of the fact that the US has conventionally curbed banks from operating nationally and holding significant stocks in companies, so that large firms have had to rely on the equity market for fund rising. After 1920s, most of the funds for financing expansion of US firms were raised from stock markets. 81 As the funds of large corporations are raised from a great member of investors, the share ownership inevitably becomes scattered. The portion of each shareholding becomes smaller. The small, dispersed shareholders lack the information, skills and incentives to monitor managers. Hence, the separation of ownership and control creates a threat to the fundamental, traditional belief that corporations should be run for maximising shareholders' profit. The incentives for traditional owner managers do not exist anymore and the salaried managers may prefer to promote their own interests instead that of shareholders. This is the mainstream corporate theorem in America, which has influenced the design of its corporate governance system and its corporate laws.

80 See Alfred D Chandler, Scale and Scope: The Dynamics of Industrial Capitalism (1990), 383-592.
81 Ibid, 49.
Many mechanisms are introduced to restrain managerial power so as to bring managerial activities into the line of maximising shareholders' interests.

On the other hand, the scattered ownership makes takeovers easier than where some big blocks of shares of a company are possessed by a few financial institutions with some kind of relationship with the company, or by a few interlocking industrial companies. Dissatisfied shareholders are likely to sell their shareholdings on stock markets and this increases the opportunities for hostile takeovers. America has highly developed securities markets which provide the most dynamic stage for takeover activities. Until recently, the law has taken a stand of basically encouraging takeovers.82

After the Second World War, the US economy has evolved to be the strongest economy in the world. Its corporate law and practice have influenced many other countries and sometimes provided models for other countries. Japan is one of the countries, whose corporate legislation is heavily influenced by US corporate law. However, in practice, the Japanese corporate system has developed along a unique path.

4. Japan

Japan is one of the latest industrialised countries in the developed world. The initiation of the corporate movement came as part of the government’s scheme of modernisation. Seeing the success of the Western industry which was largely produced by private owned companies, the Japanese aspired to similar prosperity.83 Since the Meiji period (1868),


83 The statement made by one of the most successful entrepreneurs of 1870s-1880s, Shibusawa, can be a representative example. He said “My object does not lie in the increase of wealth, but from the nature of the business it so happens. That is all. Never for a moment did I aim at my own profit”. See Stephen Wilks,
the Japanese government began to promote corporate practice. As a result, the Japanese corporate system has strongly reflected the political influence and strategic consciousness.

Because the Government's support was essential for business success at the initial stage of corporate development, a corporate culture of banks taking part in corporate governance has been developed in Japan. Banks have been a convenient method used by the government in relation to directing the movement of industrialization. They are major corporate financiers. Through directly lending, acquiring shares, and cross holdings, banks have controlled big blocks of shares and exerted influence on companies at every crucial moment. Surveys show that 99% Japanese companies are unlisted and they see the bank system as the only source of external capital. This results in the highly concentrated ownership structure in Japanese companies and the relatively underdeveloped stock markets in Japan. Banks are also the key actor in the Japanese corporate group system.

In Japan, most companies survive collectively. A typical Japanese company usually belongs to a group. A corporate group is a conglomerate of companies and related

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financial institutions. The core of the group is usually a powerful bank. Around the bank, many companies are bound together by the common ties to the banks, interlocking shareholdings and trading relations. The strength of these corporate groups lies in cooperation through lending, inter-group trading and exchanges of directorships.

In terms of corporate ideology, it is the general understanding that corporations exist to advance the interests of the whole nation. Moreover, companies provide jobs for the people. The primary goal of the board is to insure the perpetuity and healthy growth of the company, instead of maximising the profits of the shareholders. Therefore, the interests of management and employees should not be conflicting but coincident. It has been the longstanding policy of Japanese companies to maintain employment stability through lifetime employment to secure employees’ loyalty and willingness to make contribution to the company. Through lifetime employment, welfare and promotion scheme, employees’ personal improvement and social status are bound up with the prosperity of their companies.

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88 Ibid.


91 Ibid, 212.
The distinctive historical and cultural background of corporate development in Japan fosters a unique internal corporate governance system. This system has two characteristics. The first one is that all the members of the board are insiders. It has been a long-standing practice of Japanese companies that directors are to be appointed from management ranks. Surveys show that about 80% Japanese companies have no outside directors, and other 15% have less than two outside directors.\textsuperscript{92} The second feature is that shareholders are passive owners.\textsuperscript{93} As mentioned, the ownership structure in Japanese companies is concentrated. The majority shares of a company is held by banks and related companies, which have strong business ties with the company. These banks and related companies are stable shareholders. During hard times, they are more likely to help their companies out, instead of selling their shares.

The development of corporate governance has shown the tendency of gradual integration of different models.\textsuperscript{94} Recent years have seen that the corporate development in different systems has been moving toward convergence. For instance, while Anglo-American systems is moving to adopt a wider conception of stakeholders’ interests, German and Japanese corporate systems are moving to adopt the idea of shareholder activism. However, it seems unlikely that a high degree of harmonization will happen.

Apart from the above models, part three also gives certain attention to the corporate practice of overseas Chinese communities, and the corporate reform movements in some


\textsuperscript{93} \textit{Ibid}, 273.

common wealth countries. This is because the overseas Chinese business plays an important role in generating a dynamic economic growth in the Asia-pacific region and the selected commonwealth countries have all carried out dynamic reforms on their corporate systems, recently. This further illustrates the diversity of corporate systems and practice in the world. The co-existence of different systems of corporation and corporate governance provides valuable experience and lessons for today’s Chinese to learn from in the course of seeking for a suitable model of corporate governance.

Part Four: DESIGNING A CHINESE MODEL OF CORPORATE GOVERNANCE

The existence of various systems of corporate governance illustrates the truism that a corporate governance system is shaped by the society where it evolves. Economy, politics, culture, and historical events all play important roles in molding the corporate governance system.

Economy is the major driving force in all social development. The development of a corporate economy is a prerequisite of economic development. When technological development enables firms to manufacture on an ever-large scale and the industrial sector becomes the major contributor of the national wealth, there is the need to pool large amounts of capital for the operation. Investors of a wider range are invited to invest in firms. The increase in the number of investors makes the traditional owner/management relationship unworkable. The intensification in specialisation requires professional managers’ contribution to corporate management. These cannot possibly be achieved by traditional firms where investors take unlimited liability for business failures. The corporation offers a business structure where investors’ liability is limited. This makes
the economic need of acquiring public investment and managerial specialisation achievable. Once corporations are established, they face the task of how to survive. A corporation has to be run according to economic rationality. This is the premise for the corporate development in all systems.

Generally, the particular economic situation of a particular system decides the basic appearance of its corporate governance system. A country with a strong economy and a great industrial basis is more capable of fully exploiting economies of scale or scope\(^95\) and of operating capital intensive industries. Such an economy is more likely to nurture large corporations with numerous investors and sizable employees and executives. In these corporations, the issue of control generated from the separation of ownership and management is the focus of corporate governance. The USA and the UK fall into this category. A country of limited national wealth and feeble technological and industrial foundation tends to be impeded in relation to developing large scale corporations. Most corporations in such an economy are likely to be closely held. These corporations, usually, are not troubled by the separation of ownership and control but by shortage of capital, difficulty of cash flow, and restriction of further expansion.

However, this is not always the case. Germany and Japan have developed strong corporate economies like the USA, but their corporations have not developed a similar degree of concentration of ownership. There are not many public companies with dispersed shareholdings in the two countries. This illustrates that, apart from economic

\(^95\) Large manufacturing works applying the new technologies can produce at lower unit costs than can the smaller works. See Alfred D Chandler, *Scale and Scope, The Dynamics of Industrial Capitalism* (1990), 8.
variables, there must be other factors constituting a joint force in shaping the feature of a corporate governance system.

Political intervention is an important power of influencing the development of corporate governance. The political attitudes of a country can deeply influence the ways of organising the nation’s financial institutions so as to determine its large firms’ corporate ownership structures. In history, the governments of America have deliberately fragmented financial institutions, their portfolios, and their ability to aggregate stocks into influential voting blocks. This results in small and fragmented banking system in the country. Large companies cannot obtain vast amounts of equity capital from banks and have to pool capital from scattered investors. The dispersed ownership structure in large American companies thus shifts control from investors to managers. On the contrary, financial institutions in Germany and Japan have been the important financiers of their firms. In these two countries, the role played by banks in supplying capital to large firms has moderated the need of raising funds from outside investors. As a result, the shareholdings of companies in the two countries are comparatively concentrated.


Culture is another factor that has a significant influence in relation to molding a corporate governance system. Corporations are run by the people who are shaped by different cultures that have different beliefs of behavior norms and values. Hence, cultures have an effect on people’s preferences in favor of certain forms of corporate governance. The strong sense of group and the cooperative approach of management in Japanese firms all have deep roots in Japanese culture. The highly developed business network in overseas Chinese communities is another example of how strong the culture can influence people’s business behavior. Culture not only plays an important role in shaping corporate systems but also is an important force in sustaining the established system. It causes the corporate system to become part of the social system. In the program of corporate harmonisation, culture usually is a big obstacle.

Different determinants and historical events shape the path of corporate development of different systems. The development of human society has shown the fact that each system has a strong tendency of adhering to its initial path, although the initial rationality of certain aspects may not exist any more. This reminds us the fact that a successful corporate system may not necessarily be rational at every aspect. In the process of finding a model of corporate governance, China must be aware of this fact so as to selectively take reference from other systems.


China has its special social and economic situations. The corporatisation must give special consideration to these particular social and economic conditions. Today, the economic reforms have come to a stage that, for further economic development, China must engage in the global economy. The reception into the WTO indicates that China’s enterprises will be thrown in the arena of intensive international competition. Therefore, China has no choice but to standardize its enterprise practice and to bring competitive mechanisms of the modern corporation into its enterprises. For the purpose of retaining the dominant position of state ownership upon the completion of the enterprise reform, China has converted and will convert all state-owned enterprises into state-owned or state-controlled companies. 101 A large number of them has taken or will take the form of state-owned companies. 102

The purpose of the enterprise reform is to solve the problems which existed in previous state-owned enterprises. These problems include: Firstly, the integration of the role of the enterprise owner and the role of the administrator of the national economy. 103

101 A state-owned company is a kind of one man company, in which the State is the only shareholder. In a state-controlled company, the State holds the controlling shares.

102 In 1996, China put 100 state-owned enterprises into the trial of corporatisation. At the end, 73 of them take the form of state-owned enterprises. See Liu, Maocai & Xhou Diankun, “Introspection and Improvement Suggestion on ‘Only Ownership by State and Authorized Management by Firm’ Phenomenon” (1996) 11 Jing Ji Yan Jiu (Economic Research Journal) 21, 21-26.

103 In this system, the State, as the administrative authority of the national economy, had the power and duty to make economic plans and supervise the implementation of the economic plans on the one hand, and was the owner of state-owned enterprises on the other. It is believed that these two roles inherently conflict in interest. As the administrative authority of the state economy, the State should concern itself with the overall economic performance of all enterprises; and as the owner of an enterprise, the State should only concern itself with the economic performance and efficiency of the individual enterprise. Therefore, to break up such an integration of administration and management is essential in relation to making the owner of the enterprise to focus on the interests of the enterprise. See Wu Jiaxiang & Jing Lizou, “Corporatisation: A thought about Further Reform”, (1985) 12 Jing Ji Fa Zhan Yu Ti Zhi Gai Ge (Economic Development and System Reform) 1, 1-12.
Secondly, the integration of the role of the enterprise owner and the role of the enterprise manager.\textsuperscript{104} The enterprise reform attempts to introduce the ideology and the governance structure of the modern firm into China’s enterprise system, so as to break up the multiple roles played by the State through division of powers among different government branches. In doing so, the first step is to separate the role of the administrator of the national economy from the role of the owner of state-owned enterprises. In 1988, China established the Administrative Bureau of State Assets as the only authority for exercising the ownership rights of state assets. Since then, the role of the administrator of the national economy and the role of the owner of state-owned enterprises have been separately played by different governmental organisations. While the macro administrative branch is in charge of the nation’s macro-economy, the Administrative Bureau of State Assets is responsible for supervising and organising the use of state assets in state-owned enterprises or companies. It has the power to appoint and dismiss the managers and other personnel of state-owned companies. However, the Administrative Bureau of State Assets does not involve itself in directly managing the state assets. This function is delegated to state asset management companies (management companies).\textsuperscript{105} These companies are, in fact, the holding or parent

\textsuperscript{104} As mentioned, state ownership did not have an appropriate appearance in an enterprise. This amounted to \textit{de facto} absence of ownership. As the owner, the State had to rely on administrative officers as agents to run the enterprise. These agents implemented the State’s policies and plans, and there was no much relevance between the economic efficiency of the enterprise and the officers’ work records.

\textsuperscript{105} Some proposed that China should reform the previous administrative department of a trade into state assets management companies. Some proposed that the core enterprises of the previous enterprise groups should be reformed into management companies.
companies of state-owned companies. They involve themselves in business affairs of their subsidiaries by using their shareholders’ rights to control the board of directors.

The country has begun the trial of establishing management companies according to trades, *ie*, establishing a national asset management company for each trade, since the late 1980s. The three core enterprises of the former enterprise groups in petrochemistry, aviation and nonferrous metal and the two former ministries of electric industry and metallurgical industry were reformed into the management companies of their trades. In the meantime, new arguments arose. Some pointed out that setting up a national management company for a trade would lead to trade monopoly. Therefore, it was desirable to set up more local management companies in different trades, as well as management companies for different corporate groups. Currently, these two types of management companies are also in a trial process.

After all these efforts, there is still the question: how will corporate mechanisms work in these companies? Or, have the old problems been solved by introducing the corporate mechanisms into the Chinese enterprise system?

To answer this question we need to identify three issues. Firstly, has the problem of absence of ownership in previous state enterprises been solved? The establishment of the Administrative Bureau of State Assets and management companies, has shown the government’s desire to wholeheartedly exercise shareholders’ rights and powers in relation to directing companies. However, it is still problematic. In a conventional Western company, the ultimate shareholders have the residual claimant right over the corporate properties and the ultimate controlling rights (voting rights). In a state-owned company, the Administrative Bureau of State Assets and the state asset management

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company exercise all the power of supervision and governance over the company, but do not have the residual claimant right. The right belongs to the State. Furthermore, the Bureau and the management companies are run by either salaried bureaucrats or salaried board members. Hence, theoretically, the shareholders’ incentives in a conventional commercial company do not apply in the case of a state-owned company.

The second issue is: are all the mechanisms of corporate governance in the modern firm applicable to a state-owned company? A negative example is at hand. If state ownership in a state-owned company is not subject to dilution, then the market mechanism (supervision from the stock market) cannot be exerted in such a company.

The third issue is: will the agency cost be reduced to a minimum degree. It is unlikely. From the State to the Administrative Bureau of State Assets, to state asset management companies, to lower parent companies, then to individual companies, there are too many hierarchical chains of principal/agent relationship. The agency cost increases as the chains increase.

When designing a corporate governance system for today’s China, all the above elements must be taken into account. First of all, it is desirable that, except in the case of some trades which are important to the national economy and the people’s living, state-owned enterprises in other trades may not take the form of the state-owned company. It may be more advantageous, if, in a company, the State takes the role of the large shareholder by holding controlling shares. Firstly, this allows the company to raise funds
from the public. Secondly, the performance of these companies can be monitored by
the market mechanism. Thirdly, this can bring in supervisory mechanisms from the
public, as the performance of the companies can be checked by other shareholders
including other companies and individuals.

It is also desirable if there is a system of choosing and examining directors and
managers. If the excessive hierarchical chains and the separation of the residual claimant
right and the controlling right increase the agency cost in state-owned and controlled
companies, we have to seek for some other mechanisms to improve the situation. To
introduce incentive and penal mechanisms may be a solution. Research tells us that
individuals in real life do not totally fit in the description of individuals in economic
theories. According to economic theories, individuals pursue their maximum economic
interests. In real life, an individual’s needs not only include material interests but also
other things including reputation, position, profession, sense of achievement and future
development. If a system of examining directors’ quality and work record is
established and a competitive market of managerial personnel exists, cases of “shirking”
and “stealing” are likely to be effectively curtailed.

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106 To fully exploit the production of the economies of scale, it is necessary to pool capital from the public
into these companies. Currently, large amounts of capital in China lie idle. It is estimated that the amount of
bank deposit by individuals reached 50,000 billion RMB Yen in 1997. See Xu Xiangyi et al, Organization
and Management in Modern Companies (1999), 622.

made at the Conference on Alternative Perspectives on Corporate Governance, Columbia University Law
School, 33.
Corporate development has come to a stage where human capital or employees play an important role in creating and increasing corporate value. Employees are physical owners of companies. The outcome of corporate performance directly concerns their interests. China should have a corporate system where employees consciously play a dynamic role in corporate governance. The current *Company Law* imports the co-determination system into Chinese corporate system. However, more needs to be done to successfully implement the co-determination system.

Banks’ ability to finance and supervise corporations should be maximally utilized. German and Japanese experience has shown that, compared with the securities market, under certain circumstances, banks can be a more efficient and less expensive mechanism of monitoring corporate performance and rescuing distressed companies. At a time when state-owned and controlled companies play an indispensable role in the national economy, it is desirable to fully exploit banks’ potential relating to corporate governance. It is one’s expectation that the shares of a state-owned company are not freely transferable on the securities market, and the shares of public ownership in a state-controlled company are also not freely tradable. The Chinese government is keen to preserve the dominance of public ownership on the one hand, and allow the securities market function on the other. This has resulted in the creation of a hierarchy of class of shares and a secondary share market in practice. Shares are classified into state-owned

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shares, state-owned legal person shares,\textsuperscript{110} and shares of Chinese public members.\textsuperscript{111} While the public members can trade their shares among themselves on the securities market, the trading of state shares is prohibited and state-owned legal person shares can only be traded among state-owned legal persons.\textsuperscript{112} With such an arrangement, it is not expected that the monitoring function of the securities market will fully operate. Under such a situation, banks' role in the corporate governance becomes even more important.

The advantages of corporate groups should also be fully recognised. The group structure encourages cross holdings among group companies. This enhances the competitive strength of individual companies. In order to survive in international competition, Chinese enterprises need to aggregate into corporate conglomerates. This is also helpful in relation to enhancing shareholders' governance power.

To sum up, the Chinese corporate system should develop a position somewhere close to German and Japanese practice in relation to banks' influence, corporate groups and worker participation in corporate affairs. China also needs a comparatively developed stock market. Finally, as state-owned and controlled companies will account for the bulk of the national economy, it is important to have a specially designed examining and supervising system to govern the salaried bureaucrats and directors in the Administrative

\textsuperscript{110} State-owned shares refer to the shares obtained by an institution on behalf of the State. State-owned legal person shares refer to the shares obtained by a state-owned legal person (industrial enterprise or non-industrial entity).

\textsuperscript{111} Apart from these categories, shares can be further classified into A shares, B shares, C shares, H shares, and N shares. For detailed discussions about the share structure in China, see Yao Chengxi, \textit{Stock Market and Futures Market in the People's Republic of China} (1998), Oxford University Press, New York, 3-37.

Bureau of State Assets, state asset management companies, and state-owned and controlled companies.

It should always be kept in mind that when we talk about increasing corporate efficiency by improving corporate governance, we are talking about it at the micro-economic level. Corporate governance has limited control over macroeconomic development. No matter how perfectly a company is directed, it is still affected by the events that are outside its control. However, better corporate governance should offer a corporation a better chance of survival.\textsuperscript{113}

PART ONE

THE CONCEPTUAL ASPECTS OF CORPORATE GOVERNANCE
Chapter 1

AN OVERVIEW

If the initiation of the economic reforms showed that China began to embrace the market economic theory, the current enterprise reform indicates the reception of Western corporate ideology in the country. The economic reforms in China have been carried out in a gradual fashion. They have been carried out step by step, and expanded from sectors to sectors and areas to areas. When the rural sector underwent a full-scale reform in the late 1970s and the early 1980s, the enterprise reform just made an experimental move. The enterprise reform methods such as increasing enterprises' autonomy, clarifying enterprises' financial targets through contracts between enterprises and their administrative departments, and corporatising some enterprises, were put into trial one after another. The decision to reform state-owned enterprises through massive corporatisation was finally made by the government in the late 1990s.

Like the economic reforms in other sectors, the enterprise reform follows a top-down process. The government plays the essential role in directing and controlling the reform process by providing reform policies and financial support. In the course of searching for a model for the Chinese enterprise reform, law and policy makers have been consciously integrating modern enterprise theories into Chinese practice. For the convenience in

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proceeding with the discussions and analyses of the practice and problems of the enterprise reform and designing a corporate governance model for China, it is necessary for this thesis to clarify relevant theoretical issues at an early stage. Part One takes on this task. This chapter outlines the theoretical development of the enterprise reform and corporate governance in China. The next four chapters focus on some important conceptual issues relating to the corporation and corporate governance, and their influence on Chinese corporate practice.

INITIAL CHINESE VIEWS AGAINST CORPORATISATION

The aim of the enterprise reform is to set up an enterprise system that can clarify property rights in enterprises and to introduce limited liability, insolvency mechanisms and standard accounting methods into the current enterprise system. From this viewpoint, the modern corporate system can satisfy all the above requirements. However, the Chinese have taken a considerable long time to finally decide to reform the enterprise system through corporatisation.

Since the start of the economic reforms in the late 1970s, quite a few enterprise reform strategies were adopted, including greater enterprise autonomy, increased responsibility for factory directors, contracting out and leasing. However, the implementation of these strategies did not bring the expected outcomes. Not until the early 1980s, was the idea of corporatisation introduced. The idea was first intensively discussed and debated by

intellectuals and practitioners in newspapers and periodicals. Then, trials were carried out in some areas since the mid-1980s. Later, the official endorsement and blessing on the experiment were explicitly expressed in some official documents.\textsuperscript{116} In the meantime, a considerable amount of arguments expressed views opposing the practice of incorporation and corporatisation.

The major concern of those rejecting the corporate ideology was that corporatisation would inevitably lead to privatisation. They held that corporatisation would dilute public/state ownership in state-owned enterprises, as selling the shares of state-owned enterprises to individuals could amount to selling state property to private hands.\textsuperscript{117} These people took the stand that public ownership was superior to private ownership. They believed that, in the course of economic reform, it was crucial to maintain social stability.\textsuperscript{118} The economic reforms were means but not ends. The principal goal of the economic reforms was to develop the economy and improve people's living standards. In other words, the goal was to realize a common enrichment in China. For this purpose, there was the need to uphold social justice. As public ownership was the economic foundation of social justice, it was necessary to maintain the dominance of public ownership in China. If the dominance of public ownership was eroded in the process of the economic reforms, polarization would become inevitable. This would result in the

\textsuperscript{116} For example, the \textit{Regulations on Deepening the Enterprise Reform and Enhancing the Vitality of the Enterprises} (the State council 1996).

\textsuperscript{117} See the remarks made by Guo Cai, in Zhang, Wenmin \textit{et al} (eds), \textit{The Great Economic Debate in China} (1997), 133-134.

exacerbation of all types of conflicts including conflicts between different areas, different levels of governments, and different ethnic groups, and bring a disastrous outcome.119 Some went further to argue that corporatised state-owned enterprises could never achieve the same economic outcome of a privately owned corporation, because corporatisation could not solve problems such as de facto absence of owners’ control and inefficiency of management which existed in state-owned enterprises. Furthermore, corporatisation would destroy advantages of public ownership. One example of public ownership superiority was that the system of public ownership rendered a better distribution method, a system of distribution based on work.120 This distribution method was superior to the method of distribution according to capital, a distribution system related to the corporate system. The people with this view warned that corporatisation might bring China into a situation where the advantage of public ownership would diminish on the one hand, and the benefit of corporatisation would not be fully exploited on the other. Hence, much sanguine expectations should not be attached to the outcome of corporatisation.

The ideological debate over corporatisation became a major topic of economic, legal and political literatures from the mid-1980s to the early 1990s. During this period, policy makers took a cautious but firm stand in promoting corporate practice. Adjustments were made in corporate trials and efforts were made to improve the environment for corporatisation. From 1990 to 1991, two stock exchanges were established in Shanghai and Shenzhen. In 1993, the People’s Congress passed the first corporate code, the


120 See the remarks made by Yu Weiguo in Zhang Wenmin et al (eds), The Economic Debate in China (1997), 110-111.
Company Law. The law has come into effect since July 1994. In 1997, the Fifteenth National Congress of the Communist Party of China made it clear that China would reform its state-owned enterprises through corporatisation. The government’s determination finally brought the debate on whether or not to reform the state-owned enterprise through corporatisation to an end. Since then, Chinese scholars have shifted their attention to issues, such as understanding the characteristics of the modern corporate system and corporate property rights, and seeking suitable corporate models for the enterprise reform.

THE THEORETICAL DEVELOPMENT OF THE CORPORATION AND CORPORATE GOVERNANCE

A literature on reforming state-owned enterprises through corporatisation was initiated in the early 1980s and has become full-fledged after the enactment of the 1994 Company Law. At the early stage, discussions focused on analysing the economic irrationalities which existed in state-owned enterprises and the cures. Later, the attention turned to the designation of the share ownership structure in state-owned enterprises and how the State would exercise the control right in the enterprises. Many discussions directly used modern corporate governance theories including corporate property theories and the agency theory to examine problems encountering state-owned enterprises. In this literature, the rationality of the governance structure and norms in the modern corporate system were firmly recognized. Under this premise, the deficiencies of state-owned enterprises were found as follows:
Firstly, the ownership structure of state-owned enterprises did not facilitate the economic efficiency of the enterprises.\textsuperscript{121} From a conventional view, the right of ownership was an absolute right that consists of a bundle of rights including residual claimant rights, the right of disposition, the right of control, the right to interest.\textsuperscript{122} This meant that the owner of the property had a complete and absolute right over the property. Such an absolute ownership right existed in a classic firm. The owner(s) of such a firm had the absolute right over his or her property.\textsuperscript{123} However, in a corporation, the classic concept of absolute ownership right no longer applied. While shareholders had residual claimant rights over the property, the right to use and dispose of property was exercised by salaried managers.\textsuperscript{124} According to modern corporate theory, the role of the manager was an agent in nature, and it was normal for a principal and an agent to have different interests.\textsuperscript{125} Instead of maximising the interests of the principal, the agent was likely to pursue other interests including their personal interests. The reason that a corporation could survive and develop lay in the fact that the modern corporate system exerted certain mechanisms to restrain the divergence of interest and bring the agency cost down to a reasonable degree. An important mechanism was to balance powers among the internal organs of a corporation. As a result, shareholders exercised their controlling power

\textsuperscript{121} See Mei Shenshi, \textit{A Research on the Structure of Modern Corporate Organs' Power: A Legal Analysis of Corporate Governance} (1996), 32-37.


\textsuperscript{123} \textit{Ibid}.

\textsuperscript{124} \textit{Ibid}, 8-9.
through the supervisory role of the board. However, in a state-owned enterprise, the owner of the enterprise was the State or the people as a whole. In reality, it was not practicable for the people as a whole to exercise monitoring functions in an enterprise. In other words, it was impossible for the owner, the people as a whole, to have real presence in the enterprise.\textsuperscript{126} Hence, in such an enterprise, there was no sufficient supervision and control over the management from the owner.\textsuperscript{127}

Secondly, the State played multiple and conflicting roles in a state-owned enterprise. The State was the owner, supervisor, manager and creditor of such an enterprise at the same time. Moreover, the State exercised macro-economic functions including the social, regulatory and policy making function on the one hand, and engaged itself in micro-economic activities on the other. These two roles are inherently conflicting. The macro-economic role required that the State should concern itself with the overall economic performance of all enterprises; and the micro-economic role required that the State should only concern itself with the performance and economic efficiency of the particular enterprise.\textsuperscript{128} Therefore, to break such an integration of conflicting roles was essential in relation to making the enterprise focus on the interests of its own.\textsuperscript{129}

\begin{itemize}
\item \textsuperscript{125} See Arthur A Thompson, Jr & John P Formby, \textit{Economics of the Firm: Theory and Practice} (6th edn, 1993), 260-261.
\item \textsuperscript{126} The State (or the whole people) has to use agents.
\item \textsuperscript{127} Such a function is exercised by relevant administrative personnel or institutions. However, there are no incentives for these personnel and institutions to fulfill their duties diligently. Moreover, these people and institutions bring administrative interference which violate economic rules.
\item \textsuperscript{128} See Jiang, Yiwei (1980), “The Theory of an Enterprise Based Economy”, 1 \textit{Zhong Guo She Hui Ke Xue (Social Sciences in China)} 21, 29-36.
\item \textsuperscript{129} \textit{Ibid.}
\end{itemize}
Thirdly, there were no discipline and incentive mechanisms for the managers of state-owned enterprises to maximise the economic efficiency of the enterprises. A manager of such an enterprise was a government official who had no authority to run the enterprise independently and was not personally liable for the failure in business decision making. The appointment and promotion of a manager were decided by the administrative department, not the interested groups of the enterprises.\textsuperscript{130}

From the above analyses, it was concluded that to introduce corporate mechanisms into state-owned enterprises was necessary in relation to improve the economic performance of the enterprises. The attention then turned to how to corporatise state-owned enterprises. First of all, the status of state ownership and the share structure in a corporatised state-owned enterprise must be decided, because, after the corporatisation, state ownership had to exist in the form of equity. This caused debates about who was the owner of the corporation and corporate property and how to clarify state property in corporatised enterprises. There was the view that, upon the purchase of shares, a shareholder had transferred its ownership rights over the assets to the corporation.\textsuperscript{131} Thus, the corporation became the owner of the corporation and corporate property. This suggested that, after corporatisation, public ownership would be converted into corporate ownership.\textsuperscript{132} This view was generally rejected. In the end, the Chinese have basically

\begin{itemize}
\item \textsuperscript{130} See Mei Shenshi, \textit{Research on the Structure of Modern Corporate Organs' Power: A Legal Analysis of Corporate Governance} (1996), 34.
\item \textsuperscript{131} See Han Zhiguo, "The Important Issues on Ownership System Reform", \textit{Guangming Ri Bao} (\textit{Guangming Daily}, 10 October 1987), 2.
\item \textsuperscript{132} \textit{Ibid.}
\end{itemize}

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accepted the mainstream idea in Anglo-American systems that shareholders are the ultimate owners of the corporation.

It is understood that the ownership right over a corporation is different from the ownership right over corporate property. As the owners of a corporation, shareholders exercise their ownership rights in a different fashion. They can not directly dispose of corporate assets, but have the right to vote on decisions over corporate affairs. By investing in the corporation, the shareholders receive share ownership rights. Share ownership rights include the rights to receive dividends, to vote on important matters of the corporation, and to claim residual profits and assets upon termination of the corporation. Shareholders’ voting rights are an efficient and important monitoring instrument. It is the residual power to make decisions over corporate affairs. Therefore, it is believed that, after corporatisation, state ownership can still exist in the corporatised enterprises. A more sanguine view is that corporatisation will strengthen state ownership as a whole, because by exercising the controlling shareholder’s rights in the enterprises, the State’s overall capacity to control and utilize capital is enhanced.

It seems that the academic discussions have reached an agreement on share ownership rights. However, corporate legislation has been inconsistent. For example, Article 4 of the


134 Ibid.


136 Ibid, 66.

1994 Company Law states that “the ownership right over the state assets of a company belongs to the State”. This not only contradicts other provisions concerning shareholders’ status and corporate personality in the law, but also brings confusion as to the settled understanding of share ownership rights and corporate property rights.138

The share structure of a corporatised enterprise is basically designed to include state shares,139 corporate shares (legal person shares) and individual shares. The difficulty lies in the designation of state shares. Firstly, there is the need to separate commercial activities from the State’s policy, regulatory and social affairs. This is solved by setting up the Administrative Bureau of State Assets and state asset management companies to exercise the ownership rights of state assets and to manage state assets.140 The Administrative Bureau of State Assets is responsible for supervising and organising the use of state assets in state-owned enterprises or companies. State asset management companies function as holding companies. They own state shares in companies and involve themselves in the affairs of their subsidiaries through using their shareholders’ rights.


139 Here, the term “state shares” is used in a loose sense and include state shares and state-owned legal person shares. See discussions in “Introduction” of this thesis, 23.

Secondly, there is the question of how to clarify the state property in an enterprise. State property is the property received and controlled by the State according to the law.\textsuperscript{141} There should be no argument over the fact that the property in a state-owned enterprise is state property. However, since China tried various strategies to reform state-owned enterprises since the economic reforms, the situation has become complicated.

In China, state-owned enterprises comprise those confiscated enterprises of the former Guomindang Government and those purchased enterprises from the national capitalists after 1949, and the enterprises established by the State since 1949. Before 1984, as the State invested capital in state-owned enterprises and received all the profits, the property in this kind of enterprises all belonged to the State. After 1984, the country changed the policy. The capital investment of the State was treated as bank debts of the enterprises. After repaying interest to the State, the enterprises could have their own capital reserves. This brought complexity to the job of defining state property in these enterprises. Some suggested that the profits from the investment of the enterprises by using bank debts and issuing shares to the public should be treated as the property of the enterprises. Some held that these profits were still state property, as they were made by taking the policy advantages available for state-owned enterprises. For example, some state-owned enterprises used state assets as guarantees to borrow bank debts.\textsuperscript{142} In the end, the 1991 \textit{Interim Regulation on Determining the State Ownership Right over State Assets in}

\begin{footnotesize}
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\textsuperscript{141} Ibid, 31.
\textsuperscript{142} Ibid.
\end{footnotesize}
Enterprises states that the profits made by an enterprise established by using bank loans guaranteed by the State, are deemed as state property.\footnote{See the 1991 Interim Regulation on Determining the State Ownership Right over State Assets in Enterprises.}

In the process of corporatisation, state assets in state-owned enterprises are to be valued and converted into shares. The country has enacted laws to provide ways of valuing state assets.\footnote{See the 1991 Administrative Methods of the Evaluation of State Assets.} The reports from trials are mixed. In some cases, the value of state assets have been over estimated, and in other cases, under estimated.

It is generally perceived that, for the sake of economic efficiency, it is desirable to have different share owners in corporatised state-owned enterprises. This is because a company with the State as the only shareholder may not easily overcome the problem of administrative interventions which happened in the past. Thus, it is advantageous to invite other corporate and individual shareholders to take part in the company’s affairs.\footnote{See Xu Xiangyi et al, Organisation and Management of Modern Companies (1999), 180.} The participation of outside shareholders can enhance the supervisory capacity of shareholders. Hence, many suggest that only those state-owned enterprises that are important to the national economy should be reformed into state-owned companies. The rest of them, except a small number of them which are subject to privatisation, should be corporatised as state-controlled or state-invested companies, where the State holds controlling shareholdings or non-controlling shareholdings.\footnote{Ibid, 118-123.}
One of the important characteristics of shares is that they are freely transferable. This gives shareholders not only a freedom to quit the game, but also an effective governing power. The share price on the securities market is a significant reference for judging the managerial efficiency of a corporation. At this point, the corporatisation of state-owned enterprises in China poses a dilemma to the Chinese. If one allows state shares to be freely transferable, the State has to take the risk of losing its residual ownership rights over the state property and the controlling power in state-owned or controlled companies. Upon the sale of the state shares, the State is no longer the ultimate owner of a particular company and the company becomes a privatised enterprise. If one forbids state shares to be freely transferable, the external control mechanism over corporate management will have little influence over state-owned or controlled corporations.

For the time being, many Chinese are aware of the difficulty of allowing state shares to be transferred freely.147 This is not only because there are ideological obstacles, but also pragmatic concerns. It is understood that high social costs will be associated with the departure of state ownership from the companies. Consequently, the unemployment rate will go up and the risk of social instability will increase.148 Nevertheless, many people tend to support the view that except for some companies important to the national economy, the state shares in most other companies should be permitted to be sold on the


securities market, in order to bring the market control mechanism into and provide more financial sources for these companies.

In summary, although the economic and legal framework of corporatisation has been completed in China, many problems remain unsolved in relation to corporate governance in corporatised enterprises. These problems require special attention and detailed treatments, and present new challenges for Chinese policy makers and intellectuals.

CONCLUSIONS

The development of corporate ideology in China shows that Western concepts of ownership rights, the corporation and corporate governance are basically accepted by the Chinese academics and policy makers. The Chinese have relied on Western property right theories and corporate theories, especially the agency theory of the law and economic literature, to investigate the problems existed in state owned enterprises and to propose solutions.

The enterprise reform through corporatisation in China has just been initiated. The corporate law and practice are still at a stage of development. Before a full fledged, competent corporate governance system evolves in China, the Chinese will have to make their best efforts to appreciate and interpret the concepts and rationale of the modern firm.

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\[149\] Ibid.
Chapter 2

THE NATURE OF THE CORPORATION AND CORPORATE GOVERNANCE

(There is) the need to reeducate a whole generation to the fact that corporations exist in society as an important source of rights but with that comes some concomitant social obligations as the price to be paid for recognition of those rights. This is a projection into the corporate universe of an approach to the rights and duties of individuals in society which is predicated by a basic principle of reciprocity. – Professor John H Farrar 150

Corporate governance was not an important topic until the 1980s.151 In the aftermath of the Stock Market Crash of 1987, there were a large number of corporate collapses caused by corporate failure on a global basis.152 Corporate governance has, since, caught the public’s attention. In the 1990s, the discussion on corporate governance in legal and economic literature has become intensive. The continued economic globalisation, the growing negative public opinion about board effectiveness, and new regulatory and political pressure have been the joint forces to bring attention towards the subject.153


152 See Zhu Yikun, Corporate Governance (1999), 35-36.

The prominent object of studies and discussions on corporate governance is to find measures of improving corporate efficiency. For achieving this goal, a few specific issues must be dealt with first. These include questions about the nature of the corporation, why the corporation, for whose benefits the corporation is governed, and how the corporation is and should be governed. Before these questions are satisfactorily answered, talks about corporate efficiency represent castles in the air. Inquiries about the nature of the corporation and why the corporation, give explanations of the rationale of the corporation as the most popular business vehicle in modern society. Discussions about the question in whose interests the corporation is governed provide the direction and basis for judging corporate efficiency. Investigation of how the corporation is and should be governed will help us to understand what has been achieved and what has failed in current corporate governance systems. Only based on these theoretical and factual analyses, can the practical reform plans and mechanisms relating to increased corporate efficiency be introduced and implemented. This chapter attempts to find answers for the above issues, in order to provide the theoretical foundation for analysing some influential systems of corporate governance and for sketching a model of corporate governance for modern China, in the later parts of this thesis.

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THE NATURE OF THE CORPORATION

The concept of incorporation can be traced back to Roman law. However, it was not used as a common business vehicle until the 19th century. The Romans’ contribution relating the corporation lay in their comprehensive explanations of separate personality. This heritage was shared by both English and Continental corporate laws. This determined that modern corporate systems were built by the earliest industrial countries on a common foundation and had a fundamental similarity.

During the Middle Ages, incorporation was widely adopted by municipalities and churches in England and the Continental countries. However, the corporate objective of that time was by no means comparable to today’s corporate purposes. Evolution came slowly. In the 15th century, the earliest business companies were created by Royal Charter in England. Later, incorporation by Act of Parliament appeared. The purpose of incorporation by Crown Charters or by Acts of Parliament was to gain a monopoly in a particular trade, especially in colonial trade. A company of this type had a few characteristics of a modern company, but was virtually an extension of the domestic guild to overseas trade. However, such practice led to the development of the concepts of

156 Ibid.
joint stock and share.\textsuperscript{161} Furthermore, as incorporation was a special state privilege, it could only be obtained by a few businesses. Because of the substantial differences between a corporation of that time and a modern company, we can safely say that there was not a common practice of incorporation during that period. Nevertheless, some important corporate concepts such as perpetual existence, separation of its own acts from its members' acts, and transferable shares were firmly established.\textsuperscript{162} The same story happened in continental Europe.

As a result, before the mid-19th century, business structures were generally limited to the sole trader and partnership.\textsuperscript{163} A common characteristic of the sole trader and partnership was that investors of the business took unlimited personal responsibility for their business failure. This character determined that business investment was the sole practice of a small number of entrepreneurs. It was hard to image that the public with no experience and knowledge in trade and management would be interested in investing in a business by risking their entire wealth. With the occurrence of the industrial revolution and the expansion of trade, firms of those earlier industrialised countries first saw the necessity of raising funds from the public. However, without a business form that had a separate legal personality and a perpetual life, and moreover, which offered its members limited personal liability, this could never be achieved. There was the need to adopt a new business structure which could accommodate the needs of growing firms of pooling


\textsuperscript{162} \textit{Ibid}, 15-18.

capital from the public on the one hand, and the needs of investors of seeking an outlet for their accumulated wealth without risking their personal fortune on the other. This was the historical premise for the modern corporate concept and it provided the basis for corporate prosperity in modern society.

Although the needs were clearly comprehended, the corporate development did not come without a struggle. In England, efforts were once made to confine corporate activities within the authority of a Royal Charter or an Act of Parliament. A law was passed in 1720, which prohibited an undertaking from acting as a corporate body and from raising transferable stocks and shares unless a Crown Charter or an Act of Parliament was conferred. The difficulty and expense of a Royal Charter and an Act of Parliament were politically designed to curb the expansion of incorporation. However, the businessmen sought help from legal draftsmanship. By complex drafting by the legal profession, the “deed of settlement company” was invented. It was a hybrid of trust and partnership where subscribers invested in an enterprise with the invested joint stock divided into a specified number of shares. The assets were held by a trust, and the trust was managed by directors or managers. By a deed of settlement the function of a joint stock company and the limited liability were both achieved. The widely adopted “deed of settlement” motivated the government to regulate incorporation activities. As a result, a Companies Act was passed in 1844, which for the first time in English history provided

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166 Ibid, 30-32.
that companies could be established by registration. The significance of the 1844
*Companies Act* lay in that it, for the first time in the history of English law, confirmed the
idea that incorporation was a right under the law. In 1855, English company law made a
crucial move toward creating a modern corporate system by defining another most
important characteristic of a modern company, limited liability.

Parallel development happened in continental Europe. In France, corporations were
regulated as early as in 1673. Since the beginning of the nineteenth century, an
incorporated business form, *société en commandite par actions*, was developed, where
managing directors had unlimited liability and outside investors took limited liability for
the debts, a practice that was taken as reference when enacting the 1855 *Companies Act*
in the UK. In 1863, a limited liability company, a *société à responsabilité limitée*, was
created by law, where limited liability was conferred on both managing directors and
outsider shareholders. In Germany, the limited company was not permitted until 1884,
subject to the regulation of the comprehensive company code. A major contribution by
Germany to corporate development was the creation of the private company in 1892. The
private company was created to answer business people’s needs of incorporation by
taking the advantage of limited liability, without raising outside funds. Such a company
had limited membership with restrictions on transferring its shares.

The historical development of the corporation shows that the corporation came as a
result of business people’s practice of seeking to achieve their commercial purposes. Law
and legal theories often lagged behind the practice and sometimes only managed to
recognise the existing business activities. With this picture in mind, one should not be amazed by the fact that legal science has not yet delivered a satisfactory explanation of the nature of the corporation.

Legal Theories

A number of theories on the nature of the corporation have been developed by legal thinkers. Only a few have stood the test of time and evolved as influential until today. The organic theory has a wide influence in the Continent. The doctrine treats a corporation as a social organism with a real life, just as a human being of physical organism. It assumes:

[T]he subjects of rights need not be human beings, that every being which possesses a will and life of its own may be the subject of rights and that States, corporations, foundations are beings just as alive and just as capable of having a will as are human beings... Man uses his bodily organs for the purpose. Corporations use men.

Further down the road, the theory even attempts to identify which organ of the corporation corresponds to which physical organ of a human being. The fundamental fallacy of the organic theory is its unscientific approach that endows an inanimate

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169 Ibid, 499.


171 Ibid, 498.
concept with life. The approach confronts difficulty when applying it in reality. In the strict sense of the organic theory, a company's action of resolving to dissolve can amount to committing suicide, and a company's action of using another company in a subservient capacity can amount to slavery. These are the problems that courts encountered as early as the beginning of the twentieth century. Although the organic theory attempts to assert that a legal person is real, not imaginary, it ends up with making considerable demands on our imagination. Its basic flaw is that it treats analogy with a human being as a basis of a parallel reality. Therefore, this approach does not answer the question what is the nature of the corporation.

In the common law systems, the fiction theory evolved as the dominant approach to determine corporate personality. According to this theory, a corporation has legal capacity as if it were a natural person. This theory has, in fact, bypassed the question of what a corporation truly is, by taking a metaphorical approach. A corporation can be treated as a human being in some respects, and a non-human being in others. In other words, the common law only endows a corporation with the rights of a real person when it feels it necessary. The theory has the advantage of being able to reject some undesirable consequences of legal personality on the one hand, and to avoid an

172 Ibid.


174 Ibid.
anthropomorphic approach to analyse a corporation and to attach some personified ethical elements to a legal person on the other.\textsuperscript{175}

An alternative approach is to treat a corporation as a contractual arrangement of the incorporators. This doctrine is an advanced form of the fiction theory.\textsuperscript{176} While acknowledging that a corporation is an artificial person created by law, the theory emphasizes that the corporation is, in reality, a private arrangement of individuals contracting with each other.\textsuperscript{177} A modern version of the doctrine has recently developed to simply view a corporation as a “nexus of contracts”.\textsuperscript{178} The contractual theory is a complementary doctrine to the fiction theory. Moreover, it can be argued that it is another metaphorical statement. Hence, the inquiry into the nature of the corporation remains somewhat unanswered.

It seems that the legal investigation into the nature of the corporation has merely been pursued to the extent of being flexible enough to achieve practical purposes and then, it stops. As long as separate personality can provide a desirable business mechanism for investors, as long as the pragmatic problems can be solved through the devices such as lifting the corporate veil, the legal literature is prepared to overlook the theoretical inadequacy concerning the nature of the corporation. As a result, people turn to

\textsuperscript{175} Ibid.


\textsuperscript{177} Ibid, 27-28.

\textsuperscript{178} Ibid.
economics in searching for the answer. A new literature, the law and economics literature, has arisen against such a background.

Law and Economics Theories

The law and economics literature was initiated by Ronald Coase in the 1930s. In his article "The Nature of the Firm", he analysed why firms exist. He explained that firms exist as a team method of production. When people make transactions in the market system, there will be transaction costs caused by the imperfect market conditions. In other words, when people use the market system, there are uncertainties existing in the transaction process. The uncertainties are caused by limited market information and people's opportunism. The costs can be reduced by internalising market transactions in a firm. In a firm, relationships of parties are long-term and information exchange is centrally administrated. As a result, the transaction costs of market exchanges are considerably reduced. The later work of the first generation of the new literature has further developed to examine management in different firms, the separation of ownership and control in modern firms due to specialisation, and the monitoring role of markets. A second generation has concentrated on the problems of regulation.


181 Ibid.

According to this literature, firms, once established, face the task of survival and growth. The key is to improve their economic efficiency. Those who fail to do so, cannot survive market competition. Apart from improving technology in order to reduce the costs of production, to improve firms' management to curtail the agency cost is a crucial strategy to increase the firms' economic efficiency. The agency costs that result from the divergence of interests among the participants of the firm, are the inherent disadvantage associated with teamwork.183 In a firm, the evaluation of productive outcome and the reward associated with the evaluation are no longer based on the performance of each individual but the performance of the team as a whole. As a result, the incentives for individuals to devote their best efforts to the firm reduce, and the difficulty of monitoring individual performance increases. Sufficient devices should be put in places to reduce the costs caused by the above problems, such as to build a hierarchy chain for internal control, to establish incentives or monitoring measures for employees to limit the divergence of interests, and to exert the monitoring function of the market.184


In this literature, the corporation is nothing more but one type of firm. The reason that the corporation accounts for the bulk of today’s economic activities is because it is a type of firm that offers a separate personality with a perpetual life and limited liability.

To sum up, according to the law and economics theory, the firm exists because it provides a means of reducing the costs of market transactions. However, there is also a cost of using this administrative organisation. This cost can be restricted to a relatively low level through internal and external monitoring and control. The firm must make decisions about how to organise itself internally in order to maintain its internal efficiency.

The law and economics theory provides a useful perspective for the debates about the nature of the corporation. By employing economic rationality to explain the corporate nature, the theory stands on a solid ground. The literature has had a significant and sophisticated influence on modern corporate development.

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185 Ibid.


THE NATURE OF CORPORATE GOVERNANCE

The Fundamental Concepts

Many works have given a definition of corporation governance. Although there are differences in details, the general agreement is that corporate governance is a system or a process of directing and controlling the corporation.\(^{188}\) In terms of the scope of corporate governance, some hold the view that corporate governance only concerns the relationships among the corporation and its shareholders, executives and employees and productive efficiency.\(^{189}\) Others believe that it concerns all the relevant laws, cultures, and questions about distribution of profits and assumption of risks.\(^{190}\) Professor John H Farrar identifies the scope of corporate governance from a different perspective. Instead of specifying who should be the actors of corporate governance, he argues that corporate governance can be seen in terms of a core and series of penumbras:

The core is the law of directors’ duties, meetings and shareholder rights and remedies. The first penumbra is what might be described as hard soft law ... Next there are the codes of practice ... After this there is an outer penumbra of business ethics, increasingly the subject of company codes.\(^{191}\)

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\(^{190}\) See Margaret M Blair, Ownership and Control (1995), 3.

\(^{191}\) See John H Farrar, Corporate Governance in Australia and New Zealand (forthcoming in 2001), 1-2.
In this definition, all the parties and activities concerned and regulated by the relevant laws, codes and business ethics are in the scope of corporate governance.

Upon comprehending the economic significance of corporate existence, the object of corporate governance becomes clear. To improve the economic efficiency of the corporation is the first priority of corporate governance. However, there are different views on how to evaluate economic efficiency. This results from the theoretical divergence over the issue of whose economic interests the corporation should be directed towards. The orthodox view in the Anglo-American system is that the corporation should be run to maximise its shareholders’ economic interests. The shareholders’ interests are calculated by profits, because the creation of the corporation is for providing a means of increasing investors’ profits. However, some other systems prefer a broader interpretation by taking relevant social interests such as public relationship and employees’ welfare into consideration.

Therefore, according to the conventional view of the Anglo-American system, corporate governance is about how the corporation should be governed to ensure a maximum of return for the shareholders’ investment. From this point of view, people are likely to attribute most evils causing corporate failure to the fact that the separation of ownership and control has considerably shifted the controlling power from shareholders to managers. The relationship between shareholders and managers is seen as the typical

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193 Such as Germany and Japan.
principal/agent relationship. When the agent has more information and knowledge than the principal, the opportunity for the agent to use his or her position to pursue self-interests increases. Managers have better information about the company than shareholders. This asymmetry in information makes it possible for managers, instead of acting for the best interests of shareholders, ie, maximising the profitability of the company, to pursue other goals including their personal goals. This results in increase of agency costs. The solution is to design an incentive structure that can reduce the divergence of interests between shareholders and managers. An important strategy is to strengthen the monitoring capacity within the corporation, including to enhance shareholders’ participation and to reconstruct the board of directors in order to make the board more accountable to the shareholders. External markets are another controlling mechanism of limiting managers from straying too far from shareholders’ interests. Survival in market competition requires the corporation to engage in profit-maximising behavior. If the shares of a company fall below a certain level as the result of conflict of interest, the company will be likely to become the target of a takeover.

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195 Ibid.
196 Ibid.
197 Ibid.
With the theoretical development of corporate governance, the approach of regarding the primary goal of the corporation as maximising shareholders' profits is subject to more and more scrutiny. There is increased awareness of the appropriateness of elevating shareholders' interests over the interests of the corporation as a firm. Sometimes, shareholders' short-term goals of profit chasing may not be convergent with the corporation's long-term goals of development. To a corporation as a firm, the priority is to secure its long-term prosperity. For this purpose, a corporation does not necessarily maximise profits. Besides profits, it may need to give consideration to other goals such as gaining bigger market shares, long-run survival, satisfactory and secure profits, technological leadership, and attaining a good image.\textsuperscript{200} Hence, besides shareholders, a company needs to give certain attention to other interested groups such as employees, creditors, banks, and consumers. Moreover, shareholders' gains should not be obtained at the expense of social interests, or at least, the shareholders' gains should not generate an overall loss of wealth of the community.\textsuperscript{201}

Recently, there is a development in "contract theory" and "stakeholder theory", which provides rational justification for the corporation assuming more social responsibilities. According to the contract theory, a corporation is nothing more than a series of implicit or explicit contracts among the participants including shareholders, managers,


\textsuperscript{201} For example, while making profits, a company may create serious environmental problems. Healing the environmental will cost the community more money than that made by the company.
bondholders, employees, suppliers and customers. The term of "contract" refers to an economic relationship with reciprocal expectations and behavior between participants, and has a far broader range of coverage than a legal contract. It is a metaphorical description of "the complex arrangements of many sorts that those who associate voluntarily in the corporation will work out among themselves". Thus, shareholders in the constitution bargain their terms such as limited liability, transferable ownership, the relationship between them and management and the relationship among themselves. Creditors in debt contracts bargain their terms for restricting default. Workers in labor contracts bargain the terms of wages, work hours and holidays. The theory suggests that attention should be given to the overall relationship among corporate actors including shareholders, managers, creditors, debtors, employees, suppliers and consumers.

If the contract theory recommends that importance should be attached to all the bargaining powers of the corporation, the stakeholder theory goes one step further by holding that the society's attitude is a decisive power relating to the survival and prosperity of a corporation. Hence, a corporation has to effectively assume its social responsibilities and behave in a way that is beneficial to the public as a whole. Due to the power of society, "a corporation cannot afford to act in a detrimental way. For if it does, the corporation will surely perish". The stakeholders are those groups with a direct

203 Ibid.
interest in the survival of the corporation and without their support the corporation might cease to exist.\textsuperscript{206} Therefore, apart from shareholders, employees, the board of directors, management, major consumers, major creditors, major suppliers, unions, and the government can all be stakeholders.\textsuperscript{207} The corporation should be viewed as a multipurpose organisation and should be directed and managed to balance the interests of various stakeholders and achieve a general satisfaction. The stakeholder theory, since its appearance in the 1960s, has had a significant and far-reaching influence on corporate development, which has gone beyond the Anglo-American system into the rest of the world.\textsuperscript{208} Today, the development of the corporate economy has brought the world into an era of democratic capitalism.

In continental Europe, the idea of corporate social responsibility and industrial democracy are not new to many countries.\textsuperscript{209} In Western Europe, the issue of corporate governance has been tied up with the ideological debates over private ownership and public ownership, and owners and workers.\textsuperscript{210} In these countries, state-owned enterprises account for a significant proportion of their economic outputs, and the idea of political

\textsuperscript{206} Ibid, 103.

\textsuperscript{207} See Adrian Daview, \textit{A Strategic Approach to Corporate Governance} (1999), 23-7. Also see Abbass F Alkhafaji, \textit{A Stakeholder Approach to Corporate Governance, Managing in a Dynamic Environment} (1989), 103-17.


\textsuperscript{210} See Abbass F Alkhafaji, \textit{A Stakeholder Approach to Corporate Governance: Managing in a Dynamic Environment} (1989), 92.
democracy has been extended into industrial sectors.\textsuperscript{211} The essential point of industrial democracy is to acknowledge the importance of labor.\textsuperscript{212} The system of co-determination is the major reflection of the ideology of industrial democracy. There is also the consensus that corporations have the obligation to deliver goods and services to the community on a continuing basis.\textsuperscript{213} Some other systems, such as Japan, also adopt a cooperative approach, where employees' contribution to the success of the corporation is highlighted.

With the intensification of the research on corporate governance, it has become more and more evident that to regard the corporation as a sole economic entity created for maximising investors' profits is not feasible. The economic efficiency of the corporation should be measured on a basis that will ensure the long-term prosperity of the corporation and increase overall social wealth and welfare.

**Theories of Control**

The corporation must be governed. It must be governed so that its purpose of increasing corporate efficiency can be fulfilled. There is a number of controlling mechanisms that form a joint force to keep the corporation on track for realizing its objectives. Namely, these are internal control and external control including market control and regulatory

\textsuperscript{211} Ibid.

\textsuperscript{212} Ibid.

control. Internal control refers to control through corporate organs and through dividing powers among the internal organs.

The conventional model of the internal control structure comprises the shareholders’ meeting, the board of directors and management. As the founders and ultimate owners, shareholders have a right to decide important matters of the corporation. This right is practised through exercising shareholders’ voting rights at the shareholders’ meeting. Shareholders’ voting rights are efficient and important monitoring instruments, which, in fact, are the residual claimant rights.214 As the shareholders are the residual claimants of the company’s income and their claims are not fixed and depend on the company’s performance, they have the incentives to exercise voting rights.215 As a result, the voting rights actually flow to the shareholders.216 With the voting rights, the shareholders can remove inefficient management and block managers’ self-interested amendments to the constitution. As it is impossible for the shareholders of a corporation, especially a large corporation, to direct the company and monitor the managers daily, such powers and duties are conferred on the monitoring institution of the corporation, the board. The board has the power to supervise managers. The members of the board owe fiduciary duties to the corporation. Their appointment and dismissal are subject to the decision of the shareholders’ meeting. Hence, shareholders’ power to influence the company’s management is indirect, by either re-electing directors or amending the constitution.

215 Ibid, 68.
216 Ibid.
Lack of satisfaction by the general public with corporate performance highlights the issues that the separation of ownership and control has enabled management to pre-empt control of the corporation, and the board members are increasingly subservient to management. In many systems, reforms relating to enhancing shareholders' power, restructuring board, introducing industrial democracy, and encouraging the participation of interested groups have been proposed and implemented.

The inadequacy of shareholders' control is caused not only by the separation of ownership and control but also by the collective nature of the voting system. When large numbers of shareholders vote together, a single shareholder's voice will not be heard unless he or she joins with others to form a majority.\(^{217}\) As a result, none of them expects his or her votes to decide contest.\(^{218}\) Moreover, no shareholder has the incentives to study the company's affairs because of the "free rider" problem.\(^{219}\) The problem is mitigated to some extent by introducing the proxy mechanism and encouraging the participation of institutional investors. Those shareholders who do not want to invest money and time in attending shareholders' meetings can appoint proxies to vote on their behalf. Institutional investors are usually financial institutions investing and managing the funds of small investors, and their stock holdings are comparatively sizable. They are managed by professional managers and competing for investors' capital input. Thus, they have the incentives and the ability to invest money and time to study companies' affairs and to


\(^{218}\) *Ibid.*

\(^{219}\) *Ibid.*
exercise their voting power sufficiently. Judicial intervention is another important power of ensuring the adequate exercise of voting rights. It is particularly helpful in the case of protecting minority shareholders’ voting rights.\(^{220}\)

The accountability of the board is expected to increase by the separation of its supervisory function from its managerial function, and by increased scrutiny of interested groups and society. In the one-tier board system, the stress is put on the role of non-executive directors. It is believed that the non-executive directors’ independent judgement and monitoring of corporate performance strategies can raise the standards of good corporate governance.\(^{221}\) In the two-tier board system, efforts to enhance the independence and strength of the supervisory board are made constantly. Independent auditors are introduced into many jurisdictions. In some jurisdictions, major creditors, financial institutions and related companies are all actors that can effectively influence the board. Recently, it is increasingly proposed that interested groups should have representatives on the board.

Apart from the above internal control devices, the corporation is subject to certain external control mechanisms. The securities market is a major force of external corporate control. The price of a company’s shares on the stock market generally reflects the managerial efficiency of the company.\(^{222}\) The more inefficient the management is, the


lower the share price will be. Firstly, a company in such a situation will have difficulty in continually raising funds. Secondly, when many shareholders begin to sell their shares at a declining price, the company becomes more attractive to takeover bids. If the takeover succeeds, the board and the management will be replaced. For this reason, every board cares about their share prices on the stock market. As a result, the board of a company must take shareholders’ satisfaction into account when making business decisions.

Law and regulation are important means of government intervention in economic activities. By regulating corporate activities, the government ensures that the social fairness and justice, as well as the economic interests of the society, as a whole, are not undermined by the irresponsible practice of some corporations. The regulatory power of the government has its limits. The regulatory demand may exceed the government’s capacity of delivering such service. There is also a high cost associated with regulatory activities. Furthermore, research has shown that governmental operation can be imperfect and governmental intervention can be ineffective. Therefore, it is advisable for the State to facilitate the development of a self-regulation system, in order to reduce direct intervention.

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When regulation is desirable to a group of individuals or institutions for their common interests, there is the potential of self-regulation.\textsuperscript{225} Thus, the rules of performance and duties should be established and enforced. "Typical of such arrangements are those to which members of professional bodies subscribe in order to establish appropriate standards of professional conduct and competence".\textsuperscript{226} Self-regulation is the practice firmly embedded in the stock exchange market where capital can be raised and securities dealt in.\textsuperscript{227} While using the services, members must agree to conduct their business in accordance with the exchange’s rules and regulations. Those have failed to do so face the penalties ranging from censure to expulsion. Self-regulation is "conventionally regarded as having the virtues of flexibility and adaptability in the formulation and application of rules, speed and finality in decision making, and of being administered by experts".\textsuperscript{228} Although self-regulation has its limits and there are also cases of abuse and mismanagement,\textsuperscript{229} great faith and reliance are placed upon the principles of self-regulation in relation to the securities market.

To sum up, corporate governance is about directing corporations to achieve a maximum of corporate efficiency so as to ensure corporate continuity and expansion. It is about organising corporate organs and various relationships among corporate participants


\textsuperscript{226} Ibid.

\textsuperscript{227} Ibid.

\textsuperscript{228} See Neil Gunningham, "Moving the Goalposts: Financial Market Regulation in Hong Kong and the Crash of October 1987" (1990) 15 Law and Social Inquiry 1, 12.

\textsuperscript{229} Ibid., 1-48.
for an optimal economic outcome. In this course, shareholders, the board, managers, workers, the law and the market all play important roles.

THE NATURE OF THE CORPORATION AND CORPORATE GOVERNANCE IN THE CHINESE CONTEXT

Discussions of theories of the corporation and corporate governance have been increasing in China since the 1990s. Theories of the law and economics literature about the firm are basically accepted in academic discussions. The Chinese intellectuals have been trying to apply the agency theory, the corporate property theory and the theory of corporate governance to identify the defects of China’s current enterprise system and to make reform suggestions. The current enterprise reform strategies are also under the influence. The academic discussions conclude:

As a species of firm, the advantages of the corporation include: firstly, it is the most effective device of accumulating capital. Because the corporation can reduce the risk of investment to a minimum degree by limiting liability of members, it is more attractive to investors than other types of firms. Public companies by issuing shares to the general public can pool a large amount of capital.

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230 See the recent works of some leading academics of law and economics including The System of Legal Person (by Jiang Ping et al), A Few Theoretical Questions about Modern Enterprise System (by Jiang Xuemo), “What is Corporate Governance” in 5 Shanghai Economic Studies (by Fei Fangyu), Research on the Structure of Modern Corporate Organs’ Powes: A Legal Analysis of Corporate Governance (by Mei Shenshi), Modern Corporate Organisation and Management (by Xu Xiangyi et al), etc.

231 See Jiang Ping & Fang Lufang (eds), New Corporate Law Textbook (9th edn, 1998), 48-9.
Secondly, the corporation offers the most effective structure for enterprise property. It is understood that by separating investors from the company in which they invested, the corporation creates two legal subjects, two types of rights and liability. The shareholder and the corporation are two separate legal persons. They have different rights and liability. The former owns share property rights, while the latter owns corporate property rights. Their interests are basically convergent, but sometimes divergent. This kind of the interaction provides an effective mechanism of economic efficiency.

Thirdly, the corporation offers the possibility of producing most effective management. The corporation enables the owner to separate from the management. This enables the corporation to develop towards specialization and to adopt scientific managerial strategies. The association of public capital and scientific management facilitates productivity.

Fourthly, the corporation is a business device for effective central control and management. The continuation and expansion of companies result in the formation of company groups. This brings about the concentration of capital and labor, which facilitates large-scale production.

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233 Ibid.
234 Ibid.
235 Ibid.
236 Ibid, 50.
237 Ibid.
238 Ibid.
At the time when the enterprise reform started, it was well understood that, if China was to establish a market economy, its traditional enterprise system must be reformed. This traditional enterprise system was a system of high degree of administrative intervention in economic activities. The enterprises in the system were basically workshops of the government. The system had its distinctive methods of directing the enterprises. The government allocated capital and resources and the enterprises carried out productive activities according to the State’s plans. The profits of the enterprises should be submitted to the State and the products were collected and distributed by the government. The losses of an enterprise were compensated by the State and the State’s property could be used to offset the losses. This system was suitable to a product economy but not a market economy. Under this system, an enterprise could not and need not to be an independent legal entity.

As China’s traditional enterprises were managed by governmental departments and administrative staff, the economic inefficiency caused by the integration of government administration and enterprise management appeared to be a serious problem. To many Chinese, the first step of the enterprise reform towards the establishment of an enterprise system suitable to a market economy, should be to separate ownership from control. The separation of ownership and control was regarded as an important progress of the development of the firm. It encouraged specialisation and technological advancement and

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240 See Jiang Ping & Zhao Xudong (eds), *The System of Legal Person* (2nd edn, 1996), 236.

241 Ibid.
made it possible for enterprises to be managed by professional managers. This was seen as a crucial step to improve the enterprise' performance. In this respect, only the corporation could satisfy such a need.

Once the separation of ownership and control was achieved, the next stage was to worry about a range of problems of corporate governance including those caused by the separation of ownership and control. Discussions on corporate governance in some leading works of law and economics in China, have suggested that the mainstream theories of corporate governance in Anglo-American systems have basically been accepted by the Chinese. The theories are primarily influenced by the agency theory. Hence, many discussions on reform strategies focus on how to reduce agency costs through establishing monitoring mechanisms.

In terms of corporate purposes and the role of labor, the Chinese prefer the European model. The 1994 Company Law clearly states that, in the course of realizing its economic goals, a corporation is subject to the surveillance of the State and the general public. China is building up a securities market and the market begins to bring economic benefits. A system similar to co-determination in the European systems is also introduced by the company law. Recently, the stakeholder model began to attract more attention.

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242 Ibid, 237.
243 See On Kit Tam, The Development of Corporate Governance in China, 19.
244 See relevant sectors in the 1994 Company Law.
This may become the dominant theoretical model, since it suits the current position of Chinese corporate law.\textsuperscript{245}

**CONCLUSIONS**

The inquiry into the nature of the corporation should be made in a broader context. To limit the investigation to the boundary of legal study will confine our thoughts in the course of understanding the truth and reality. As the corporate system is used to serve various economic and social purposes, its development in character must inherently reflect economic and social rationality. The law comes to regulate corporate activities by establishing models that will maximise corporate value. The law also preserves social values such as social good, fairness and justice. However, in seeking to deal with the corporate nature, the law has only gone so far. As a result, a theoretical gap remains. The recently developed law and economics literature brings inspirational insight to the research on the corporate nature.

At an early stage, when capital was scarce, the market was closed and competition was not intense, the problems inherent in corporate governance were not so acute. With the development of a corporate economy, the problems become serious. A series of cases of corporate failure since the 1960s, has caused wide concerns on corporate accountability. Corporate governance becomes an important issue in the corporate world. Corporate governance is about directing corporations to achieve maximum efficiency so as to ensure corporate continuity and expansion. It is about organising corporate organs and

\textsuperscript{245} Both the shareholder value and the stakeholder value can be found in the Chinese law.
various relationships among corporate participants for an optimal economic outcome. Apart from market and regulatory control, the corporation provides a fundamental structure for corporate governance. By dividing powers among corporate organs and corporate participants, the corporation achieves the purpose of long-term growth and prosperity. This internal control mechanism is becoming more and more important in relation to corporate governance.

The acceptance of the corporation as a reform policy has been firmly upheld in China since the 1990s. The notions of the corporation and corporate governance begin to take root in China. Although a consistent and mature system of corporate governance is far from completed, it can be predicted that a modern corporate system will ultimately be in its place as part of the enterprise reform.
Chapter 3

THE EXTENSION OF THE CORPORATE CONCEPT: CORPORATE GROUPS

The advent of corporate groups is the result of corporate development.246 A corporation can become a shareholder of other corporations by purchasing their shares. By holding and cross holding of shares, a number of companies connected together may form a corporate group.247 The controllers of the group may plan, instigate and co-ordinate the managerial, operational and financial activities on a group basis, and implement these activities through individual group companies.248 In doing so, the corporation can enjoy the advantages of maximising financial returns, limiting commercial risks and expanding markets.249 However, the practice adds new complexities to the already complicated corporate system, which stems from the fact that the fundamental norms and legal framework of the corporation had been built up prior to the emergence of corporate groups in the early-industrialised countries. As a result, the use of corporate groups


247 Ibid.


249 Ibid, 1.8.
inevitably brings certain contradictions and challenges to the well-established corporate notions and practice.\textsuperscript{250}

Today, most companies of the corporate world belong to different corporate groups in one way or another.\textsuperscript{251} Efforts have been made by different legal systems in favor of developing an effective legal framework to deal with the problems presented by corporate groups. Basically, two strategies have been predominant. The first is to create or build a separate legal regime to regulate the operation of corporate groups. German corporate law falls into this class. The second involves conditionally abandoning traditional principles of corporate law and applying specially designed legal structures to corporate groups, upon the occurrence of certain events. This principle is generally applied by Anglo-American systems.

Since the 1970s, for the purpose of enhancing the competitive ability of its enterprises, China has made a great deal of efforts to establish a network for enterprise co-operation. Various trials were carried out, including setting up various enterprise alliances (\textit{lian ying}), enterprise groups (\textit{qi ye ji tuan}) and corporate groups (\textit{ji tuan gong si}). China’s 1994 \textit{Company Law} only addresses the terminology of parent companies and subsidiaries, but has no further provisions specific to corporate groups.\textsuperscript{252} With the development of corporate practice, the patchy provisions concerning enterprise alliances


\textsuperscript{252} See Article 12 & 13 of the 1994 \textit{Company Law}. 

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in the 1986 Civil Code become less and less relevant. China urgently needs to develop an effective legal framework to guide the practice of corporate groups.

This chapter firstly examines the theoretical challenges and difficulties brought by corporate groups. Then, it discusses how the problems corporate groups are tackled by other jurisdictions so as to provide some wisdom and inspirations for the Chinese government’s legislative efforts in these arena.

THE THEORETICAL ISSUES CONCERNING CORPORATE GROUPS

The Abuse of Separate Personality and Limited Liability

Separate personality and limited liability form the basis for the modern corporation. The vitality and attraction of the corporate structure rest on its predictability to investors. It makes it possible for investors to evaluate their business risks and liabilities. These qualities were foreseen by those founding fathers of modern corporate law. When designing corporate laws, they had the clear view of designing a business form that would protect individual investors through preventing their investment from triggering unlimited personal liability. As holding the shares of other companies was generally forbidden by laws at that time, the doctrines of separate personality and limited liability


were, for a time, thought to be sufficient.\(^{255}\) However, problems appeared when limited liability was needed to extend to holding companies. This then introduced limited liability within limited liabilities.

As a means of pooling resources and sharing profits, portfolio investment by corporations was generally permitted since the end of nineteenth century.\(^ {256}\) Since then, the conventional concepts of separate personality and limited liability began to apply to holding companies and started to experience crises. As the existence of groups of companies is to achieve an optimal performance of the group as a whole,\(^ {257}\) this goal thus, sometimes, necessitate sacrifice of an individual company's benefits in order to maximase the gains of the whole group. For example, to implement a strategy that is good for the group, a parent company may instruct a particular subsidiary to sell raw materials to another subsidiary at a low price and to buy the products manufactured by the first company at a high price. In doing so, the group makes gains at the expense of the interests of outside shareholders and creditors of that particular subsidiary. In such a case, business is fragmented among the component companies of the group, and limited liability and separate personality are used to “protect each fragment of the business from liability for the obligations of all the other fragment”.\(^ {258}\) Hence, it becomes evident that

\(^{255}\) The action of purchasing other companies’ shares was firmly forbidden by the common law at the early stage of corporate history.


the traditional doctrines of corporate separate personality and limited liability are no longer adequate in dealing with corporate groups.

In relation to corporate governance, corporate groups pose the question of how the directors of the companies of the same group direct their loyalties. How do they comprehend and judge the concept of “for the best interests of the company” when they make their business decisions, especially in a situation where there is a conflict of interests between the group as a whole and the individual companies to which they owe their duty of loyalty. With the increasing domination of corporate groups in the world and the national economies, every corporate system has to give adequate attention to the issues posed by corporate groups, such as remedial mechanisms for outside shareholders and duties of controlling companies.

The Strategies of Regulating Corporate Groups

In the conventional sense, corporate groups disturb the balance of power between management and the companies concerned in the conventional sense. As a result, the fate of the subsidiary companies is decided by someone other than their direct management and board of directors. This is the problem that every corporate system has to face. Different strategies have been developed. While some systems regulate a corporate group as a single entity, others adopt the approach of conditionally disregarding the separate personality of individual companies of the group. While some systems allow greater freedom to the controlling companies, others may have stricter rules relating to the
exercise of power by parent companies. The best example of this could be the divergence between German law and the common law.

Germany was the first country that has a separate legal regime in the form of Aktiengesetz as a way of regulating groups of companies. The law stipulates strict rules of disclosure. It defines the situations of contractual group relations, de facto group relations and integrated group relations. Once a company falls into the category of group companies, it is regulated by a different and self-inclusive set of rules in terms of liabilities and corporate governance. The rules clarify the responsibility of holding company managers to the subsidiaries, and the liability of a holding company to the debts of the subsidiaries. While a parent company enjoys the freedom of directing its subsidiaries, it has to fully indemnify the subsidiaries’ losses caused by its decisions within the next accounting period. In other words, the German law treats a corporate group as a single entity. Hence, it is a logical conclusion that this entity exists to pursue the interests of the group as a whole. Recently, German courts have also developed a body of leading cases, which has further enhanced the potential of the German law in


260 The separate legal regime, Aktiengesetz, was created in 1965.

261 See sec. 20-21 of Aktiengesetz.

262 See sec. 309, 317 & 322 of Aktiengesetz.

relation to the regulation of corporate groups. Some other continental European countries have followed the German approach.

In common law jurisdictions, groups of companies are gradually brought under effective control by extensively introducing statutory rules concerning corporate groups. In the early stages, traditional law, based on the doctrine of separate personality and limited liability, was unable to deal effectively with corporate groups. As a result, equity jurisprudence developed the concept of "piercing the corporate veil". However, the remedy was still inadequate, as it was only available in "rare" and "exceptional" situations. The situation was not improved until a sophisticated doctrine of "control" was generally adopted by the common law jurisdictions. The United States has taken the lead in this process. The concept of "control" refers to situations where a company has the power to direct or command the direction of management or policies of another company. It is used to determine the demarcation of selective abandonment of the traditional principle of corporate personality, and the demarcation of selective application of enterprise principles, a system of rules specially designed for regulating corporate groups. Once a company satisfies certain conditions, it is assumed to have control over


266 Ibid, 298.


another company. Thus, the relationship between the companies should be regulated by the enterprise principles. When enterprise principles apply, the corporate group is treated as a single entity.

The difference between the German approach and the Anglo-American approach lies in the fact that the Anglo-American model persists in the separate entity approach. In this system, each company in a corporate group is a separate legal entity with its own rights and duties. Therefore, parent companies are not automatically parties to the contracts entered into by other subsidiaries with external parties, nor do they become automatically liable for the debts of the subsidiaries. Directors owe their primary duties to their individual companies and they should make business decisions for the good of their own companies. Directors can take the group’s welfare into consideration only if there is no conflict of interests, and may be liable if they make a decision that benefits the group as a whole but to the detriment of their own individual companies. This doctrine has been firmly accepted by the courts of Anglo-American jurisdictions. For instance, in the

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269 "Control" is universally used to determine group relationship. However, different systems have different interpretations regarding its content. For example, in the USA, "control" means the power, directly or indirectly, to exercise a controlling influence over the management and policies of a company. It can be exerted either by the ownership of voting securities, or one or more intermediary persons, or by contract, etc. A person who, alone or jointly with others, owns or has the power to vote more than 25 per cent of the outstanding voting securities of a company is assumed to have the control over that company. In the UK, a company is assumed to have control influence over another company, if it is a member and controls the composition of the latter's board of directors, or it controls half nominal value of latter’s voting share capital. See sec. 202(29) of the Federal Securities Code of the USA. Also see Klaus J Hopt (ed), *Groups of Companies in European Laws* (1982), 99.


272 The clear example can be found in the UK company law and Australian company law.
English case *Charterbridge Corp Ltd v Lloyds Bank*, Pennycuick J rejected the view that the directors in a subsidiary could act with a view to the benefit of the group as a whole, without giving separate consideration to the interests of their own company. His Lordship said:

Each company in the group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interest of that company. This becomes apparent when one considers the case where the particular company has separate creditors.\(^{273}\)

In the Australian case *Equiticorp Finance Ltd (in liq) v. Bank of New Zealand*, Clarke and Cripps JJA took an even stricter view in relation to breach of directors’ duties. Their honours said:

A preferable view may be that where the directors have failed to consider the interests of the relevant company they should be found to have committed a breach of duty. If, however, the transaction was, objectively viewed in the interests of the company, then no consequences would flow from the breach.\(^{274}\)

Single enterprise principles apply where there is the possibility of victimizing creditors and minority shareholders.\(^{275}\) The general view is that single enterprise principles supersede separate entity principles when certain events stipulated by the corporate laws have occurred.

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\(^{273}\) *Charterbridge Corp Ltd v. Lloyds Bank* [1970] Ch. 62 at 74.


Comparatively, the single entity model of Germany is generally perceived as advantageous in coping with the problems of corporate groups.\textsuperscript{276} One certainty is that this approach is definitely closer to economic reality.\textsuperscript{277} The adoption of the model is beneficial in term of reducing practical and theoretical complexities.

THE ISSUES OF CORPORATE GROUPS IN THE CHINESE CONTEXT

The Historical Development of Corporate Groups in China

The Chinese leadership has long had the intention of establishing an efficient business network in China in order to foster economies of scale and to improve firm performance. However, the aspiration of establishing enterprise groups was constantly frustrated by political and other reasons. As early as in 1948, Liu Shaoqi, the first vice-president of the PRC, made the suggestion of establishing a corporate system that nurtured enterprise alliances in China.\textsuperscript{278} When Liu Shaoqi and Dong Xiaoping were in charge of economic development in the early 1960s, they frequently made a point of learning from the experience of establishing trusts and economic monopoly in developed countries so as to enhance the productive capacity of the state-owned enterprises. In 1964, the first twelve trusts were put in trial. Some trusts were made up of the enterprises making the same

\textsuperscript{276} See Companies & Securities Advisory Committee (Australia), \textit{Corporate Groups Discussion Paper} (1998), 1.44 – 1.48. Also see Alfred F Conard, \textit{Corporations in Perspective} (1976), 82-83.

\textsuperscript{277} See Companies & Securities Advisory Committee (Australia), \textit{Corporate Groups Discussion Paper} (1998), 1.44.

products for the purpose of unification of management. Some trusts comprised enterprises of main products and by-products for the purpose of comprehensive utilization of resources. As China strictly held the economic doctrines of the planned economy at that time, a trust was defined as an economic organisation of socialist public ownership with a central management. In other words, a trust was an economic unit with independent accounts that carried out business activities under state plans. The historical situation determined that these trusts were established as a result of the state's administrative arrangement, rather than voluntary coalitions among enterprises. Although the goal of establishing the trust system was to increase managerial efficiency, it was questionable whether it could significantly reduce administrative intervention at a time when state plans penetrated every aspect of economic activities. Before the trial was completed, the Cultural Revolution began, which put the practice of trusts to an end.

Since the economic reforms in the late 1970s, enterprises were given a certain degree of autonomy. As the enterprises were allowed to retain part of the profits they generated, it became possible for the enterprises to freely form their business alliances. As a result, various forms of enterprise alliances appeared. The Chinese government believed that the development of these enterprise alliances served the purpose of the economic reforms, and thus provided legal and policy support for the exercise. At a time when the planned economy was still playing the dominant role and the market economy only played a

279 See the 1964 Report on establishing Trusts in Industry and Transportation Sectors by the Economic Council of the State.

280 Ibid.
supplementary role, this type of free combination among enterprises was helpful in relation to improving the situation of self-isolation in different areas and different sectors caused by the planned economic structure. Because of lack of legal definitions, all kinds of alliances were generally called horizontal economic alliance (lian ying or heng xiang jing ji lian he), in contrast with the vertical relationship between administrative departments and their controlled enterprises in traditional enterprise system.

Later, the 1986 Civil Code classified different types of economic alliances. According to the Civil Code, there were three types of economic alliances: first, the economic alliance that creates a new legal entity (legal entity alliance); second, the economic alliance that does not creates a new legal entity (partnership alliance); third, the economic alliance based on a contract (contractual alliance). Strictly speaking, all these economic alliances described were, in fact, not corporate groups, but special types of business co-operations that were a joint product of China’s planned economy and the economic reforms. Apart from some provisions in the Civil Code, there were also a few legal documents regulating these economic alliances. These provisions and regulations were obviously inadequate and defective. For example, the economic alliance creating a new legal entity was bound by limited but rigid rules. The binding tie of the alliance was not shareholding or interlocking directorship, but a co-operative contract. Each party might subscribe some investment. The alliance ceased to exist once the contract was terminated. The parties to the alliance had no duty to disclose the contents of the

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281 This was the macro-economic structure at the early stage of the economic reforms.

282 See Article 7 of Supreme Court’s Answers to the Questions Arisen from the Trials Involving Co-operative Contracts.
contract to the third party, but had the right to freely withdraw their invested funds. Furthermore, there were no requirements on consolidated accounts and unified management of the group. As a result, the third party was left unprotected in the transactions with the economic alliance. The arrangement also created uncertainties to the co-operation, as parties could terminate their contract at any time.

The rules regulating partnership alliances brought even more confusion. *The Civil Code* distinguished the partnership consisted of individuals and the partnership consisted of enterprises (partnership alliance). While individual partners took unlimited liabilities, enterprise partners only did so if there were clear statements about their joint and unlimited liabilities in laws or in the co-operative contracts. This provided the opportunity for the parties of such an alliance to avoid their liability and to victimize the creditors and other third parties.

With the deepening of the economic reforms, the need to further advance the co-operation between enterprises increased. The existing economic alliances were not competent enough to accommodate the increasingly comprehensive enterprise co-operation. A new type of economic alliance, enterprise groups, emerged. The practice of enterprise groups started at the end of 1980s and the beginning of 1990s, and soon became dominant. In the beginning, there was no clear definition of enterprise groups.

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An enterprise group was generally perceived as a form of business alliances that could deliver a larger scale co-operation among enterprises. It was an aggregation of a large number of individual enterprises. The advantages of enterprise groups included accelerating the enterprise specialization, promoting technology development and reducing informational asymmetries by facilitating the flow of information among enterprises.287

Although the enterprise groups have served important practical purposes and have been used as a leverage by the government to assist enterprise reforms, little legal attention has been given to them. Up to now, there is no definition of enterprise groups from legislative sources. However, academic discussions have gradually become sophisticated. In the early stages, an enterprise group was defined as an “economic alliance consisting of a number of enterprises of different areas and different trades”, or “an economic organisation with multiple levels to answer the need of large scale of economy”.288 It is clear that the above descriptions do not capture the essence of the relationship. Later works provide clearer views on the nature of enterprise groups. Some point out that the essential characteristic of an enterprise group lies in its central management.289 Therefore, an enterprise group has to be defined as an economic alliance consisting of a number of legal entities and based on a central management.290

287 Ibid, 404.


289 See Jiang Ping & Zhao Xudong (eds), The System of Legal Person (2nd edn, 1996), 390-391.

290 Ibid, 391.
The situation of lack of legal regulation relating to the practice of enterprise groups may soon end. The Chinese government is aware of the urgency of producing a legal framework to control the practice of enterprise groups. With the launching of the enterprise reform, the corporation becomes the focus of the country's economic activities. It is predictable that China will head in the direction of standardizing the activities of its economic alliances by introducing the practice of corporate groups into its system.

The Perception of Corporate Groups

The Chinese government and the intellectuals are well aware of the importance of business groups to an economy. They have seen how business groups function in increasing economic efficiency by internalising market transactions within the groups, in the leading economies such as the USA, Germany, Japan and other developed countries. They are also aware of the fact that business groups have facilitated the rapid industrialisation in some late industrialised countries such as Japan and South Korea.291 Hence, it is believed that to develop China's large business groups with similar structural features of those in the above mentioned countries will speed up the process of modernisation in China.292

The practice of business groups in China is still in a primitive stage. The existing enterprise groups, in fact, amount to a kind of joint ventures in a loose sense. They are


small in size and lack stability. The tie binding individual enterprises to an enterprise group is a contractual agreement, rather than shareholdings. In China, it is common that the individual enterprises of an enterprise group may not comply with the decisions of the central management. Some hold that the situation of lack of compliance will change, if the enterprises of a business group are brought together through holding and cross holding shares among the enterprises. Hence, it is necessary to introduce a stockholding mechanism into China's enterprise groups. This will become reality before long, as the current enterprise reform is a process of achieving a general corporatisation. Upon the completion of the reform, most Chinese enterprises will be transferred into companies. The enterprise groups will certainly be replaced by the corporate conglomerates.

It is believed that the government should take the responsibility for designing an effective corporate group system for the country. The experience of Japan and South Korea shows that governmental guidance and support have been important in fostering their dynamic corporate group systems, which, in return, have remarkably enhanced the competitive capacity of their corporations in the international market. In China, most large and important enterprises are state-owned enterprises which, after the corporatisation, have remained and will remain as state-owned or controlled companies. The situation makes the government's role become even more significant in the process

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293 See Jiang Ping & Zhao Xudong (eds), The System of Legal Person (2nd edn, 1996), 393.


295 See Xu Xiangyi et al, Organisation and Management of Modern Companies (1999), 228-229.

296 Ibid.
of establishing a corporate group system. The enterprise reform may enable the government to kill two birds with one stone, *ie*, to corporatising state-owned enterprises on one hand, and assembling them into corporate groups on the other.

Companies should be bound to a group by the shareholding mechanism and by contracts. Shareholding is a crucial mechanism of sustaining control in the group structure. It is recommended that the vertical and horizontal shareholding relationships should all be introduced into the Chinese enterprise system. By establishing holding or parent companies, a corporate group forms a hierarchical chain of control among companies. This is the so-called vertical shareholding group. Meanwhile, it is suggested that the experience of cross-shareholding widely exercised by the Japanese *keiretsu* is also worth emulating. The Chinese call this type of shareholding structure a "horizontal shareholding structure" and intend to utilize the method to form the marriages between core companies, so as to achieve "strong and strong combination" (*qiang qiang lian he*).

The 1994 *Company Law* is primarily drafted to regulate single companies. There are nearly no provisions about corporate groups. Producing legal guidance for the practice of corporate groups should be the top priority of the government. At the moment, academic discussions have not yet reached an agreement on the legislative method. While some

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297 Ibid.
298 Ibid.
299 Ibid.
300 Ibid.
suggest having a separate law to regulate corporate groups, others recommend inserting special provisions on corporate group. 301 An alternative view is to regulate corporate groups by the joint work of all relevant laws including company law, taxation law, and anti-trust law.

Although it is not clear whether China will take the single entity approach or separate entity approach, the control test in Anglo-American systems is well received in academic discussions. 302 Attention is also directed to the issue of protecting minority shareholders.

On December 21, 1999, in the 13th Session of the National People's Congress (NPC) Standing Committee, China's top legislature, examined and deliberated on the Draft Amendments to the Corporate Law. It is expected that the forthcoming amended Company Law will provide indications about the direction of future development of the Chinese law on corporate groups.

THE EXTENSION OF THE CONCEPT OF CORPORATE GROUPS: COOPERATIVE STRATEGIES - STRATEGIC ALLIANCES AND NETWORKS

The corporate group is a device of resource allocation in a market economy. It is the third transaction mechanism after markets and the firm. Markets and the firm are alternative choices for transactions. Depending on their comparative efficiency or advantages,


302 See Jiang Ping & Zhao Xudong (eds), The System of Legal Person (2nd edn 1996), 392-411. Also see Xu, Xiangyi et al, Organisation and Management of Modern Companies (1999), 250-253.
people can choose to execute their transactions either cross markets or within a firm. While firms have developed to reduce the transaction costs occurred in the market by internalising transactions, they can also be costly due to scale diseconomies or control losses. Thus, corporate groups are used to fill the gap. Using corporate groups to execute transactions can avoid the transaction costs which would have incurred by using markets and the costs caused by expansion of the firm. Firms have strong incentives to form or join a group, when the benefit of forming or joining a group exceeds that of using the market and firm mechanisms.

However, business groups are not the only alternative of markets and the firm. In fact, hierarchical relationships within firms and explicit market relations between firms are just “the extreme points of an organisational spectrum”, and “hybrid forms of organisation occupy the intervening space”. These hybrid forms include not only business groups but also cooperative strategies comprising strategic alliances and business networks. In certain circumstances, for certain business purposes, strategic alliances and business networks have advantages over corporate groups. A corporate group, in essence, is a formal cooperative arrangement. There have to be some kind of

304 Ibid, 61.
305 Ibid.
306 Ibid.
307 See the Bureau of Industry Economics (Australia), Networks: A Third Form of Organisation (Discussion Paper 14, 1991), 7. Also see the detailed discussions and analyses on this issue in Oliver E Williamson, The Economic Institutions of Capitalism (1985).
formal or binding links existing between the members of the corporate group, including common parent, cross shareholdings, and interchange of directorships. Costs are incurred in the process of establishing, maintaining and effectively using these binding links to achieve business purposes. Furthermore, forming or joining a corporate group is not the desirable solution for achieving certain business purposes in certain business environments. For example, to enter into an industry or regional sector by acquiring or establishing subsidiaries may be infeasible according to a country's law.309 In this situation, it is desirable to do business through strategic alliances and networks.

Strategic alliances are defined as to include “joint ventures, collaborations, and consortia”.310 A joint venture is usually “either a partnership or something closely allied to partnership, although it can take the form of formation of a joint venture company”.311 Compared with a joint venture, other types of alliances are looser forms of cooperation such as product swaps, production licences and technology alliances.312 A network is also a loose form of business cooperation. To distinguish a network from other types of alliances, We need to look at the purpose of using networks and alliances.

Firms go into a joint venture or an alliance for avoidance of the uncertainty inherent in market transactions and the costs of establishing hierarchies. The strength of joint

308 See John H Farrar, Corporate Governance in Australia and New Zealand (forthcoming in 2001), 18.
310 Ibid, 6.
311 See John H Farrar, Corporate Governance in Australia and New Zealand (forthcoming in 2001), 19.
312 Ibid.
ventures and alliances lies in their ability of promoting organisational learning. Through joining joint ventures and alliances, technological and managerial know-how and knowledge are transferred and exchanged among partners, new product researches and development are jointly carried out, and employees are jointly trained. In addition, firms are motivated by the challenge of entering into international market to set up joint ventures and alliances. This is because the choices of doing business in a target market are limited. In some situations, apart from direct exporting, a firm has to make a choice from licensing, counter-trade, product swap, or setting up a joint venture.

Contrasting strategic alliances, the strength of networks lies in their specialisation, adaptability and flexibility, not necessary in learning opportunities. Networks exist for the reason that members of a network are complementary and synergistic in relation to functions and contribution. A typical scenario is that a firm finds its customers, distributors or suppliers in its network. The bonds of the network are usually friendship, trust and interdependence. Consequently, a network “suggests close but non exclusive relationships”.

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313 See John Child & David Faulkner, *Strategies of Cooperation, Managing Alliances, Networks and Joint Ventures* (1998), 67

314 Ibid.

315 Ibid.

316 Ibid.

317 Ibid, 113.


Recently, the function and advantage of cooperative strategies including strategic alliances and networks have been increasingly acknowledged. This is because the economic globalisation requires more effective business devices for global competition, and the technology development has provided opportunities for more flexible business arrangements by reducing the costs of communication.\textsuperscript{320} It is interesting to see, with increasing exploitation of these strategies, what influence the practice may impose on corporate development.

Since opening up, China has effectively used many types of strategic alliances to assist its economic reforms. These strategies have proven to be remarkably successful in attracting foreign investment to serve the purpose of the reforms. Chinese-foreign joint ventures and other types of Chinese-foreign alliances play an important role in China’s rapid economic development. Internally, enterprise cooperation has also been encouraged by the government. Recently, discussions about enhancing enterprise strength by promoting enterprise cooperation have increased. However, more attention has been paid to the formation of corporate groups and some close forms of cooperation. It seems the importance of informal cooperative arrangements, particularly business networks, has not been sufficiently addressed in China.

CONCLUSIONS

The development of corporate groups is the choice of economic development. Firm production reduces the transaction costs of using the market mechanism. However, there is an organisational cost for using firms. Business groups offer an alternative transaction mechanism that, under certain circumstances, is more efficient than the market mechanism and internal organisation. Corporate groups have shown power in terms of facilitating economies of scale. To survive in groups makes corporations become fitter and more adapted to encountering the challenges brought about by increasing market competition and globalisation.

The formation of corporate groups is one of the most significant components of China’s enterprise reform. The Chinese government is planning a corporate system with strong corporate groups to ensure that the existing enterprises can survive the pressure from further opening up and to gain a share in international competition. The practice and the law making are still processing. The experience of corporate groups in different systems provides rich resources for the Chinese to selectively take in suitable practice and make appropriate legal transplants. In current China, apart from corporate groups, adequate attention should also be paid to the issue of how to foster informal cooperation among Chinese firms, such as strategic alliances and networks. In a fast changing environment fueled by economic globalisation and rapid technologic innovation, it is

important to be aware that "informal cooperative arrangements are fundamental to the success of decentralised economic organisation".\textsuperscript{322}

\textsuperscript{322} See the Bureau of Industry Economics (Australia), \textit{Networks: A Third Form of Organisation} (Discussion Paper 14, 1991), 1.
Chapter 4

THE EXTENSION OF THE CORPORATE CONCEPT: MULTINATIONALS AND TRANSNATIONALS

Corporate development continually brings new challenges to corporate law and practice. New problems arise from the operation of multinationals and transnationals. Structures of corporate governance are basically national. Differences exist in corporate laws and corporate governance systems of different countries. To discipline multinational activities requires international co-operation.

Although some works make distinction between the term “multinational” and the term “transnational”, generally, the two are used as different labels for essentially the same entity and thus, are used synonymously. A multinational or a transnational has been

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323 Literally, multinational suggests a firm associated with many countries, and transnational suggests a firm that crosses national borders. Robert Tindall in his book *Multinational Enterprises* made such distinction between the multinational and the transnational: while a multinational refers to a corporate group with a parent company of a particular nationality, a transnational is a corporate group with two or more parent companies of different nationalities. For a detailed discussion on the definition of the multinational and the transnational see chapter 44 in John H Farrar & Brenda Hannigan, *Farrar’s Company Law* (4th edn, 1998), 789-778.

defined differently according to different criteria.\textsuperscript{325} However, essentially, it is a firm which owns outputs of goods and services originated in more than one country.\textsuperscript{326}

The earliest form of multinational operation occurred at the early stage of corporate development. After the Second World War, there has been a rapid growth in multinational corporations, due to technological development and the improvement of communications and transport.\textsuperscript{327} It is suggested that, today, the market structure of many industries is developing toward multinational domination.\textsuperscript{328}

The international operation of multinationals goes beyond the national sovereignty of any jurisdiction and thus creates serious problems for the national law. So far, enterprise principles or similar strategies are widely adopted by most systems for the purpose of regulating corporate groups. However, when multinational groups are involved, a national law may frequently find itself in the position of violating other countries' legal rules and national policies. Such violation usually attracts retaliation and results in heavy political and economic costs to both sides.\textsuperscript{329} To find an effective method of disciplining multinational business becomes a challenge to all legal systems.


\textsuperscript{326} See Peter Hertner & Geoffrey Jones, in Peter Hertner & Geoffrey Jones (eds) \textit{Multinationals: Theory and History} (1986), 1.


\textsuperscript{328} See Mark Casson and George Norman "Pricing and Sourcing Strategies in a Multinational Oligopoly", in Mark Casson (ed), \textit{The Growth of International Business} (1983) 63, 63.

After the opening up of China in 1978, within a period of two decades, about 400 largest multinationals have a presence in China.\textsuperscript{330} The multinational operation brings competition to the Chinese market and imposes pressure on Chinese enterprises. Since 1979, China has begun its overseas investment. Up to 1997, China has 4,557 enterprises that have directly invested overseas.\textsuperscript{331} Multinational business brings China challenges as well as opportunities. It is interesting to see how China will design its enterprise development in the international dimension during the course of enterprise reform.

**THE THEORY AND REGULATION OF MULTINATIONALS AND TRANSNATIONALS**

Attempts of searching for a catch-all theory in relation to international production have been marked with lack of success.\textsuperscript{332} However, a variety of theoretical approaches demonstrate the fact that the development of multinationals and transnationals can be attributed to a number of factors, macro-economic and micro-economic. At an early stage, the international production of the firm was simply explained as the extension of domestic growth.\textsuperscript{333} It served as an outlet of the surplus capital for seeking high rate of profits. The theory particularly suited the case of colonial trade. It explained the capital movement from developed countries to developing countries. However, it did not explain


\textsuperscript{331} See Xu Xiangyi *et al, Organisation and Management of Modern Companies* (1999), 712.


the cross-investment among developed countries, which has counted for the bulk of international trade and investment since 1945. New theories have been produced. These theories analyse the international production of the firm from different levels (macro-economic, meso-economic and micro-economic) and with different economic focuses (trade, location, industrial organisation, innovation and the firm). According to these theories, the reasons for multinational production mainly include increasing concentration in foreign markets, avoiding transactional market failure by internalising transactions within multinational enterprises, and accumulating technology within the multinational. These theories explain the growth of international production from their specific perspectives.

The theoretical difficulty extends to the area of disciplining multinational activities. Nowadays, the output of multinationals accounts for one third of the total output of the industrial world. Their liquid capital surpasses the total foreign currency reserve of the developed world. With such economic power, multinationals inevitably play an important role in the development of the world economy. However, the economic strength of multinationals also indicates that these gigantic conglomerates, during the


335 Ibid.


337 See Xu Xiangyi et al, Organisation and Management of Modern Companies (1999), 346.

338 Ibid.
course of seeking global profits and market monopoly, can cause serious problems to particular countries, even to the overall international economy. For instance, a multinational may manage to avoid the taxation of a particular country by transfer pricing. It may, in its global economic interests, instruct a particular subsidiary to deliberately make a loss, at the expense of the avenue of the country where the subsidiary resides. Hence, to regulate multinational operations is crucial not only to individual countries but also to international society.

However, the nature of multinational operation poses immense challenges to regulatory efforts. The national regulation of multinational activities basically relies on limited principles based on the entity law. At an early stage, the reflection of entity law in international law rendered the domination of the nationality principle that gave the State of incorporation the exclusive authority of control over corporations.\footnote{See Phillip I Blumberg, The Law of Corporate Groups: Problems of Parent and Subsidiary Corporations under Statutory Law of General Application (1989), 170.} As a result, a foreign subsidiary was only subject to the law of its host country regardless of the will of its holding company. Such an arrangement, although firmly accepted at one time, definitely contradicted with the economic reality of multinational activities. The evasion of national laws by multinational groups was inevitably widely exercised.

Later, countries such as the USA has sought to modify the nationality principle by conditionally extending the home country's jurisdiction to the activities of foreign subsidiaries.\footnote{Ibid, 173.} The extension of the home country's jurisdiction depends on a number of

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\footnote{Ibid, 173.}
justifications such as “reasonableness” and “fairness”. However, the soft criteria like “reasonableness”, “fairness” and “major national interests” grant the home country extensive authority in determining the situations of extending its domestic law over its multinational groups. This results in many countries being able to impose their national laws on their multinational enterprises. Therefore, the effort can be perceived as an endeavor to extend national control over world business, which will inevitably create disputes and confrontations among nations, and in turn, will cause severe economic and political costs. The modification of the nationality principle and similar efforts of national control proved ineffective and the cause of disputes. International law is in urgent need of an appropriate method of regulating multinational activities.

Apart from unilateral efforts, countries have been looking for co-operative devices to regulate multinationals. Treaties, as one of the most ancient devices of international co-operation, are used for the purpose. The last three decades have seen the increase in bilateral agreements between governments in relation to foreign direct investment. Regional and international attempts of regulating multinational activities have also been made. However, because multinational operations involve different countries with different social and cultural backgrounds and at different stages of economic development, and because multinational practice can cause significant economic and

344 Ibid, 775-777
political consequences in both home countries and host countries, the task of producing a common, acceptable system of regulating multinationals is far from completed. So far, a significant effort made by the international community relating to disciplining multinational enterprises is the publication of the United Nation Code of Conduct on Transnational Corporations (1986) and the OECD Guidelines for Multinational Enterprises (2000).

The OECD guidelines are voluntarily adopted by the OECD member countries and have no legally binding power. The Guidelines aim to ensure that multinational operations can make contribution to economic, environmental and social progress, and to encourage multinationals to minimise their operational difficulties so as to enhance their sustainable development. For achieving these purposes, it is essential for multinationals to build and enhance the confidence between themselves and host societies and to ensure their operations are in harmony with government policies. This includes respecting the human rights, environment and laws of host countries. Meanwhile, the development of good corporate governance and self-regulatory practices is also important. The Guidelines emphasize the application of high quality standards for

345 Ibid, 776.

346 The Guidelines declare the three objects including ensuring that the operations of multinational enterprises are in harmony with government policies, strengthening the basis of mutual confidence between enterprises and the societies in which they operate, helping improve the foreign investment climate and to enhance the contribution to sustainable development made by multinational enterprises. See the OECD Guidelines for Multinational Enterprises (2000). <http://www.oecd.org/daf/investment/guidelines/mnetext.htm>.

347 The Guidelines uphold eleven general policies: (1) contribute to economic, social and environmental progress with a view to achieving sustainable development; (2) respect human rights; (3) encourage local capacity building; (4) encourage human capital formation; (5) refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework; (6) support and uphold good corporate
disclosure, accounting, and audit by multinationals. Furthermore, the *Guidelines* require multinationals to improve industrial relations, protect consumers' interests, promote fair competition and science and technology development of host countries, and comply with the tax laws and regulations of host countries. In addition, the *Guidelines* address the bribery problem caused by multinationals. The Guidelines list the situations of bribery and recommend anti-bribery mechanisms and practice. Generally speaking, the focus of the *Guidelines* is to promote responsible business conduct of multinationals and to restrain multinationals from abuse of their economic and political power and gaining undue advantages.

The *United Nation Draft Code of Conduct on Transnational Corporations* (1986) contains basic requirements of multinational conduct. This is a document that gives more consideration to the interests of developing countries. Reflecting developing countries' desire, it puts certain emphasis on respecting and promoting host countries' sovereignty and economic interests.

China is the last and the biggest market yet to be exploited by multinationals. In the meantime, after switching to the market economy, China has become a newcomer to international competition. With its domestic efforts to carry out enterprise reforms and its international efforts to have a share in international trade and development, China's endeavor to attract foreign direct investment and build its own international networks illustrates the important role of multinationals in a country's economic development.
China's case may provide some useful thoughts for international endeavour to regulation of multinationals.

THE CHINESE ASPIRATION TO MULTINATIONAL DEVELOPMENT

Since the late 1970s, China has aggressively pursued the policy of attracting foreign direct investment into the country to enhance its capacity of access to the resources of foreign capital. Meanwhile, the Chinese regard multinational investment as a way of seeking for high rates of capital returns. Hence, since 1979, some Chinese enterprises begin to make direct investment in overseas.

As the Chinese understand, the practice of multinational enterprises has positive effects on the host country's economy including increasing economic efficiency and promoting technology exchanges. However, cross-country investment also bears high risks. A host country has to provide a favorable environment for encouraging foreign investment. In this respect, the Chinese government has worked hard to create an attractive climate for possible foreign investors including improving its legal framework to protect foreign investment, and offering taxation advantages and other encouragement.

enterprise' policies by business partners; (11) abstain from any improper involvement in local political activities.

348 See Xu Xiangyi et al, Organisation and Management of Modern Companies (1999), 349.
349 Ibid, 712.
In the meantime, the Chinese are aware of the negative impact of multinational investment. For instance, multinationals may pursue their profits at the expense of a host country’s economic interests. However, because attracting foreign investment is a priority and because of lack of a feasible strategy to regulate multinational enterprises in international law, China has been cautious of placing legal restrictions on multinational activities. One strategy used by the Chinese government to confine multinational activities is to make them bind themselves to local enterprises. The country has been consciously encouraging multinational investment to take the form of joint ventures.

The Chinese joint venture law requires that, in a joint venture, the contribution of the foreign partner(s) should not be less than 25% of the total registered capital and the invested capital is not allowed to be withdrawn freely. In doing so, the country makes sure that the invested foreign capital is truly used to serve the initial co-operative purposes. Meanwhile, through examination and approval control, the foreign partner’s contribution to the joint venture is limited to a degree of less than 50% of the total registered capital. This method is used to effectively confine the expansion of multinationals, and to prevent them from manipulating domestic enterprises by taking

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352 See Xu Xiangyi et al, Organisation and Management of Modern Companies (1999), 703.

over the control of the joint ventures. In some sectors, the ceiling of foreign capital subscription is even lower. For example, the law requires that the contribution of the foreign partner to a joint venture involved in airport construction cannot exceed 35% of the total registered capital.

However, there is still the possibility of *de facto* control by foreign joint venturers. In this respect, the Chinese have attached great importance to enhancing Chinese parties' bargaining power and negotiation skills. It is anticipated that a clear and careful co-operative agreement can reduce the opportunity of *de facto* control and transfer pricing.

Meanwhile, the Chinese government has always encouraged Chinese enterprises to make overseas investment, so as to enhance these enterprises' competitive ability in the international market. In the past two decades, the Chinese overseas investment has increased at a rate of 120% every year. Most overseas investment takes the form of a joint venture. It is believed that by co-operating with developed countries, China can get access to advanced technology and managerial skills. Co-operation can also reduce risks by engaging local partners into the business. The form of wholly owned foreign

354 As a result, the capital contribution by the foreign joint venturer is limited to 25% to 49% of the total registered capital.


358 See Xu Xiangyi *et al*, *Organisation and Management of Modern Companies* (1999), 712.

subsidiaries is only used in cases where the local profits are important to the holding companies.\footnote{Ibid.}

Up to now, how to control and protect overseas Chinese subsidiaries through national legislation is still not a topic of discussion and attention. A limited literature on multinational practice has largely focused on technical issues such as the strategies of making international investment.\footnote{This is the main focus of most works concerning the discussions about multinationals.}

The principles and policies in the OECD \textit{Guidelines} and the United Nation Draft \textit{Code of Conduct on Transnational Corporations} provide basic guides for China to regulate multinationals within its territory and to standardise the business conduct of its overseas companies. As a developing country, China benefits from the principles and policies set out in the OECD \textit{Guidelines} and the UN \textit{Code of Conduct} in relation to preventing multinationals from abuse of power. By observing these principles, overseas Chinese subsidiaries may obtain a stable and safe environment for development.

One thing is certain, for achieving the goal of internationalization, many tasks need to be completed by the Chinese government and enterprises. The government needs to give subsidies and preferences in tax, insurance, and information to investors who make overseas investment. China is also in need of skilled and experienced managerial staff to manage overseas businesses.
CONCLUSIONS

Economic development is leading world business into a new era, an era of globalisation and internationalisation. Multinational enterprises are important actors in this process. Economic globalisation is threatening national sovereignty. In a world where business has no nationality and knows no borders, all countries face the challenge of searching for a new economic order.\textsuperscript{362}

The pressure faced by China is even greater. While the country is urgently in need of foreign capital to facilitate its economic reforms towards the development of a market economy, its enterprises are in a hurry to catch up with global economic development. Thus, China’s enterprise reform is a project that has to serve multiple purposes.

\textsuperscript{362} For detailed discussions, see in David Korten, \textit{When Corporations Rule the World}, (1995).
Chapter 5

THE CURRENT TREND: CORPORATISATION AND PRIVATISATION

The increasing economic globalisation over the past two decades has raised considerable concern over the competitive capacity of public enterprises, which have, in turn, imposed pressure on the public sectors of all systems. Thus, starting from the 1980s and becoming prevalent in the 1990s, a new wave of liberating or commercialising public enterprises has happened in many jurisdictions. This process involves the application of private sector management techniques and structures to public enterprises. The strategies of commercialisation include corporatisation, a scheme of approximating the private sector model of incorporation within the context of public ownership, and privatisation, a scheme of total adoption of the private sector model by selling public ownership to private hands.

The spread of the practice of commercialising the public sector is due to the following factors: firstly, corporatisation and privatisation have been widely promoted in the former


socialist countries and some East-Asian economies as part of their reform packages to counteract the failures of their past highly interventionist systems. Secondly, many developed countries have embraced the idea of increasing the economic efficiency of their public sectors by introducing an incentive environment, similar to the one in the private sector, into these public sectors. Thirdly, the World Bank has pushed hard in terms of urging countries to take steps to privatise their public enterprises.

Although the enterprise reform in China has its own causes, it concurs with the current movement of commercialising public enterprises in a global sense. Thus, in the course of the enterprise reform, China has the advantage of drawing lessons and gaining wisdom from the experience of other jurisdictions. Consequently, China may achieve two goals, commercialising its public sector and standardising the practice of its corporatised enterprises, at the same time. Meanwhile, the Chinese enterprise reform will provide an interesting case for comparative study, since the country is pioneering a different path in the process of corporatising and privatising its public enterprises, ie, by retaining the dominance of public ownership.

365 Ibid.
367 For example, the USA, the UK, Canada, New Zealand and Australia all embraced the practice. See Roger Wettenhall, "Public Enterprise in an Age of Privatisation" (1993) 69(9) Current Affairs Bulletin 4, 4-12.
THE RATIONALITY OF CORPORATISATION AND PRIVATISATION

The Economic and Political Rationality of the Existence of the Public Sector

Before understanding the rationality of corporatisation and privatisation of the public sector, it is necessary to explore the rationality of the existence of the public sector in different systems. Why have most systems retained some degree of public ownership over their national economies in the first place? Will the current commercialisation of the public sector lead to the extinction of the public sector in any jurisdictions?

The biggest public ownership regime in modern history existed in those former socialist countries. These countries established their socialist economies according to the economic model advocated by the Marxist literature. The prominent characteristics of the socialist economy were the domination of public ownership and administration of the national economy in accordance with economic plans. According to Marxism, the highly concentrated private ownership and the highly socialised production constitute the uncompromising contradiction of the capitalist system, which will inevitably hinder the development of the productive forces of society. Ultimately, the capitalist system will be replaced by socialist and communist systems, in which public ownership combined with the heightened productivity achieved by capitalism will serve the common good of


369 See Karl Marx, Capital (published in 1867, reprinted in 1930), 10-94.
society. Since the rise of the former Soviet Union, many countries in the Eastern Europe and Asia embraced communist doctrines by establishing their communist governments. As a result, all these countries adopted the planned economy system based on the domination of public ownership. However, all these countries experienced economic stagnation under the planned economy system. In the late 1970s, China pioneered the economic reforms of switching to a market economy. Then, since the 1980s, most East bloc countries launched their political and economic reforms. This has resulted in the decrease of the proportion of public ownership in these countries' economies. All the reforms had the aim of increasing the proportion of the private sector in their economies. However, few had the objective of delivering a total extinction of the public sector. The reason is simple: the public sector has its irreplaceable role in all economies.

The public sector in every economy has the function of assisting the government to assure public accountability and consistency in public policy. Moreover, public enterprises are used to ensure the accomplishment of the national goals. In a non-socialist system, the government usually uses public enterprises as legal and social instruments for the public control of basic industries in an economy still based on private

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enterprises. During and after World War I, with the rapid expansion of government responsibility for social and economic programs, the number of public enterprises in Western countries increased significantly. In some countries, this was achieved by extensive nationalisation of their basic industrial sectors.

There are different types of public enterprises. At the one end, there are the public enterprises that exist in the form of an organisation on the same basis as other government activities. At the other end, there are the public enterprises taking the form of the autonomous corporation with almost complete freedom from executive and legislative controls. In the middle, a public enterprise may take the form of a public corporation, subject to specially devised executive and legislative controls. Corporatisation in this context usually refers to corporatising those public enterprises of the first category. Sometimes, it may extend to include the third category by further introducing corporate mechanisms into such an enterprise.

Different from a private firm that exists for maximising the economic interests of its owners, a public enterprise is created to perform social objectives or to serve public purposes. Sometimes, the social goals may be achieved at an economic cost. Thus, in Western countries, despite the good that public enterprises have provided for the


375 Ibid, 183.

376 Ibid.
community, there have always been debates about the economic efficiency and the quality of the services delivered by public enterprises. There have also been substantial reports about the waste of taxpayer’s money caused by lack of managerial accountability and bureaucracy in the public sector in every system. Efforts have been made to tackle the problems existed in public sector. The basic methods of curtailing the excessive bureaucratic control include introducing corporate autonomy into the public sector or abandoning the control altogether. \(^{378}\) However, a high degree of autonomy and privatisation means abandonment of the existing controls of ensuring public accountability and responsiveness without adequate substitutes. \(^{379}\) Hence, corporatisation has been regarded as a more applicable reform strategy, which could serve the purposes of limiting excessive autonomy on the one hand and retaining political controls for promoting the public interest on the other. \(^{380}\) The logic behind this is: if public ownership is inevitable, then it is wise to make a public enterprise as much like a private enterprise as possible. \(^{381}\)

There have been many waves of corporatisation of public enterprises to provide operational conditions of corporate flexibility and autonomy. Sometimes, they have been
followed by counter waves of efforts to curtail excessive autonomy in the form of restoration of governmental control, so as to ensure that the public interest is served in a real sense.\textsuperscript{382} The current move of commercialisation of public sectors in a global sense is triggered by a number of combined forces including the increasing acceptance of economic liberalisation, the collapse of the former planned economies and the particular problems faced by public sectors in different systems.

**The Economic Rationality of Corporatisation and Privatisation**

The characteristic of the current movement of corporatisation and privatisation, which started in the 1980s, is that it has been under the influence of the new economic literature of the agency theory of the firm.\textsuperscript{383} In this new move of commercialisation, New Zealand and Australia have taken the lead. The public sectors have played an important role in the economic development of both countries.\textsuperscript{384}

As discussed in Chapter 2 of this thesis, according to the agency theory, a principal-agent relationship exists where a party is entrusted to do a particular job on behalf of

\textsuperscript{381} See G N Ostergaard, “Labour and the Development of the Public Corporation” (1954) 22 Manchester School of Economic and Social studies 192, 193.


\textsuperscript{383} Ibid.


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another party. The former is the principal and the latter becomes the agent. There is a cost in using an agent, which is called the agency cost. This is because the interests of the agent are not necessarily identical with those of the principal. While the principal expects to extract a maximum of gains from the agent’s activities, the agent may pursue extra benefits for itself from the job. There are a number of terms describing the agent’s conduct of abuse of its position, include shirking, slacking and theft. The agent is able to do so because it is the party who has all the information relating to the job. The principal certainly wants to reduce such a cost. The measures adopted basically include bonding strategy and monitoring strategy. Bonding strategy is about to ensure the convergence of the principal’s interests and the agent’s interests by introducing incentive schemes. Monitoring strategy means to introduce supervisory schemes to closely watch the performance of the agent in order to reduce or eliminate the opportunity of abuse of power by the agent. However, these strategies also generate costs which form part of the agency cost. The principal wishes to adopt these strategies, only when the adoption of them will reduce the overall agency cost.


High agency costs associate with the operation of the public enterprise. In his book *Corporate Governance in Australia and New Zealand*, Professor John H Farrar provides detailed analyses on the agency cost of the public sector. The agency problem that arises from the separation of ownership and control becomes more severe in a public enterprise. First of all, a public enterprise usually faces the problem arising from lack of well defined property rights in its equity.\(^{390}\) The economic behaviour and performance are affected by the manner of how the property is held, used and organised.\(^{391}\) Where property rights are clear and well defined, the economic goals of the firm is likely to be clear, the costs of using economic incentives and monitoring mechanisms are likely to reduce and the economic efficiency of the firm is likely to increase.\(^{392}\) Although the State (or Crown in a commonwealth country) is defined as the residual claimant of the property of a public enterprise, the claims over the enterprise's property is either held by one or more government departments or ministers. As a result, it is not the owner but the agent of the owner who is in the position of exercising the property rights. Compared with a private owner of a private firm, the incentives of the government agent to drive for wealth creation in the public enterprise is weaker,\(^{393}\) not to mention that a public enterprise is likely to entangle commercial objectives with other social goals.

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\(^{392}\) *Ibid*.

\(^{393}\) *Ibid*, 187.
Moreover, some of the monitoring mechanisms available to a private corporation are not available to a public enterprise. For example, a dissatisfied owner may sell his or her shares in the stock market. However, the property or shareholdings of public enterprises are usually not tradable. The government may want to devise some new incentives and monitoring mechanisms specially applicable to public enterprises. However, the result of the practice is not encouraging and sometimes, the cost may exceed the benefit.  

Compared with the enterprise structure in the public sector, the modern corporate structure of the private sector is regarded as more adept in reducing the agency cost. A corporation, by assuming independent identity, obtains a bundle of clearly defined property rights over its property. It shields owners from liability and allows them to transfer their ownership. As a result, an external market for corporate control has been developed, which brings the accountability of management in line with the owners' interests. Furthermore, by allocating powers among the major participants, the corporation offers an efficient internal structure to curtail the agency cost. Because the modern corporation possesses the above merits, it has been employed by different systems to facilitate their economic reforms of restructuring their public enterprises in recent decades.


396 Ibid.
The difficulty of reforming the public enterprise does not lie in the adoption of the corporate form, but in realising of the economic efficiency of the public enterprise by embracing the corporate structure on the one hand and retaining public ownership on the other. A public owned corporation can never become identical with a private owned corporation. It is also unlikely to achieve the economic efficiency that a private corporation can achieve, as it cannot replicate all the benefits of a private corporation. Therefore, if privatisation indicates the full acceptance of the corporate structure at micro-economic level, corporatisation can only go half way toward that direction. In other words, corporatisation, at most, means creating a maximum degree of similarity with the corporate form of the private sector in the corporatised public enterprise. Nevertheless, in the case where public ownership is determined to be reserved, corporatisation is a step in the right direction.

CORPORATISATION AND PRIVATISATION IN CHINA

Although the public sector has played an important role in nation-building in many Western systems, there has been no ideological drive to sustain it, nor did it win the emotional allegiance of the people. The situation in socialist countries has been different. Public ownership has been upheld as the final goal of human achievement. Public ownership is also regarded as the premise of delivering the common good and realising high social values such as social justice, freedom and equality. With the collapse


of the Soviet Union and other socialist countries since the 1980s, the belief has been abandoned by the reformist governments of many of these countries. As a result, privatisation has been promoted aggressively in those countries.

The economic reforms in China have followed a different path. The historical significance of public ownership and the contribution of state-owned enterprises to the nation’s development have never been officially denied. The attachment of the public to public ownership has been strong. Thus, the enterprise reform is widely understood as a reform at tactical level. The introduction of the corporate structure is aimed at bringing incentive mechanisms into existing enterprises but not at making fundamental changes to the ownership structure. On the contrary, it is expected that the corporatised state-owned enterprises will achieve a greater economic outcome than the enterprises in the private sector. Therefore, it is clear that, except those enterprises of small and medium size, which will be subject to privatisation, most large-sized state-owned enterprises, especially in the basic sectors, will remain as state-owned companies after the reform.

In China, the decision of commercialising state-owned enterprises has taken a long time to be finalised. In this process, modern corporate theories and the international experience of corporatisation and privatisation were carefully studied by Chinese policy makers and intellectuals. At a time when China decided to draw lessons from the international experience of public enterprise reforms and to apply them to the Chinese


practice, China joined the global movement of commercialisation. Like many other countries, China has embraced the new economic literature as the theoretical guidance, and has striven to introduce the internal and external incentives applied by the modern corporation into its enterprise system.401 The objectives of the Chinese enterprise reform at the micro-economic level include:

- Separating government from enterprise operations, including the introduction of “hard” budget constraints and market-based governance systems;
- Restructuring state-owned enterprises in terms of their social burdens, financial and employment structures, physical plant and equipment and managerial systems; and
- Enhancing the enabling environment for non-state enterprises to participate in the market.402

Looking at international experience, one finds that the above objectives, as the basic goals of commercialising the public sector, can apply universally. For example, the Minister for Finance of New Zealand announced five general principles for reorganising the country’s state trading activities in 1985. They were: (1) Non-commercial functions would be removed from trading organisations; (2) Managers would be required to run the trading organisations as successful businesses; (3) Managers would be responsible for using inputs, for pricing and for marketing products within performance objectives set by Ministers; (4) The enterprises would be required to operated without competitive advantage or disadvantage so that commercial criteria would provide the assessment of


402 See the summary of the Chinese government’s development agenda in Harry G Broadman, Meeting the Challenge of Chinese Enterprise Reform (1995), 32.
managerial performance; (5) Enterprises would operate under the guidance of boards modeled on private sector organisations. Although there are differences in detailed focus, the basic contents of the reform agendas of the two countries are comparable.

The special situation of China’s commercialisation is that there has not been in existence a mature corporate system for a long time. Many other systems possess well developed corporate systems in their private sectors. Hence, their commercialisation only needs to establish “an operating environment for appropriate public sector enterprises which replicates the internal and external conditions that successful private enterprises face”. However, China’s situation poses greater difficulties for Chinese policy makers in relation to designing a commercial environment for their corporatised enterprises, as they do not have much opportunity to draw lessons and experience from “the successful private sector” in their own system. Hence, the current commercialisation in China is a reform that needs to achieve multiple goals, ie, to carry out the reform in law and practice for both the private sector and the public sector.

In relation to the task of separating the government from enterprise operations, in 1988, China established the Administrative Bureau of State Assets which exercises the function of the owner of state property. This arrangement is designed to separate the


government’s role of administrative control and its role as the owner of state assets.\textsuperscript{405}

The Administrative Bureau of State Assets decides to increase or reduce its shareholding in different state-owned or controlled companies according to their share performance in the securities market. It delegates the responsibilities to its agents in different state-owned or controlled companies according to the share sizes and share structures of those companies.\textsuperscript{406}

However, the Bureau only exercises the function of supervising the use of state assets. It does not take part in the management of state assets. The task is intended to be delegated to state asset management companies.\textsuperscript{407} It is understood that the managing companies take the form of a corporation and are subject to the supervision of the Administrative Bureau of State Assets. There is not an official model for the establishment of management companies. Academic discussions have recommended three methods of structuring these institutions. Firstly, the State can turn some existing large enterprises or holding companies into state asset management companies. Secondly, the State can authorise the government departments in charge of different industrial sectors or the “general companies” of different industrial sectors to exercise the function of management companies.\textsuperscript{408} Thirdly, the State can also authorise local governments to


\textsuperscript{406} See Xu Xiangyi et al, Organisation and Management of Modern Companies (1999), 114-115.


\textsuperscript{408} The general company is another special thing in China’s enterprise system. It is another remains of the old system. In the past, different industrial sectors were administrated by different government departments
turn some local state-owned enterprises into management companies. The third method is designed to reduce the possibility of trade monopolies that the first two methods may bring. At present, the three methods are all adopted in practice.\textsuperscript{409}

In terms of restructuring social burdens, financial and employment structures, physical plants and equipment, and managerial systems of state-owned enterprises, corporatisation and privatisation provide effective mechanisms for ensuring that the restructured enterprises will be able to combine capital and labor efficiently. Restructuring state-owned enterprises requires the management of the enterprises to have clear objectives. It also requires increasing the managerial autonomy of the enterprises, so that the management has the liberty to make decisions on allocating resources and to market products. To fulfil these tasks, apart from commercialising the enterprises, a range of policy support is needed. The government should provide mechanisms that enable the enterprises to pass many of their social service burdens to the government who will finance these services through public revenues. The government should also provide policy guidance and financial support for creating a favorable environment for a market economy, which allows enterprises to freely consolidate, diversify, exit and engage in asset sales and purchases and enable them to shed redundant labor and recruit high quality employees in the labor market.

The policy of enhancing the environment for non-state enterprises to participate in the market is aimed at removing all the policy disadvantages and advantages associated with state-owned enterprises, so as to create a commercial environment where all types of enterprises will compete fairly.\textsuperscript{410} Thus, the managerial accountability and performance of the enterprises can be assessed more accurately.

There have been different suggestions on a range of issues relating to commercialising state-owned enterprises and the governance of the corporatised enterprises, including how the State will exercise its supervisory power in the corporatised enterprises, and how to design a system of rewarding and punishing directors and managers. In academic discussions, foreign experience is frequently referred to. However, given the size of the Chinese economy and China's special social and economic situations, the process of corporatisation and privatisation in China will have to encounter some unprecedented complexities and difficulties.

In summary, to fulfil the objectives of the enterprise reform is a complex and lengthy process. It needs a comprehensive overarching strategy to deal with all the issues involved. At present, China has set up very clear goals for the reform. However, the strategies regarding physical implementation of the reform objectives are still in the process of debate and experiment. Before a comprehensive approach is developed, one

can expect to see a variety of approaches being taken in a process of trial and error across localities, sectors, and institutions.411

CONCLUSIONS

The waves of corporatisation and privatisation in many countries in the past years, illustrated the difficulty of devising an acceptable form of control over public enterprises.412 It seems that profit making and the maintenance of public accountability pose a dilemma to every government in deciding how to deal with the public sector. Over many years, mechanisms aimed at improving the firm’s economic efficiency are devised for and introduced into the public sector. Although the improvement has been visible, the task is far from complete.

The process of corporatisation and privatisation in China is still at an early stage. In this process, China has drawn on international experience for initiative and inspiration. Chinese policy makers see the enterprise reform as a crucial step toward the success of a full delivery of the economic reforms. Given the size of the public sector and the important role of the enterprise reform in China, it can be predicted that the Chinese experience of corporatisation and privatisation will become an important event in the history of corporate development.

411 See the World Bank, China, Weathering the Storm and Learning the Lessons (1999), 7.
PART TWO

THE CHINESE EXPERIENCE OF THE CORPORATION AND CORPORATE GOVERNANCE
Chapter 6

CORPORATE DEVELOPMENT BEFORE 1949

Traditional China had a totally different experience from Western nations in relation to philosophies and social and political orientations. Since the Han dynasty (206 BC - 24 AC), traditional China adopted the policy of "promoting agriculture and restricting trades".\textsuperscript{413} As a result, although partnerships appeared as early as in the Spring and Autumn Period (770-476 BC) and became highly developed to a degree akin to the Commenda and Societas in the Ming and Qing Dynasties (1368-1911), they never evolved to some kind of business form resembling the modern company.\textsuperscript{414} Hence, the initial development of a corporate system and corporate law was a sheer matter of transplantation from the industrialised world.

THE INITIAL DEVELOPMENT OF THE CORPORATE SYSTEM

The word "company" (gongsi) first appeared in an official document in 1687.\textsuperscript{415} When the governor of Fujian province reported to the Qing emperor that they had seized the cargo of the Zheng Chenggong government, he mentioned that some seized goods were

\textsuperscript{413} For example, business was heavily taxed. The law provided severe punishments on breaches in the course of business transaction. Sea trade was forbidden many times.

\textsuperscript{414} See Huang Sujian, Companies (1989), 71.
some “companies’ assets” (gongsi huowu). Zheng Chenggong was the general and the governor of Taiwan at the end of the Ming dynasty. When the Manchus conquered mainland China and replaced the Ming with the Qing dynasty, Zheng declared that his government in Taiwan was the continuation of the Ming dynasty. As a result, Taiwan was not under the rule of the Qing government until 1683, after Zheng’s death. Chinese scholars believed that the term gongsi was invented by the Taiwanese during the course of dealing with the Dutch East India Company, and thereafter was widely adopted by various social institutions. Not until 1842, was gongsi specially used to refer to the particular business form, the corporation, by scholar Wei Yuan in his book *Mastering the Ocean (Hai Guo Tu Zi)*. Following Wei Yuan, many Chinese intellectuals began to discuss corporate concepts and systems. In their works, the importance and contribution of the corporation to the development of modernisation was enthusiastically addressed in the highest terms. Their promotion had the positive result in terms of catching the attention of society to the corporate system.

The physical appearance of the company in China started after the Opium War (1840), which was the beginning of the infiltration of Western imperialism into China. China was forced to open up to accommodate Western imperialist expansion. Foreign capitalists began to set up various companies, and these companies began to issue their shares to
foreign and Chinese investors in places such as Shanghai.\textsuperscript{419} They were the earliest companies in China. These earliest foreign companies mainly concentrated on trades such as sea transportation, shipping, banking, electricity power plants, and textiles.\textsuperscript{420}

In the meantime, the Qing government began to recognize the significance of the corporation to the development of the national industry and was willing to promote and support corporate activities.\textsuperscript{421} Some officials of the Qing government initiated a "foreign affair movement" aimed at modernising China and establishing the national industry through learning from the West. The movement resulted in the establishment of the earliest Chinese companies. These companies could be divided into three categories: government owned, merchant owned but government supervised, and jointly owned by the government and merchants.\textsuperscript{422} The companies of the first category were those owned and managed by the government. The second category referred to those invested in by merchants but managed by the government. The last category were those jointly owned and managed by the government and merchants. In these companies, the government could directly interfere in every matter including the appointment of directors and executives. The government could freely dispose of the assets of the companies.\textsuperscript{423} Other

\textsuperscript{419} See Chen Zhengao, \textit{The Historical Materials of Present Chinese Industries} (1961), volume 4, 57.


\textsuperscript{422} \textit{Ibid}, 101.

\textsuperscript{423} For example, in 1885, the Qing government took away the reserve fund 100,000 \textit{taels} form Zhaoshangju, a merchant owned and government managed company. In 1896, the government took away another 800,000 \textit{taels} from the company.

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shareholders basically exercised no shareholders’ rights apart from being entitled to dividends (guanli). The rates of guanli were fixed in the articles of association and guanli had to be contributed to the shareholders on time, no matter whether the companies made profits or not. Obviously, these companies were not modern companies in a strict sense, although some were faster in imitating some of the practice of foreign companies, such as issuing shares to the public.

Later, companies established by private capital appeared in China. This was a significant step of corporate development in China. These companies were true commercial companies with no governmental capital and involvement. The first company promoted by private capital was set up in 1866. More came in the following years. From 1895 to 1911 the number of this type of companies began to increase. However, limited by capital resources, technology and managerial skills, these companies were chiefly concentrated on light industries.424

Lack of experience and legal framework caused many problems for the early corporate activities in China. Equity investment became the hottest business in cities such as Shanghai. Companies’ shares were sold at incredible prices. Soon the bubble burst and resulted in the financial crisis in Shanghai in 1883, which was followed by a number of

cases of corporate bankruptcy. Corporate accountability began to attract public attention.

The early development of corporate practice and the desire to promote corporate activities in order to accelerate national industrialisation, motivated the Qing government to make a law to regulate and protect corporate practice. Qing officials Liu Kunyi and Zhang Zhidong in their famous memorial to the throne stated:

Since trading with foreign countries, large businesses have been dominated by foreign businessmen. Chinese businessmen can only engage in some small business. This is because foreign trade and manufacture require large amounts of capital which cannot be supplied by a few individuals. Foreign companies have the strength because they can pool capital from hundreds and thousands investors. America and some European countries have the most detailed and explicit corporate legislation and their governments are keen to support their corporate activities. This leads to the prosperity of their economies. China has conventionally underestimated commerce and neglected commercial legislation. As a result, merchants gain self-interest through deception. The shrewd profit by fraudulence and the unskilled receive all the detriments. This is the reason that the Chinese regard investment as a difficult matter and dare not compete with foreign traders. Once disputes between Chinese traders and foreign traders arise, foreign consuls usually shield foreign traders. As a result, Chinese merchants either invest in foreign companies, or set up fake foreign companies and employ rascals to be protectors. If the government does not deal with the matter immediately, Chinese merchants will never be able to compete with foreign merchants.

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426 See the numbers of articles published on the newspaper *Shenbo* (shanghai) during that period (October 21, November 4, December 25 & 31, 1883).
China must have commercial law. Then, Chinese businessmen can rely on the law and have no worries. They can establish transport companies and manufacturing factories of high productivity.\textsuperscript{427}

The view was reiterated in the imperial edict instructing the drafting of a Chinese commercial law. Emperor Guang Xu stated in the imperial edict:

Trade and industry are important national affairs. The tradition of regarding industry and commerce as inferior occupations has been carried on for so long. This is the main cause for the decline of our national economy and the destitution of the people’s livelihood. There is the necessity to change the situation and giving special attention to industry and commerce.

In 1904, the Qing government enacted the first Chinese company law, \textit{Gongsilu}. The law had 11 divisions and 131 articles. It was based on the 1855 \textit{Companies Act} and the 1862 \textit{Companies Act} of the United Kingdom, and the 1899 \textit{Commercial Code} of Japan\textsuperscript{428} and was, therefore, a hybrid of the common law and civil law. Since the enactment of the 1904 \textit{Company Law (gongsilu)}, the term of \textit{gongsi} was formally used to refer the corporation. The law contained fundamental principles of corporate practice. It had provisions about corporate registration procedure, shareholders’ rights and meetings, directors’ duties and board meetings, amendment of constitutions, accounts, dissolution, and penalties. The law provided for four types of company, \textit{hezi gongsi} (partnership), \textit{hezi youxian gongsi} (limited partnership), \textit{gufen gongsi} (joint stock company with limited

\textsuperscript{427} The document was later collected in volume 54 of \textit{Complete Works of Zhang Wenxiang}.

\textsuperscript{428} The Japanese 1899 \textit{Commercial Code} was based on German corporate legislation.
and unlimited shareholders), *gufen youxian gongsi* (company limited by shares).\(^{429}\) The main contribution of the law was the introduction of the last type of company, *gufen youxian gongsi*, which was the modern company in a real sense. Companies were required to have at least 2 or 7 members with no top ceiling. Separate personality was, for the first time, recognised. All companies had to be registered with the Ministry of Commerce in Beijing.\(^ {430}\)

The enactment of the law further encouraged industrial activities. Up to the end of the Qing dynasty in 1911, there were 615 factories.\(^ {431}\) Among them, 521 factories were set up by Chinese entrepreneurs.\(^ {432}\) Nevertheless, it was assessed that the law was not as adequate and successful as expected in terms of encouraging corporate operations as expected.\(^ {433}\) This might have been the result of the fact that the vague and ambiguous provisions “badly translated from two other nations’ experience engendered distrust”.\(^ {434}\) By 1908, among 227 registered companies, only 21 were significant in size.\(^ {435}\) Consequently, the Qing government saw the need to amend the existing *Company Law*. The amendment work began in 1908. A revised version of the *Company Law* was

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\(^ {429}\) See Article 10 of the 1904 *Company Law*.

\(^ {430}\) Ibid, Article 2.


\(^ {432}\) Ibid.


\(^ {434}\) Ibid.

\(^ {435}\) Ibid.
finalised but never enacted, as the Qing government collapsed and China became a republic in 1911.

The early republican government continued the operation of the 1904 *Company Law* until 1914. In 1914, the new government enacted the *Company Regulations*. The new law was based on the unpublished revision of the 1904 *Company Law*. The 1914 *Company Regulations* were based on German corporate legislation and were a clearer corporate code, compared with the 1904 *Company Law*. The new code provided for four types of company including *wuxian gongsi* (unlimited company), *lianghe gongsi* (joint company), *gufen lianghe gongsi* (joint share company), and *gufen youxian gongsi* (company limited by shares). It stipulated that banks should be formed as companies limited by shares (*gufen youxian gongsi*). The new law had considerable effect on promoting corporate activities. The period from 1914 to 1927 was a time that commercial activities developed rapidly in China. In 1920, the number of factories reached 1759. From 1911 to 1920 there were 807 registered companies.

The most distinctive characteristic of Chinese corporate practice during the initial stage of corporate development was the attempt to establish companies invested in by merchants but managed by the State. This type of business form was the product of the

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436 A joint company had at least one limited liability shareholder and one unlimited liability shareholder. The later would manage the company, whereas the former only provided capital.

437 The difference of a joint share company from a joint company was that a joint share company issued shares to general public.


special social and economic situation of China at that time. Experience showed that when foreign corporations became dominant in many trades of a country, the government’s support and subsidies were important to the development of national corporations. At the early state of corporate development, the Chinese entrepreneurs sought government’s support and protection. They were willing to establish a relationship of mutual dependence with the government. This was a matter which the government had also been considering. Since the mid-19th century, the Qing government was under the consistent pressure to increase its military spending. This resulted in the available funds being heavily allocated to national defense. Consequently, the government’s capacity to develop civil industries suffered. There were trades where the government saw the necessity of retaining central control, for example, water transportation. A solution was to pool the necessary funds from rich individuals. As a result, companies, invested in by merchants but controlled by the government, came into being at that time. From the publications of that time, we can perceive that the idea of establishing this type of company was not only preferred by the government and merchants, but also favored by the academics.

440 For example, the corporate development in Japan fell in the case.


442 Ibid.

443 See Wang Tao, “The Report to Guangzhuo Government”, in Wang Tao, Collections of Wang Tao’s Works (volume 10); Chen Chi, “About Retaining the Rights over Mines”, in Chen Chi, Continuation of the Strategies of National Enrichment (volume 2); Xia Yandong, Collections of Zheng Guanying’s Works (volume 1); Ma Jianzhong, “About Railway”, in Ma Jianzhong, Shi Ke Zhai Records (volume 1).
Later, however, the manner of governance in this type of company was criticized. People began to see the unattractive aspect of administrative intervention in corporate management. There were calls for separation of the State and enterprises. The 1904 Company Law put the issue to an end by omitting this type of company and by stressing the equal rights of all shareholders. After that, companies invested in by merchants and managed by the government were gradually nationalised or privatised.

THE CORPORATE SYSTEM DURING THE NATIONALIST PERIOD

In 1927, the Nationalist Party took over the government of the republic. The Nationalist government initiated the movement of bringing economic development under state control. It endeavored to retain a number of companies in important sectors under state control. The movement was influenced by the belief that the expansion of private capital should be checked by the State. Around the beginning of the 19th century, people became increasingly aware of the negative impact of corporate development. Many believed that the development of private enterprises would exacerbate economic monopoly and social division. Therefore, it was necessary to develop public enterprises and enhance the involvement of state capital in the national economy. The founding father of the Nationalist Party and the Nationalist government, Sun Zhongshan, pointed out that the industries concerning the people’s livelihood and national economy were not to be controlled by private capital.444 The discussion, then, focused on how to establish public

enterprises. Many favored the forms of state-owned companies where the State was the sole shareholder, state holding companies where the State controlled the parent companies, and joint companies which were jointly invested in by state capital and private capital. 445

As a result, government enterprises expanded rapidly and soon gained a dominant position in the national economy. After the Second World War, the Nationalist government confiscated the assets of all the former Japanese companies and state capital further swelled. At the end of World War II, the government possessed an amount of capital between 100 to 200 billion US dollars. 446 The government controlled 80% of total industrial capital and monopolised the banking system. 447 The initial effort to avoid a private monopoly had resulted in a state monopoly. Then, the state monopoly under a corrupt government turned into a bureaucratic monopoly, as state enterprises were used to pursue individual interests by government officials. It was known by the Chinese that state enterprises and capital were basically controlled by four families. 448 Hence, the corporate development during the Nationalist ruling period had the characteristic that was

445 See the arguments made in Shen Jingyi, “The Discussion about Controlling Public Enterprises” (1936) 33 (1) Dong Fang Zha Zhi (Journal of East); Wu Bannong, “Government Enterprises” (1941) 6 (3) Xin Jing Ji (New Economy); Wu Bannong, “Provincial enterprises” (1941) 5 (8) Xin Jing Ji (New Economy).

446 See Liu Yipeng, Zhang Guilong & Meng Chi (eds), Complete works on the Company Law of the People’s Republic of China for Practice (1994), 16.

447 Ibid.

448 This refers to Jiang, Song, Kong, and Chen four families. All had connections in the government. Jiang was the family of president Jiang Jieshi; Song was the family of the president’s wife; Kong was family of the brother in law of the president; and Chen was the family of two high rank officials with some special relationship with the president himself and his family members.
termed by the Chinese as bureaucratic monopoly capitalism. It referred to the change from state capitalism to bureaucratic capitalism.

Surviving under the domination of foreign capital and bureaucratic capital, the fate of the private sector can be imagined. Private owned companies were usually small in size and capital. Their economic efficiency and productivity were low, and their technology, equipment, and managerial skills were backward. They heavily relied on foreign capital and technology. All these elements limited and shaped the development of private owned companies. Private owned companies were concentrated in a few light industry sectors such as silk reeling and textiles in order to supply the needs of foreign markets. Most of them were located in a few coastal cities for the convenience of importing technology and equipment and shipping their products abroad.

The rampage of bureaucratic capitalism attracted a tide of criticisms. People saw all the evils caused by it. It suffocated the development of the private sector. It became the instrument used by individuals to enrich themselves. It brought administrative intervention to corporate management. It devastated the national economy and was

450 Ibid, 17.
451 Ibid.
responsible for disastrous inflation in the late 1940s. Calls for promoting the private sector and separating the governmental function from enterprise management arose.\textsuperscript{453}

Despite the disastrous practice of state capitalism, company legislation was further completed under the Nationalist government. In 1929, a new \textit{Company Law} with 233 articles was promulgated but would only come into effective two years later (July 1931). The law reflected the government’s intention of closely regulating corporate activities. Companies limited by shares were brought under greater regulation. More penal provisions and heavier punishments were imposed on conduct in breach of the legislation. Some held that the 1929 \textit{Company Law} was too strict. As a result, it bridled the spirit of business people.\textsuperscript{454}

A central object of the 1929 \textit{Company Law} was to give more protection to small shareholders and limit the rights of large shareholders. For example, it stated that, in a company limited by shares, a shareholder’s voting rights could not exceed one-fifth of the votes of all shares regardless of whatever his actual shareholding was.\textsuperscript{455} However, this did not apply to a company in which the government had shareholdings.

With the end of the Second World War, the Nationalist government amended the 1929 \textit{Company Law} and enacted the \textit{New Company Law} in 1946. The amendment came as an effort to regulate company conduct in changed postwar circumstances. An important

\textsuperscript{453} \textit{Ibid.}


\textsuperscript{455} See Article 129 of the 1929 \textit{Company Law}.
change was the end of foreign extraterritoriality, i.e., Chinese company law began to apply to foreign companies within China’s territory. The 1946 *New Company Law* added other two types of companies, *youxian gongsi* (limited company) and *waiguo gongsi* (foreign company). Members of a limited company were restricted to at most ten. The purpose of providing the new categories of company was to entrench the government’s control in those newly confiscated Japanese companies.\(^{456}\) The 1946 *New Company Law* soon ended its effect in Mainland China as a result of the Communist victory. In 1949, the Communist government announced the establishment of the People’s Republic of China. Since then, China switched to the system of a planned economy until the late 1970s.

**CONCLUSIONS**

Since the mid-19th century, the corporation and corporate law in China gradually developed. The Chinese government and Chinese people placed great hope in the corporate system in relation to accelerating the process of China’s modernisation. As a result, the government endeavored to build a strong corporate system which was closely under the State’s control. However, the early practice of establishing merchant owned but government supervised companies and the later efforts to promote state capitalism all ran counter to the basic policy. The enterprises under the State’s intervention did not prosper. The whole economy suffered the consequences.

The theory of developing the public sector was not unsound and the government’s support and guidance for corporate development had been proved necessary in some

\(^{456}\) See William C Kirby, “China Unincorporated: Company Law and Business Enterprise in Twentieth-
other industrialised countries, such as Germany and Japan. In China, it was the practice that went wrong. The biggest lesson for the Chinese was that the government’s support and guidance should not be exercised through direct administrative intervention in corporate governance. Instead of directly managing the day to day business of state-owned companies, the government should design a workable system that enabled the government to effectively control the companies through suitable agents so as to more efficiently realise the state’s ownership rights in these companies.
Chapter 7

CORPORATE DEVELOPMENT FROM 1949 TO 1978

Upon the establishment of the People's Republic of China, the country started to reform its old enterprise system. The new government was determined to build a socialist economic system as predicted by Marx in China. This system was supposed to be a centrally planned economic system, where economic activities would follow administrative plans of the State rather than the market demand and the price system. According to the theory, this system had to be built by totally changing and restructuring the old system, as it was a completely new project in the history of mankind. The first step taken by the government was for the State to confiscate bureaucratic enterprises. The next step was to transfer private enterprises into joint state-private enterprises and then convert them into state-owned or collective-owned enterprises. After that, state-owned enterprises played the dominant role in the national economy.

During the period of economic recovery and the period of transition towards a socialist economy, the state-owned enterprise system appeared to be successful.457 The country's economy delivered an impressive performance. Later, however, the economic

development slowed down and eventually faltered after 1958. The government noticed the economic inefficiency of state-owned enterprises and made a few endeavors to improve their economic performance. However, the political and social situation during that time in China decided that these reform attempts would end up fruitless.

THE RECOVERY OF THE NATIONAL ECONOMY

After winning the civil war, the new communist government concentrated on recovery of the national economy. The economic policy of that period was formed according to Mao’s thoughts on a new democratic economy. The essence of the policy was to eliminate bureaucratic capitalism in China. As the private sector was not a dominant economic power and could make contribution to the country’s economy, they were protected. Hence, to confiscate bureaucratic enterprises and protect private enterprises was the principal policy of that time in relation to enterprise development.

Under the policy of the new democratic economy, the economic structure was divided into different component parts according to ownership structures. There were state economy, semi-state economy, mixed economy, capitalist economy, individual economy, and state capitalist economy. These economic component parts co-existed during the economic recovery period. Accordingly, enterprises were classified into state-owned

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458 Ibid.


460 Later, the policy was embodied in The Constitution of the People’s Republic of China (1954).
enterprises, collective enterprises, private enterprises, individual enterprises and mixed enterprises.\textsuperscript{461} The traditional categories of enterprises including companies, partnerships and sole traders were largely ignored. The new enterprise categories gave clearer indication in terms of identifying which enterprises were subject to the ongoing socialist reform.

However, for the sake of regulating private enterprises, which were still large in number, the government enacted the \textit{Interim Regulations Concerning Private Enterprises} in 1950. In the next year, the \textit{Implementing Methods of the Interim Regulations Concerning Private Enterprises} came into effect. In these two pieces of legislation, private enterprises were divided into sole traders, partnerships and companies. The legislation provided for five types of companies, \textit{wuxian gongsi} (an unlimited company that had at least 2 unlimited liability shareholders), \textit{youxian gongsi} (a limited company that had at least 2 limited liability shareholders), \textit{lianghe gongsi} (a joint company that had at least 1 unlimited and 1 limited liability shareholder), \textit{gufen youxian gongsi} (a company limited by shares and must have at least 5 shareholders), and \textit{gufen lianghe gongsi} (a joint share company that had at least 1 unlimited liability shareholder and 5 limited liability shareholders).\textsuperscript{462} The legislation defined all the basic characteristics of the company.\textsuperscript{463} In these companies, shareholders exercised their residual rights through the shareholders'
meeting.\textsuperscript{464} In a company limited by shares, the executive power was exercised by the board of directors.\textsuperscript{465} In a limited company, by the executive shareholders or directors.\textsuperscript{466} In a joint company or a joint share company, by the executive shareholders with unlimited liability.\textsuperscript{467} An important characteristic of the 1950 legislation was that it introduced the provision that enabled the State to incorporate the productive activities of private enterprises into its economic plan. Article 6 stated that “for the purpose of overcoming economic anarchy, adjusting the relationship between production and marketing, and developing toward a planned economy, if necessary, the government may make production and marketing plans in relation to certain important products, which should be complied by both state-owned and private enterprises”.\textsuperscript{468} This provision paved the way for further reforming the private enterprises into state-owned or collective-owned enterprises.

In short, during the economic recovery period, the country’s policy toward private enterprises could be summarized in a few words: use, restrict, and reform. While encouraging private enterprises to make economic contribution to the country, the government took steps to prepare for peacefully reforming them into state-owned and collective-owned enterprises.

\textsuperscript{464} See Article 18 of the 1950 \textit{Interim Regulations Concerning Private Enterprises}

\textsuperscript{465} \textit{Ibid}, Article 19.

\textsuperscript{466} \textit{Ibid}, Article 20.

\textsuperscript{467} \textit{Ibid}, Article 21 & 22.

\textsuperscript{468} \textit{Ibid}, Article 6.
REFORMING PRIVATE ENTERPRISES AND DEVELOPING STATE-OWNED ENTERPRISES

In 1953, the government launched its first five-year economic plan. The process of reforming private enterprises accelerated. The government proposed the general policy of "one realisation and three reforms", i.e., realising industrialisation and reforming the agricultural sector, the small business sector, and the private sector. In relation to private enterprises, the reform methods included ordering goods, unified purchase and sale by the State, and restructuring the enterprises into joint state-private enterprises (mixed enterprises).

With more and more private enterprises being changed into joint state-private enterprises, the 1950 Interim Regulations for Private Enterprises had less and less objects to regulate. The types of companies defined in the legislation, except the limited company, which was still used by joint state-private enterprises, gradually became extinct. In 1954, the country enacted the Interim Regulations for Joint State-Private Enterprises. The regulations provided guidance for organising joint state-private enterprises. A joint state-private enterprise usually took the form of limited company. Its shareholders included the State on the one side, and private investors on the other side. All shareholders took limited liability to the extent of their shares.\textsuperscript{469} The State would appoint representatives to participate in management. Such an enterprise, if it was large in size and in shareholders, had the board of directors as the organ for discussing and deciding business affairs. There was no general meeting but only private shareholders’

\textsuperscript{469} Ibid, Article 8.
meeting which only dealt with internal matters among private shareholders. Such an organisational arrangement ensured that power was concentrated on the board. The State, by controlling the board, could enhance its control over the enterprises, and eventually dominated these enterprises.

Before the enactment of the 1954 Interim Regulations for Joint State-Private Enterprises, the State and the private shareholders of a joint state-private company appointed their respective directors. The number of the directors was distributed to each side according to their share proportions. The 1954 regulations discarded this practice. Article 20 of the legislation stated that the number of the directors appointed by each side should be decided through negotiation. The regulations made further clarification that "joint state-private enterprises are subject to the leadership of the State, and are jointly managed by state representatives and private agents". Moreover, if shareholders could not reach an agreement over an important matter, the matter should be submitted to the authoritative department for resolution. It was evident that the regulations further broke away from traditional corporate practice and made the enterprises' activities closer to that of a state-owned enterprise.

Up to 1956, all private enterprises were converted into joint state-private enterprises. In 1956, the State Council enacted new rules which fixed the dividends of private

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470 Ibid, Article 22.
471 Ibid.
472 The two piece of legislation were: the Provisions regarding the Promotion of Fixed Dividends in Joint State-Private Enterprises and the Instructions on Some Questions about Reforming Private Industrial and Commercial Sector, Private Handicraft Sector, and Private Transportation Sector.
shareholdings in a joint state-private enterprise at 5% per year.\textsuperscript{473} The dividends should be paid for a period of 7 years (later changed to 10 years) regardless of whether the enterprise made profits or not.\textsuperscript{474} The new rules, in fact, converted private shareholders to creditors. As a result, the last type of company, the limited company, were all converted into state-owned or collective-owned enterprises. The majority of them were transformed into state-owned enterprises. A state-owned enterprise was an enterprise where the State claimed not only absolute ownership but also managerial rights.\textsuperscript{475} Regarding state-owned enterprises, China adopted the method of “uniform ownership, but hierarchical control”. Thus, there were such a species of state-owned enterprises - owned by the central government but controlled by local governments.\textsuperscript{476} A collective enterprise was an enterprise where the local government had the ownership and managerial rights.\textsuperscript{477}

After the public ownership reform, some enterprises still kept the word “company” in their names. However, they were not traditional companies any more. Firstly, they carried on their businesses not for making profits but for implementing economic plans. Secondly, they operated according to the requirement of administrative plans, not the demand of the market. Thirdly, their internal organisational structure differed from that of

\footnotesize{\textsuperscript{473} See Article of the 1956 Instructions on Some Questions about Reforming Private Industrial and Commercial Sector, Private Handicraft Sector, and Private Transportation Sector.}

\footnotesize{\textsuperscript{474} Wang Baoshu & Cui Qinzhi, \textit{The Theory of the Chinese Company Law} (1998), 15.}

\footnotesize{\textsuperscript{475} See Gan Zhongpei, \textit{The Law of Enterprises and Companies} (1998), 102.}


\footnotesize{\textsuperscript{477} See Gan Zhongpei, \textit{The Law of Enterprises and Companies} (1998), 152.}
a company. The situation lasted for about 23 years until the initiation of the economic reforms in 1978.

As mentioned before, after 1958, economic development in China became stagnant. The uniform public ownership and the total absence of market competition began to make negative impact on the economy. There was increasing awareness of the inefficiency of state-owned enterprises. Quite a few attempts at reforming state-owned enterprises were made, but were all in vain. The first reform happened in 1958. The State decided to hand down 87% of its enterprises to local provinces and municipalities. However, this was simply a process of shifting central administrative control to local administrative control. The reform had little effect on the improvement of enterprise efficiency. Consequently, the State resumed central control in 1961. The second reform was carried out in 1964. The central government delegated the power of allocating funds and materials for non-industrial projects to local governments. The power was returned to the central government again as the reform proved to be failure. In 1970, another reform was launched. Half of state-owned enterprises were turned over to local governments again. It did not have a better fate than the first two reforms.

In the meantime, the government experimented with increasing the economic efficiency of state-owned enterprises through establishing enterprise groups. Around the 1960s, China launched the trial of constructing a trust (tuolasi). A tuolasi was a union of

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478 Ibid.


many enterprises which manufactured similar products or were supplementary to each another in processing and re-processing productive materials.\textsuperscript{481} In a tuolasi, individual enterprises of the tuolasi became the shareholders of the tuolasi and lost their commercial independence. Each enterprise held a certain amount of shares and would receive dividends and bonuses accordingly. A tuolasi was run by its board of directors.\textsuperscript{482} The aim of adopting the tuolasi system was to coordinate specialised enterprises and achieve managerial efficiency. The trial of tuolasi brought some visible improvement in productive efficiency.\textsuperscript{483} However, it was not as successful as expected. It did not change the situation of administrative intervention in firm productivity inherent in a planned economy.\textsuperscript{484} Before further reform measures were put into practice, the Cultural Revolution started, which not only brought political turbulence but also caused the recession of economic development in China. The method of tuolasi was also on the agenda to be rejected.

To sum up, the new government made great efforts to end bureaucratic capitalism in China. It confiscated all the bureaucratic capitalist enterprises. However, unlike the case in the Soviet Union and some other socialist countries, the socialist government in China did not nationalise private enterprises immediately. It took a more gradual and peaceful step to reform them into state-owned and collective-owned enterprises. This strategy was

\textsuperscript{481} Ibid.  
\textsuperscript{482} Ibid.  
\textsuperscript{484} Ibid.
proved to be successful. In fact, all the government’s policies concerning enterprise reforms were carried out effectively. However, the government later found out that the economic performance of state-owned enterprises was not as satisfactory as anticipated. Efforts were made to improve the performance of these enterprises. However, as these strategies were not aimed at reducing administrative intervention and increasing market mechanisms but focused on changing hands among different administrative authorities, the expectation of the reforms could not be met.

CONCLUSIONS

The early People’s Republic of China adhered to Marxist economic doctrines. The country adopted a planned economic system. The government nationalised all the enterprises of bureaucratic capital, and took steps to reform private enterprises. After three years’ economic recovery and five years’ economic reform, China basically converted all the private enterprises into state-owned or collective-owned enterprises. As a result, traditional companies became extinct after 1956. After that, China had an enterprise system of public ownership and all enterprise activities were under administrative control of the State. Later, the enterprise system under administrative control began to show defects in economic performance. As the superiority of the planned economy was not supposed to be subject to challenges and criticisms during that historical period, no significant reform efforts were made.

The Chinese experience from 1949 to 1978 illustrated that a total withdrawal of market mechanisms and modern corporate governance from an enterprise system could not serve the purpose of increasing economic efficiency of the enterprise. The Chinese
paid the price for the historical lesson. Thus, with the commencement of the economic reforms in 1978, China has determined to build a market economy and a modern enterprise system.
Chapter 8

THE ENTERPRISE REFORMS AFTER 1978

Since 1978, China has carried out its economic reforms aggressively. The goal of the economic reforms is to industrialise the country by building up a market economy. Different from other former East bloc countries, the Chinese have adopted a gradual reform strategy that "has combined the introduction of market forces, gradual reduction of mandatory planning, decentralisation and autonomy in economic management and opening the economy to international trade and foreign investment".485 After two decades, the economic reforms have produced a result of rapid economic growth and broadly shared income gains in Chinese society. However, upon closer examination, one can perceive that China's stunning economic performance after the economic reforms has been largely attributable to the liberalisation of the agricultural sector and the rapid growth of non-state industry including township and village enterprises.486 The fundamental reforms of state-owned enterprises were much postponed until the end of 1990s. Before that, less radical reform measures were implemented in state-owned enterprises with limited success. Since 1997, seeing the costs of postponing, the government has determined to accelerate the enterprise reform. According to the reform agenda, state-owned enterprises are to be reformed into modern companies, while some

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of them are to be subject to privatisation. The Chinese regard the far-reaching enterprise reform as a decisive step toward the final success of the economic reforms.


Since the commencement of the economic reforms in 1978, China’s economy has realised an average annual growth rate of 9 per cent. The agricultural sector and non-state enterprises have been largely responsible for this success. However, the financial performance of state-owned enterprises has declined. In 1996, about half of the state-owned enterprises of the industrial sector made net losses that amounted to 1.3 per cent of gross domestic products (GDP). The unsatisfactory performance by Chinese state-owned enterprises has largely resulted from the lack of a modern, market-oriented enterprise system. This raises the fundamental question: why did not the Chinese government launch a far-reaching reform policy for its enterprise system at the early stage of the economic reforms?

There were ideological and economic concerns in relation to the fundamental reform of the enterprise system. The ideological impediment was discussed in the early chapters of this thesis. The principal economic justification of delaying the enterprise reform has been the concern about the social cost at the macro-economic level. At the time of initiation of the economic reforms, state-owned enterprises accounted for 60.3 per cent of


the GDP and the collective-owned enterprises accounted for 34.6 per cent of the GDP. In the manufacturing sector, four-fifths of the output was produced by state-owned enterprises.\textsuperscript{489} State-owned enterprises employed over two-thirds of industrial employees and the majority of total fixed assets.\textsuperscript{490} Meanwhile, they were also the provider of social welfare to the employees, retirees and their families. The initial size and the dominant role of state-owned enterprises in the economy determined that it was not desirable to take a drastic strategy to reform the enterprise system. It was perceived that a radical enterprise reform would produce a massive urban unemployment and create social division between the rich and the poor, which would, in turn, bring social instability and jeopardize the entire reform program. Taking account of the high social cost, it was regarded by the Chinese as worthwhile to take less radical methods to reform the enterprise system in the early stage.\textsuperscript{491}

As a result, the enterprise reform in China has been carried out in phases. The first phase of the enterprise reform started from 1978. The reform effort in this period focused on decentralising governmental authority in enterprises and on increasing the operational autonomy of enterprise managers.\textsuperscript{492} Methods such as the Contract Responsibility System, leasing and “corporatisation” were used. Managers were given greater autonomy

\begin{itemize}
  \item \textsuperscript{488} See the World Bank, \textit{China's Management of Enterprise Assets: The State as Shareholder}, xi.
  \item \textsuperscript{489} See Nicholas R Lardy, \textit{China's Unfinished Economic Revolution} (1998), 25.
  \item \textsuperscript{491} See Nicholas R Lardy, \textit{China's Unfinished Economic Revolution} (1998), 22-23.
  \item \textsuperscript{492} Ibid.
\end{itemize}

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over allocating profits and resources.\textsuperscript{493} Meanwhile, the country encouraged the development of the enterprises with diversified ownership including Chinese foreign joint ventures, and private owned and individual owned enterprises.

With increasing expectation on the improvement of enterprise efficiency, the second phase of enterprise reform was started in the mid-1980s.\textsuperscript{494} During this period, the government, while continually encouraged managerial autonomy, promoted the formation of long-term contracts between enterprises and their administrative departments. By explicating the financial targets of the enterprises in the contracts, it was expected that the opportunity of bureaucratic intervention would be reduced, and the managerial performance and the economic efficiency of the enterprises improved.

In 1993, the third phase of enterprise reform was unfolded. Introducing modern corporate governance mechanisms into state-owned enterprises was emphasized. The trials of corporatisation and privatisation were carried out in selected sectors and enterprises.

After years of reform efforts, the Chinese enterprises made impressive progress. Up to the late 1990s, the growth rate of total factor productivity had steadily increased.\textsuperscript{495} The economic efficiency of state-owned enterprises appeared to be improved, although not as great as that of non-state owned enterprises.\textsuperscript{496} State-owned enterprises remained key

\begin{footnotesize}
\textsuperscript{493} Ibid.
\textsuperscript{494} Ibid, 23.
\end{footnotesize}
drivers of the nation’s industrial sector and dominated most capital-intensive sectors. However, the performance of state-owned enterprises was by no means satisfactory. The profits made by state-owned enterprises constantly declined, from 6 per cent of the GDP in the 1980s to 1 per cent of the GDP in the late 1990s.

The major problems of state-owned enterprises could be identified as: Firstly, the enterprises were excessively burdened by a range of social obligations. Under the planned economy, China did not develop a social insurance and welfare system. Instead, the enterprises were liable for providing such social services to the employees, retirees and their families. Since the economic reforms, the State was making efforts to relieve the enterprises from the encumbrance by building up a social insurance and welfare system. However, before such a system was fully completed and could fully function, many enterprises had to continue to assume the responsibilities. As a result, state-owned enterprises operated with a large number of redundant employees and retirees. This put them in a disadvantageous position in competition. Many of them made net losses. Moreover, because these enterprises had taken up the social responsibilities for the State, they were not able to exit freely. For certain policy concerns, the government found itself little choice but to continually inject capital into loss-making or insolvent enterprises. This revealed another major problem relative to the enterprise system, the non-commercial operation of China’s banking system.

498 Ibid.
499 Ibid.
The banks in China did not take the role of intermediaries between savers and investors as their counterparts do in a market economy. They did not assume a disciplinary role as those did in a market economy either. Under a planned economy, China had a mono-bank system where one bank played both the role of central bank and the role of commercial bank. Banks operated according to administrative plans rather than commercial principles. This situation was not improved fundamentally after the economic reforms. The government continued to control interest rates and impose credit plans on banks. Consequently, banks have extended a large proportion of “policy loans” to state-owned enterprises and had to constantly underwrite loss-making enterprises. Sometimes, bank loans were used by enterprises to pay wages and bonuses to their workers not for the purpose of making profits. The non-commercial operation of the banking system created a fatal problem for the enterprise system, *ie*, inefficient allocation of capital. If the problem persists, the major banks could all be dragged into insolvency.

Price distortion was another problem which plagued state-owned enterprises. For some policy reasons, the State continually exercised the authority of setting prices for state-owned enterprises. This further disadvantaged state-owned enterprises in market competition. The situation was more serious in the early stage of the reforms. With the expansion of the price reform, the problem was mitigated. However, the government has

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501 Ibid.

502 Ibid, 83.
retained certain measures of control over certain products in certain sectors, such as imposed price ceilings.\textsuperscript{504}

Finally, the early strategies of enterprise reform created new problems in the enterprise system. While the managers of state-owned enterprises were increasingly given managerial autonomy, the property right in the enterprises was not clearly defined. This created the opportunity for the management of state-owned enterprises to transfer the assets of these enterprises to some non-state owned enterprises. The managerial autonomy also created an insider control problem which was responsible for excessive wage payment in some enterprises. Tax evasion and de-capitalisation also became severe.\textsuperscript{505} These new problems further caused the decline of profitability of state-owned enterprises.

In summary, the policy of enterprise reform in China has not been made in isolation. It has been taken in the context of broad economic reform consideration. The fear of instability inspired the Chinese government to adopt an economic reform strategy of preventing the emergence of economic losers during the reform era, which in turn deferred the embrace of a radical reform of state-owned enterprises. However, the Chinese economy has constantly paid the price for the delay. The situation later deteriorated to the point that, without a radical enterprise reform and effective measures

\textsuperscript{503} It is suspected that the major banks are already insolvent.


being taken, the gains from the success of the economic reforms in the past years could all be consumed by the inefficient enterprise system.

THE INITIATION OF THE “BIG BANG” ENTERPRISE REFORM

Seeing the alarming problems in the enterprise system, the Chinese government finally determined to initiate the “big bang” enterprise reform package in 1997. The Fifteenth National Congress of the Communist Party of China sketched out the blueprint for the enterprise reform. The Congress confirmed that the next stage of the economic reforms should focus on reforming large and medium-sized state-owned enterprises into modern corporations so as to set up the modern enterprise system in China. Corporatisation and privatisation of state-owned enterprises are to be carried out on an ever large scale.

In September 1999, the Fourth Plenum of the fifteenth CPC Central Committee further defined the major objectives and guiding principles for the reform and development of state-owned enterprises. According to the Decision of the CPC Central Committee on Major Issues Concerning the Reform and Development of State-Owned Enterprises, the objectives for the state-owned enterprise reform and development up to the year 2010 are: completing strategic readjustment and restructuring, bringing into form a more rational layout and structure of the national economy, establishing a relatively perfect modern corporate system, improving economic performance, remarkably promoting
scientific and technological development, market competition and risk management, and making the state economy play a better, dominant role in the national economy.\textsuperscript{506}

The guidelines for the reform and development of state-owned enterprises include: maintaining public ownership as the dominant form; strategically readjusting the layout of the state economy and restructuring state-owned enterprises; establishing a modern corporate system; and fostering a competitive mechanism of survival of the fittest.\textsuperscript{507}

Under the current policy, except some important sectors, public ownership can be reduced to non-dominant proportion.\textsuperscript{508} As later official documents clarified that state-owned enterprises will remain the dominant position only in the following industrial sectors: (1) pillar industries and backbone enterprises in high technology sectors; (2) non-renewable natural resource sectors; (3) public utility and infrastructure service sectors; (4) sectors vital to the country’s national security.\textsuperscript{509} This has shown the government’s determination to introduce a diversified ownership structure into the enterprise system, so as to bring in outside competition into state-owned enterprises.

\textsuperscript{506} See the \textit{Decision of the CPC Central Committee on Major Issues Concerning the Reform and Development of State-owned Enterprises} (September 22, 1999).

\textsuperscript{507} Ibid.


\textsuperscript{509} Ibid.
In 1998, the government took radical steps to shift its function away from direct control over enterprises toward indirect and strategic planning. The government ministries were restructured to better suit the market economy. More than two hundred functions were delegated to enterprises from the ministries. The enterprises are obliged to lodge financial statements with the financial intermediaries. All the efforts have shown the government’s determination of making state-owned enterprises subject to greater financial controls.

Mechanisms were introduced to enhance industrial rationalisation. More and more loss-making enterprises were restructured through the procedure of bankruptcy, mergers and acquisitions. In 1997, about 650 enterprises declared bankruptcy and over 1,000 enterprises were acquired. The number doubled in 1998. Recently, the bankruptcy and acquisition scheme has begun to target large and medium-size enterprises.

The banking system has been subject to restructure. The banking sector reform has focused on reducing the rate of non-performing loans in the system, so as to limit financial risks and preventing future financial crises. In 1998, the Ministry of Finance took the step of strengthening the major banks’ capital bases by issuing additional

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510 See The World Bank, China: Weathering the Storm and Learning the Lessons (1999), 32.
512 Ibid.
513 See The World Bank, China: Weathering the Storm and Learning the Lessons (1999), 32.
514 Ibid, 30.
515 Ibid, 33.
 treasury bonds to them. A new indicative quota system and an asset and liability management system were introduced in the same year. It is expected that the adoption of the new systems will be helpful in reducing non-performing loans.516

To ensure the success of the reform, the Chinese government has put the development of a sound social security system high on the agenda. From July to December 1999, the government has raised the minimum of unemployment insurance and lowest income of urbanites by 30 per cent.517 A framework for a social security system consisting of pensions, unemployment and medical insurance was basically set up by the end of 2000.

According to the Chinese official reports, the reform strategies have begun to show a positive impact on the economy. The latest statistics tell that China's industrial sector registered a 61 per cent jump in net profits in 1999 and reduced the losses of under performing enterprises by 12.8 per cent.518 The future of the economic reforms seems promising. However, until the legal framework is completed and a sound social and institutional infrastructure that genuinely fosters a market economy is built up, it is hard to evaluate how successful the final delivery of the enterprise reform will be.

CORPORATISATION IN THE ENTERPRISE REFORM

On the completion of nationalisation in 1950s, traditional companies were replaced by state-owned and collective-owned enterprises. Since the economic reforms, the country


had the plan of promoting a number of specialised companies and groups of companies. In 1978, some specialised companies, groups of companies and headquarters were firstly established in Beijing, Shanghai, Tianjing and Shenyang. Since 1979, the laws concerning Chinese-Foreign joint ventures and wholly foreign owned enterprises were enacted, and joint venture enterprises and foreign subsidiaries began to appear in China. These all signaled the recovery of corporate practice. In 1980, the State Council launched the *Interim Regulations for Promoting Economic Cooperation* aimed at further encouraging the enterprise reform. More companies were set up. However, many companies at this stage were, in fact, administrative companies, as labeled by the Chinese. Some of them existed since the 1950s and 1960s. Some of them were newly formed. They were in fact administrative organisations set up by administrative authorities for controlling and administrating other enterprises.

The evaluation of the defects of administrative companies started since 1979. There was increasing awareness of the economic irrationality of administrative enterprises and companies. The discussions found that the existing enterprise system had replaced economic organisations with administrative organisations which was a practice contradicting economic rationality. This type of enterprise was vulnerable to administrative intervention. The economic reforms must take steps to restructure these

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518 Ibid.

519 See the 1978 *The Central Committee of the Communist Party of China, Decisions on Increasing Industrial Development* (draft).


enterprises into independent economic organisations\textsuperscript{522}. However, there was lack of vision relative to how to reform the enterprise system in these early discussions.

The idea of reforming the state-owned enterprise system by corporatisation emerged since 1983.\textsuperscript{523} The enterprise reform during the initial stage stimulated academic discussions on evaluating reform outcome and reform strategies. Some analyses pointed out that inefficient allocation of capital and resources was the key problem of China's enterprise system. None of the strategies used in the ongoing enterprise reform effectively attacked these issues.\textsuperscript{524} Managerial autonomy had resulted in waste and depletion of state assets and resources.\textsuperscript{525} The strategy of replacing allocation of funds by the State with bank loans could not tackle the problem of efficient allocation of capital and resources, \textit{ie}, directing limited capital and resources flow to the highly productive sectors and enterprises.\textsuperscript{526} Moreover, as the managers of state-owned enterprises were appointed by their administrative departments, the irrational and short-term behavior of the enterprises persisted. Only through corporatisation to build up a modern enterprise system, could these fundamental problems be effectively attacked.\textsuperscript{527} Notably, the World


\textsuperscript{523} See Dou Jianmin, Research on the History of Corporate Ideology in China (1999), 105.


\textsuperscript{525} Ibid.

\textsuperscript{526} Ibid.

\textsuperscript{527} Ibid.
Bank also recommended that China should reform its enterprise system through corporatisation in a report in 1983.\(^{528}\)

The issue of reforming the enterprise system through corporatisation immediately attracted wide attention in China. In the next few years, intensive debates on corporatisation occupied important spaces of many newspapers and periodicals. As mentioned in the early chapters, a large proportion of discussions during this period concerned ideological issues. In the mid-1980s, some cities began the trial of establishing share companies. The government’s approval of corporate practice was expressed in some official documents since 1986.\(^{529}\) In 1987, the Thirteenth National Congress of the Communist Party of China confirmed that the trial of corporatisation should continue.

At the early stage of corporate experiment, as the corporate legislation was not complete and the practice was not mature, many problems emerged. There were too many companies and some of them could not satisfy basic standards. For example, there were some “briefcase” companies, with no capital, no site, no stable employees and no equipment. Some companies were set up for making illegal profits. There were also managerial problems in many companies. Up to 1985, there were 300,000 different types of companies in China.\(^{530}\) Seeing the problems in practice, the State Council decided to restructure the existing companies and to enhance the regulation of company activities. In


\(^{529}\) See the State Council, *Some Regulations concerning Deepening Enterprise Reform and Increasing Enterprise Vitality* (1996).

the meantime, the State Administrative Bureau of Industry and Commerce enacted the *Interim Regulations for Administrating and Registering Companies*. After a great deal of efforts, the number of companies was reduced to 180,000. However, the number increased to 360,000 again in 1987.\(^{531}\) The State Council called for another time of restructuring the existing companies in 1989. Some ill qualified and managed companies were closed down. By 1990, the number of companies reduced to 250,000.\(^{532}\)

With the deepening of the economic reforms and the progress of corporate practice, corporate activities further developed in the early 1990s. The number of share companies increased rapidly. Many companies issued shares to the general public. Consequently, there was the need to develop a securities market. In 1990 and 1991, two stock exchange centers were set up in Shanghai and Shenzhen. The advantages of incorporation were clearly comprehended by the Chinese business and industrial sectors. In 1993, the number of registered companies reached 836,000.\(^ {533}\)

Vigorous corporate activities called for appropriate legal development. The earliest company regulations after the economic reforms were local legislation. For example, the *Regulations for Foreign Related Companies in Special Economic Zones in Guangdong Province* (1986) and the *Shenzhen City, Interim Regulations on Companies Limited by Shares* (1992). These local corporate statutes provided useful experience for the

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\(^{531}\) Ibid.

\(^{532}\) Ibid.

\(^{533}\) The total number of companies (including non-registered companies) was 1,104,000. See State Statistical Bureau (China), *Chinese Statistical Yearbook* (1993).
codification of a national company law. In 1993, after ten years’s preparation, the first company code of the People’s Republic of China was finally completed and enacted.

The scheme to draft a national company law was initiated in 1983 by the National Economic Committee. The original plan was to draft two separate pieces of legislation on the stock company (public company) and the limited company (private company) respectively. This was because there was the concern that the experience of corporations in China was not sufficient and managing a public company was far more complicated than running a limited company.\(^{534}\) Hence, it would be convenient to draft separate laws for them, and whichever was completed first would be enacted earlier.\(^{535}\) The drafting work began in 1986. After two years’ work, the draft *Regulations on Limited Companies* and *Regulations on Companies Limited by Shares* were submitted to the State Council for examination. The State Council amended the drafts in 1988 and 1989. In 1991, a draft *Limited Company Law* was completed and after some amendments, was finalised in 1992. The draft law had a very narrow field of operation. It only regulated the companies owned by two or more state-owned or collective-owned enterprises.\(^{536}\) When the draft law was sent to the Standing Committee of the People’s Congress, it was the general opinion of the Committee that the coverage of the law was too narrow, and it was necessary to make a company law with wider coverage in order to accommodate the


\(^{535}\) Ibid.

\(^{536}\) See the *Explanations on the Limited Company Law of the People’s Republic of China* (July 28, 1992) which was made by the head of the Legal Bureau of the State Council, Yang Jingyu to the Standing Committee of the People’s Congress.
economic development.  \footnote{See Wang Baoshu & Cui Qinzhi, \textit{The Theory of the Chinese Company Law} (1998), 20.} Since then, the Legal Committee of the People’s Congress and the Legal Committee of the State Council took over the work of drafting a comprehensive company code. The law drafters referred to the early company legislation and drafts, studied foreign legislative experience, listened to experts’ opinions, and eventually produced a draft company code. After much examination and many amendments, the first \textit{Company Law} of the People’s Republic of China was passed by the People’s Congress in December 29, 1993. The law came into effect in 1994.

The \textit{Company Law} specially provides that a company will manage its business independently according to the needs of market, and will be independently responsible for its profits and losses.  \footnote{See Article 5 of the 1994 \textit{Company Law}.} This is a total departure from the old notion that the function of enterprises is to implement state plans.

Different from previous legislation, the \textit{Company Law} classifies enterprises according to investors’ liability and capital structures rather than ownership. This is a demarcation indicating that China’s enterprises are developing in the direction of serving the purpose of a market economy. Consequently, the presumption that the state-owned enterprise is superior to the enterprises of other kinds of ownership has diminished.

The law definitely inherits the legacy of overseas corporate laws, especially, Anglo-American and German corporate laws. However, compared with the current development in other jurisdictions, the Chinese \textit{Company Law} has some distinctive characteristics. Firstly, it emphasizes the central role of the shareholders’ meeting. This is quite a
conservative, if not reactionary, approach. The shareholders’ meeting has a wide range of powers including making business policies and plans, deciding on the matters such as reconstruction and dissolution of the company, increasing or reducing registered capital, and issuing shares.\footnote{See Article 103 of the 1994 Company Law.} The board of directors is the executive organ of the shareholders’ meeting and is responsible to the shareholders’ meeting.\footnote{Ibid.} The legislative scheme is based on the concern that China stayed in a planned economy for too long, and there was not a tradition of participation by investors in the decision making process in those previous enterprises. Thus, there is a need to stress the power of the shareholders’ meeting, so as to ensure that the shareholders’ meeting will function effectively.\footnote{Ibid, 25-6.}

Secondly, the Company Law emphasises the function of capital in a company. It requires a minimum registered capital and stresses the importance of capital maintenance.\footnote{See Articles 23, 43, 78, and 83 of the 1994 Company Law.} The purpose of doing so is to protect shareholders’ and creditors’ rights and interests, so as to enhance investors’ confidence.\footnote{Ibid.}

Thirdly, the Company Law adopts the approach of a single company code, where public companies and closely held companies are regulated by one company code with separate provisions in relevant areas. In the process of drafting the law, it was perceived that it was unnecessary to introduce every possible type of company into China. As a result, the law provides for two basic types of companies, stock companies (public
companies) and limited companies (private companies). The last two are the basic types of companies in most corporate systems.

It is noteworthy that the *Company Law* takes a conservative position in many respects. For example, it retains the *Ultra Vires* doctrine and par value, and forbids the one man company. These appear to be old fashioned approaches, contrasting with the current legislative trend in some other jurisdictions such as the USA, the UK, Canada, New Zealand, and Australia. This may come out of the consideration that since China is in an early stage of corporate development, it is necessary to adopt a conservative model. Meanwhile, the law leaves many gaps. For example, there are no detailed provisions in regarding directors’ fiduciary duties and no provisions concerning shareholders’ class action and derivative suits. The law even fails to address the quorum for a shareholders’ meeting. It is still anyone’s guess whether the gaps will be filled by further amendments or by enacting detailed implementing regulations.

Nevertheless, the significant impact of the *Company Law* on China’s enterprise system and economic reforms was unprecedented. It indicates a complete change of the enterprise system in modern China. Modern companies become the dominant business form and play the major role in productive activities. The *Company Law* provides legal guidance and protection for corporate practice.

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544 See Articles 11,22, and 131 of the 1994 *Company Law*.

545 Only the state can set up a state owned company with one shareholder.
For those companies that existed before its enactment, the *Company Law* allowed them to be registered as companies within a certain period, if they meet the requirements of the law. Those could not meet the requirements must do so within a certain period, otherwise, upon the expiration of the period, they would not be able to operate as companies. The 1995 *State Council, the Announcement for Regulating Previous Stock Companies and Limited Companies in accordance with the Company Law of the People’s Republic of China* provided detailed provisions relating to re-registering previous companies. The deadline was December 31, 1996. Those companies which failed or refused to register under the requirements of the *Company Law* before that date, are not permitted to operate as companies and have the word “company” in their names.

The *Company Law* has provided a clear legal guide for corporate practice. After the enactment of the law, the trial of reforming the existing state-owned enterprises into corporations started. About 2,500 large and medium sized enterprises joined in the trial. Up to 1997, one third of them had completed the reform. Among them, 540 enterprises were restructured into stock companies, 540 reformed into limited companies, and 909 converted into state-owned companies. Public ownership in these companies exists in the form of shareholdings.

When the corporate form began to gain dominance, people gained a keener understanding of corporate logic. The Chinese have been more and more aware that a mere adoption of the corporate form does not substantially improve enterprise behavior.

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as well as the economic efficiency of the enterprise. It has been known that some newly converted companies still operate in the old manner.\textsuperscript{548} Hence, to plant a modern enterprise system in China requires more efforts than simply enacting a company law. It requires a range of institutional reforms. Chinese reformers have thus turned their attention to devising corporate governance mechanisms to enhance corporate accountability.

\textbf{CONCLUSIONS}

Behind the success of China's economic reforms, there has been accumulated pressure on the current enterprise system. The increased tension within the enterprise system results from the postponed delivery of a far-reaching reform package. China's social and economic conditions at the early stage of the reforms justified the gradual reform strategy. The reform cost at the macro-economic level was kept as low as possible. However, it was achieved at the expense of micro-economic efficiency. When the economic inefficiency at the micro-economic level has accumulated to an extent that begins to jeopardize the entire outcome of the economic reforms, it is time to pull full attention to corporate governance.

\textsuperscript{547} Ibid.

Chapter 9

THE DEVELOPMENT OF CORPORATE GOVERNANCE IN CHINA: LAW AND REALITY

Not until the economic reforms, were the managerial irrationality and economic inefficiency of the enterprises of public ownership publicly discussed and criticized. This inspired wide discussions and investigations of enterprise management. There were increasing calls for learning and introducing modern management strategies. This, in turn, motivated the examination of the governance of the modern corporation. Since the mid-1980s, corporate governance started to gain wide interest and attention in China. Coming into the 1990s, the issues relative to corporate governance were intensively explored. The wisdom of modern corporate governance has been providing visions for China's enterprise reform.

THE GOVERNANCE PROBLEMS IN THE ENTERPRISES UNDER PUBLIC OWNERSHIP

Since the completion of nationalisation in 1950s, traditional companies were replaced by state-owned and collective-owned enterprises. While the collective-owned enterprises were small in size and were only on the margin of the economy, the state-owned
enterprises dominated the country’s economic landscape.\footnote{At the eve of the economic reform, the state owned enterprises counted for 83.2\% of the industrial GDP and collective owned enterprises accounted for 16.8\%. See State Statistical Bureau (China), \textit{Chinese Statistical Yearbook} (1993).} Under the planned economy, state-owned enterprises played the essential role in implementing state plans. They were not only owned by the State, but also managed by the State. It was why the Chinese also called state-owned enterprises state-managed enterprises (\textit{guo ying qi yie}) in the past.

As state-owned enterprises carried out their business of implementing the state plan, their business arrangements had to be in compliance with the plan. The directors or managers of the enterprises were, in fact, governmental officials. They followed the state plan and would not suffer the consequences of business failure. They received their remuneration according to their ranks not the economic efficiency of the enterprises. Some Chinese academics pointed out that under this system no real business enterprise existed.\footnote{See Jiang Yiwei (1980), “The Theory of an Enterprise Based Economy” \textit{Zhong Guo She Hui Ke Xue 1 (Social Sciences in China)} 21, 21-36.} In a sense, the State had become a big enterprise and these state-owned enterprises were just the manufacturing units of this big enterprise. Usually, such an enterprise had the Committee of the Communist Party, the Representative Meeting of Employees, and the Union as internal organs. The function of these organs was to execute state orders and state plans.\footnote{See Mei Shenshi, \textit{Research on the Structure of Modern Corporate Organs’ Power: A Legal Analysis of Corporate Governance} (1996), 10.} The problem of this kind of arrangement was that it replaced economic rationality with administrative commands. It resulted in the suffocation of enterprise vitality.
At the initial stage of the economic reforms, calls for enterprise reforms focused on clarifying the independent identity of the enterprises. This involved handing down power to the enterprises. The government also recognised the managerial irrationality which existed in public ownership enterprises. It was argued that the government should take measures to clarify that state-owned enterprises were enterprises, not administrative units.\textsuperscript{552} This involved handing down power to the enterprises. The government also recognised the managerial irrationality existed in public ownership enterprises. The decision of the Third Plenum of the Twelfth CPC Central Committee stated that those newly established companies must be treated as enterprises, not administrative units.\textsuperscript{553} It was further stated that the old managerial measures should be abandoned and the Chinese must learn modern scientific management.\textsuperscript{554} Later, some practical measures were taken. A state-owned enterprise was defined as an economic entity with managerial autonomy, and was to assume its commercial responsibilities independently and on its own account.\textsuperscript{555} An enterprise was required to separate from its administrative department and a person who held both an administrative position and a managerial position in an enterprise had to choose to resign from one of the posts.

To increase managerial incentives and autonomy, some strategies were introduced. At the beginning, the contractual mechanism was introduced to the enterprise system. Under the contractual system, the owner of an enterprise, usually the State or a governmental

\textsuperscript{552} Ibid.

\textsuperscript{553} See the CPC Central Committee, \textit{Decisions about Reforming the Economic System} (1984).

\textsuperscript{554} Ibid.
organisation, contracted with the contractor, usually the enterprise itself or another enterprise, to let the contractor to run the enterprise. The owner would receive profits according to the contract clauses and the contractor would have the rest as profits. The more the total income produced by the enterprise, the more profits the contractor would gain. The purpose of this strategy was to bring incentives into the enterprise system so as to increase managerial efficiency in maximising the total income of the enterprise. This method was later discarded as a short-term strategy which “can guarantee incentives but not the final achievement”. The reasons were: firstly, nobody was liable if the contractor failed to realise and turn over the agreed profits to the owner. Secondly, the contractor would seek short-term benefits at the expense of the State’s long-term interests. The contractor would neglect long-term investment, and with no interest in maintaining and repairing the State’s equipment and machinery.

Another notable reform strategy was the introduction of a director’s liability mechanism. The method was introduced to overcome the defects which existed in the previous managerial system. Previously, the internal governance structure of an enterprise was that the director was responsible for managing the enterprise under the direction of the Communist Party Committee. This system easily created confusion in relation to decision making and assuming responsibilities. The new mechanism gave all the decision-making power to the director, and the director took the responsibility

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555 See Article 2 of the 1988 Industrial Law of the State Owned Enterprises.

556 A small enterprise could have an individual as the contractor.

accordingly. Externally, the director was the representative of the enterprise and was responsible for the business activities of the enterprise. Compared with the old system, the system of director’s liability had advantages in terms of managerial efficiency. However, to concentrate all the decision-making power on one person was also problematic. In other systems, this governance structure is only suitable for family firms or closely held companies. For a large firm, a more elaborate internal organisation is required.

Later, it was pointed out that the above strategies were not enough to improve economic efficiency and further reform efforts were needed, as these reform strategies only concerned the separation of the enterprises from their administrative departments and the increase of managerial autonomy. After the separation from the administrative authority and realisation of managerial autonomy, the enterprises needed to be continually stimulated to pursue economic efficiency. Otherwise, the enterprises would be used to pursue other goals rather than the interests of the owner (the State). The enterprise reform had to be carried forward, so that the State as the owner of the enterprises could produce further effective incentives for the management of the enterprises. It was suggested that, in the next stage of the enterprise reform, attention should be paid to how to enhance the organisational strength of the enterprise.

558 Ibid, 184.
559 Ibid, 127.
561 Ibid.
course of searching for further solutions, the Chinese began to apply modern enterprise
theories to examine and analyse their enterprise system.

By applying modern firm theories, the defects of the Chinese enterprise system were
found out to be: firstly, in a state-owned enterprise, there was no substantial appearance
of ownership. State ownership means the ownership of the people as a whole. At the
end of the day, state ownership in the enterprise only existed in an illusory fashion.
This created a fatal defect, i.e., the absence of monitoring and controlling by the owner of
the enterprise.

Secondly, there were no efficient monitoring mechanisms and adequate incentives for
reducing agency costs and increasing managerial efficiency. Managers of the
enterprises took no liability for the poor performance of the enterprises. If an enterprise
made profits, it would not get extra benefits. If the enterprise made a loss, it only needed
to report to the relevant department in charge. There was no such a thing as insolvency.
The productive materials and necessary finance for the production were distributed
annually by the State according to the plan. If the enterprise was closed down as a matter
of adjustment of the plan, the manager would simply be appointed to another office. The
result was that most of these enterprises were not managed to maximise profits or to
achieve optimal economic efficiency.

562 See Mei Shenshi, Research on the Structure of Modern Corporate Organs' Power: A Legal Analysis of
Corporate Governance (1996), 33.

563 See Yuwa Wei, "A Chinese Perspective on Corporate Governance" (1998) 11 Bond Law Review 363,
365.

564 Mei Shenshi, Research on the Structure of Modern Corporate Organs' Power: A Legal Analysis of
Corporate Governance (1996), 34-36.
Thirdly, there were no market monitoring mechanisms. Products of these enterprises would not go to the market but went to the State which would distribute them according to the plan. The incentives to improve technology and increase productivity stimulated by market competition did not exist.

Generally speaking, this type of enterprise system basically eliminated the process of micro-decision making and replaced it by administrative macro-decision making. After 30 years' practice, the system had been proved to be inefficient and rigid. This system could not improve the firms' performance so as to improve the national economy as a whole. To many Chinese, it became clear that, to overcome the above problems, the only solution was to introduce a modern corporate governance system into the Chinese enterprise system.

THE INTRODUCTION OF CORPORATE GOVERNANCE

The Corporate Governance Structure in the Company Law

Since the early 1990s, Chinese policy makers have been determined that, in order to improve the micro-economic efficiency of the enterprise, the enterprise reform should be directed toward the road improved corporate governance by corporatisation. By enacting the 1994 Company Law, the country encourages the development of corporate practice. The law provides a modern corporate governance system for those newly established companies and re-registered companies to adopt. The corporate governance system

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565 Ibid.
begins to play an important role in terms of bringing vitality to Chinese enterprises. The *Company Law* states that the internal governance structure of a company follows the principles of clear division of power and liability, scientific management, and reasonable incentives and punishment for wrongdoing.基本上，该法律促进股东的集中主义和双层董事会结构。

The Chinese *Company Law* provides for three types of company, the joint stock company (public company), the limited company (private company) and the wholly state-owned company. Both stock companies and limited companies are required to have the shareholders' meeting. A wholly state-owned company does not have the shareholders' meeting. Functions of the shareholders' meeting are delegated to the board of directors.

The shareholders' meeting is the organ of power in a company. It makes decisions on all the important matters of the company. Besides appointing and dismissing directors and supervisors, Article 38 and 103 stipulate that the shareholders' meeting decides the policies of business operation and the investment plans of the company. It reviews and approves reports of the board of directors and supervisory board, the annual financial budget, the final accounts, and plans for distributing profits. It also decides on increasing or reducing the registered capital and the issue of debentures, and adopts resolutions on the merger, division, dissolution, and liquidation of the company. Compared with the situation in some other jurisdictions, the range of power of the shareholders' meeting in a Chinese company is much wider. For example, in a public company in the USA, many of these functions, such as making decisions on issuance of share, distribution of dividend

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566 See Article 6 of the 1994 *Company Law*. 202
and making business plans, are exercised by the board of directors. In such a company, the important power left to the shareholders’ meeting is the power of electing directors. Chinese law-makers believe that the approach in the 1994 *Company Law* is suitable for the actual circumstances of China. 567 As corporate practice has only just started, the law should give more protection to Chinese shareholders, so that they can exercise their rights adequately. 568

There are two types of shareholders’ meeting, the regular meeting (general meeting) and the interim meeting (special or extraordinary meeting). 569 The regular meeting must be held once every year. 570 It reviews and approves the annual financial budget and accounts, and decides the plan of profit distribution and recovery losses. 571 An interim meeting must be held if the following events occur: (1) the number of directors is insufficient to comply with the law; (2) the company’s net accumulated losses have reached one-third of its total paid-up capital; (3) as requested by shareholders holding more than ten per cent of the shares; (4) as requested by the board of directors or the supervisory board. 572 An interim meeting must be held within two months after the


569 See Article 43 of the 1994 *Company Law*.


occurrence of one of these circumstances. Unlike the law of some other countries, the Chinese law does not have provisions concerning class meetings and statutory meetings.

In terms of voting, the Chinese law adopts different principles in different types of companies. Chinese jurists classify a stock company as a business structure of capital cooperation, whereas a limited company is a cooperation of both capital and people. The reliability of a company of capital cooperation lies in its capital strength. In such a company, the exercise of voting rights should be based on shareholdings. Therefore the majority rule of voting refers to the majority of the total shareholdings. The reliability of a company of capital and people cooperation lies in both its capital strength and its shareholders’ creditability. Hence, the exercise of voting rights in such a company has to reflect not only the amount of shareholdings but also the number of individual shareholders. This view results in the dual voting methods in the limited company. On the one hand, the Company Law provides that, in a limited company, shareholders exercise their voting rights according to their shareholdings. This principle applies in the case of voting for alteration to the constitution, reconstructing and dissolving the company, and capital increase and reduction. On the other hand, votes are courted according to the number of shareholders, when deciding some other matters. For example, if a shareholder

573 See Article 104 of the 1994 Company Law.
575 See Article 41 of the 1994 Company Law.
576 Ibid, Article 39.
wants to dispose of his or her shares, he or she must obtain the consensus from at least half of the total shareholders.\(^{577}\)

The principle of one share, one vote is firmly established by the 1994 *Company Law.*\(^{578}\) Regarding the voting rights attached to different shares, there is different practice in some other legal systems. The UK, France, Japan and most states of the USA permit companies to issue non-voting shares. German, Italy and Australia do not permit companies to issue non-voting ordinary shares, but allow them to issue non-voting preference shares. Chinese *Company Law* remains silent on whether companies can issue non-voting shares or preference shares. However, Article 135 of the 1994 *Company Law* states that the State Council may adopt separate regulations governing the issuance of other types of shares which are not provided for in this law. This can be taken as that the law leaves room for issuing special kinds of shares in future, if necessary.\(^{579}\)

One of the legislative defects of the 1994 *Company Law* is that it fails to stipulate the quorum of shareholders at the shareholders’ meeting and the minimum holding for the shareholders. Therefore, theoretically, the shareholders’ meeting can be held with one shareholder who holds only one share. This is particularly problematic in a case of a joint stock company, where resolutions are to be made on the basis of shareholdings.

\(^{577}\) Ibid, Article 35.

\(^{578}\) Ibid, Article 106.


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For preventing misuse of position by directors and abuse of voting rights by majority shareholders, the law allows shareholders to directly bring suits against a decision of the shareholders’ meeting or the board meeting. Article 111 of the Company Law states:

Where a resolution of the shareholders’ meeting or of the board of directors’ meeting violates the law or administrative regulations, or infringes the lawful rights and interests of the shareholders, the shareholders concerned shall be entitled to apply for an injunction in a People’s Court to terminate the violation or infringement.

There is no special requirement regarding the number of the shareholders who bring a lawsuit. The proper defendant in the suit is the company. The chair person of the board will represent the company to attend the legal process. From the wording of Article 111, shareholders have the right to seek an injunction to make an unlawful resolution void or revoke the resolution. It seems that other relief such as winding up and receivership are not available to Chinese shareholders. The novelty of the Chinese law is that shareholders can bring an action against not only a decision of the shareholders’ meeting, but also a resolution of the board meeting. It is believed that shareholders’ interests will be better protected if they have the opportunity to challenge decisions of the board meeting.\(^{580}\) In reality, there were such cases where shareholders’ rights were violated by decisions of the board of directors’ meeting. For instance, the board of directors of a company in Shanghai, at the time of calling for the shareholders’ meeting, resolved that shareholders could only vote in writing. This provoked the shareholders to bring an action against the decision.\(^{581}\)

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581 Ibid.
Apart from decisions of the shareholders' meeting and the board meeting, the law does not provide other grounds for shareholders' actions. However, in some other jurisdictions, shareholders may bring suits relating to matters such as issuance of new shares, reduction of capital, and merger.

The wording of Article 111 does not give any clue as to whether the *Company Law* approves shareholders' derivative suits. Some, from a strict view of legal interpretation, believe that the law is negative towards shareholders' derivative suits. Some hold that the law should be widely interpreted to accommodate shareholders' derivative suits. Recently, quite a few such cases have been brought to the court.582 Practice is calling for the recognition of derivative suits. It is important for shareholders to have a right to challenge not only the behavior that damages their own interests, but also the conduct that harms the company. Since shareholders are the residual claimants and the ultimate controllers of the company, it is pertinent to say that the interests of the company are also part of the shareholders' interests. The damage made to the company will eventually pass to its ultimate owners, the shareholders. From this view, to interpret Article 111 to the extent of recognising shareholders' derivative suits is consistent with the spirit and the principles of the *Company Law*.

The Chinese *Company Law* adopts the German two-tier board system. It is believed that this system provides a governance structure which delivers a strengthened monitoring function over managerial performance.583 From the viewpoint of clearly

582 Ibid.

dividing powers among corporate organs, this structure is somewhat superior to the one-tier board structure. Theoretically, to have a separate supervisory board responsible for monitoring the executives and the financial affairs of the company is a more effective arrangement in terms of ensuring that the supervisory power is exercised independently and in an effective way. The law requires that the supervisory board is mandatory in a stock company. A limited company may or not have the supervisory board, depending on its size and the number of shareholders. If it is small in size and has a small number of shareholders, it only needs to have one or two supervisors.

China’s two-tier board system does not exactly follow the path of the German system. In Germany, a supervisory board has not only the power of supervising the board of directors and company operations, but also the power of supervising the financial affairs of the corporation and making business decisions. Its members are appointed by the shareholders’ meeting. After the appointment, the supervisory board will elect the members of the board of directors. The board of directors has the duty of submitting their work reports to the supervisory board. In such a case, the supervisory board is not only the supervisory institution but also the decision-making institution of the corporation and has authority over the board of directors.

584 See Article 124 of the 1994 Company Law.
585 Ibid, Article 52.
586 Ibid.
587 Ibid, Article 38.
In China, the supervisory board does not have much power over the board of directors in a company.\(^{588}\) The supervisory board does not make business decisions and has no say in relation to the appointment of the directors. According to the 1994 *Company Law*, the shareholders' meeting has the authority to elect both directors and supervisors of a company. Both boards are obliged to submit their reports to the shareholders' meeting for review and approval.\(^{589}\) Article 54 of the *Company Law* stipulates the major function of the supervisory board including examining the financial affairs, supervising directors' and managers' work and proposing interim shareholders' meetings. Hence, in a Chinese company, the supervisory board is merely a supervisory institution responsible for supervising the work of the board of directors and corporate operations, but is not a decision-making institution. Supervisors have to be elected from shareholders and employees of a company. However, for the obvious reason, directors and managers and the responsible persons in charge of financial affairs of the company are not suitable to serve on the supervisory board concurrently.

It is the trend of corporate development in all the important systems that, today, the board of directors of today exercises more and more power. For example, in Germany, the board of directors has the power over all the matters regarding business operations.\(^{590}\) The shareholders’ meeting can deal with these matters only if the board of directors requests it to do so. The *Model Business Corporation Act* of the USA gives the board of

\(^{589}\) Ibid.
\(^{590}\) See Aktiengesetz 1965, s 119.
directors an even wider range of power over business decision making and business operations. Similar provisions can also be found in French law and Japanese law. The movement has its rationality. Specialisation and corporate expansion require professional decision-makers. In a fast changing and competitive commercial world, it is impossible to have all the business matters to be decided at the shareholders’ meeting.

However, the Chinese Company Law gives the board of directors a smaller range of power. The board of directors only has the power of formulating business plans and investment plans. The power of approving the plans is in the hands of the shareholders’ meeting. The main tasks of the board of directors are to implement resolutions passed at shareholders’ meetings.

Directors have the duty of loyalty. According to the law, directors must faithfully perform their duties to the company and must uphold the interests of the company. The directors should not use their positions to seek personal gains. A director is forbidden from engaging in the business operations of another company carrying out the same business as the company that he or she is serving, and engaging in activities which may adversely affect the interests of the company. The law also has provisions regarding self-dealings. However, there are no provisions in respect of such basic matters as the duty of care or the business judgement rule.

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591 See the US Model Business Corporation Act, s. 8.01.
592 See Article 59, 60 and 61 of the 1994 Company Law.
593 Ibid, Article 61.
It is worth noting that a board of directors of a Chinese company is an organ of decision-making for day to day business operations, but not an organ to carry out the daily business operations. The tasks of daily business management are carried out by the manager of the company. The board of directors together with the manager constitute the managerial capacity of the company. This characteristic distinguishes the board of directors of a Chinese company from the board of directors in the German system where the board of directors alone is the managerial organ of a company.

It seems problematic to impose all the duties of loyalty on the directors on the one hand, but to give all the executive power to the manager on the other. It is also unpractical and unnecessary to clearly separate the process of making daily business decisions from the process of executing daily business decisions. Having a powerful shareholders’ meeting on the top and a powerful manager underneath, the law gives the board of directors a limited role to play. There is the danger that the board of directors may become a skeleton in practice.

The Chinese law, like the laws in other systems, has provisions in respect of qualifications for directors. It disqualifies certain people from the position of director. A person who has no civil capacity cannot be a director. A person is disqualified for the position of director, if he or she has within a period of 5 years been imprisoned for certain crimes, or within a period of 3 years suffered bankruptcy or revocation of business licence, and was liable for the bankruptcy or revocation. However, unlike the laws in
some other systems, the Chinese *Company Law* does not set up a top limit on the age of a director. 944

In summary, the Chinese *Company Law* basically embraces the important principles and practice of a modern corporate system. It selectively takes in corporate rules from different systems and makes certain adjustments to suit the Chinese situation. However, it states more principles than details. This increases the opportunity of distortion in practice. In fact, as a product of legal transplantation, the whole *Company Law* is subject to the test of the practice.

The Practice

In the few years following the enactment of the *Company Law*, a large number of companies were established. Many of them were converted from former state-owned enterprises. However, many people questioned whether the managerial efficiency of these companies had really improved by simply taking the corporate form. A few issues were brought up. Firstly, too many state-owned enterprises were transformed into wholly state-owned companies. This was caused by the delay in the reform of the managing system of state-assets. 595 The delay resulted in the *de facto* absence of ownership in the previous state-owned enterprises. The managers of these enterprises tried to use this opportunity to make themselves the *de facto* owner, as well as the controller of the enterprises after the

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

corporatisation. Hence, they chose to change their enterprises into wholly state-owned companies.\textsuperscript{596} Under this circumstance, the previous relationship between the enterprises and their administrative departments tended to remain after the corporatisation.\textsuperscript{597} Some pointed out that there was a "new bottle but old wine" problem. Consequently, the administrative intervention was not mitigated substantially in these companies. Problems such as state assets stripping and overpayment to staff and workers, which existed in the previous enterprises, were not much improved. Moreover, this would not serve the reform objective of enabling these companies to get access to a wider range of capital resources.

Secondly, the share ownership structure in many companies was not optimal. In most companies converted from state-owned enterprises, the State held the majority of the shares.\textsuperscript{598} As the large shareholder with overwhelming shareholdings, the State was able to control the shareholders' meeting and the supervisory board easily. In many cases, the State controlled the board of directors and continued to appoint administrative representatives as directors and managers. As a result, the previous problems caused by administrative intervention continued in these companies. The interests of the small shareholders in these companies were likely to be infringed. Furthermore, as state shares were not freely transferable, the monitoring ability of the market was weakened considerably.

\textsuperscript{596} Ibid.
\textsuperscript{597} See On Kit Tam, \textit{The Development of Corporate Governance in China} (1999), 51.
\textsuperscript{598} Ibid.
Thirdly, after the corporatisation, many companies did not focus their attention on increasing managerial efficiency and improving corporate performance, but on raising equity and incurring debts. They only saw the advantages of the corporate form in pooling capital. Many companies were in a hurry to be listed on the securities market. However, as the companies still operated at a low level of economic efficiency, the shareholders could not receive satisfactory returns. Consequently, these companies not only had problems in retaining corporate accountability, but also had troubles in raising further funds.

Fourthly, many legislative purposes of the 1994 Company Law were not implemented well in practice. The division of power among the shareholders’ meeting, the supervisory board and the board of directors did not function as well as the law intended. For example, the law conferred on the supervisory board or a supervisor the power of supervising the work of directors and the manager, and proposing interim shareholders’ meetings. However, as the law did not have provisions for implementing the power and the duties, in practice, many supervisory boards did not function as expected.

In summary, the reality suggests that by simply taking the corporate form without sophisticated changes in institutions, property structures and public attitudes, a substantial improvement in corporate governance will not happen. In other words, creating a sound

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599 Ibid.
600 Ibid, 52.
corporate governance system in China is a social project that requires far more comprehensive efforts.

The Further Development of Corporate Governance

The problems which persisted in newly converted and newly established companies brought general attention to corporate governance. The Chinese academics began to study the issue of corporate governance. The modern law and economics theories of the firm have started to have a strong influence upon people’s thinking. The government has also begun to stress issues such as separating its commercial objectives from social objectives, clarifying property rights and simplifying state asset management structures.

To the writer’s knowledge, the concept of corporate governance was introduced into China in the mid-1990s. It has gained wide interest and attention since. The introduction of the concept of “agency costs” was earlier than that. With the debates focusing on corporate governance, people have been searching for measures to improve the situation of the principal, reduce agency costs, and utilize external monitoring mechanisms.

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Studies have found that, compared with private companies, wholly state-owned companies and state-controlled companies have intrinsic disadvantages. Firstly, since the State can not have real physical presence in the companies, in spite of the administrative institutions of state asset or shareholding ministers, there is no equivalent of a private owner. The administrative institutions or the shareholding ministers are, in fact, agents. The agents, then, hire other agents including state asset management companies and executive staff to run the companies. As a result, the agent chains will increase. This means that, in a wholly state-owned company or a state-controlled company, the agency costs inevitably increases. Moreover, a state asset management company comprises of administrative staff. These people are different from the residual claimants in the private sector, as their personal interests are not tied up with the economic performance of the companies. Hence, they have less monitoring incentives in supervising corporate efficiency.

Secondly, state-owned companies and state-controlled companies have to make a choice between retaining state control and having the ability to transfer residual claimant rights. At the moment, the priority is given to ensure state control. As a result, state

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606 Ibid.
shares are not allowed to be transferred freely. This hinders the function of external supervisory mechanisms.\textsuperscript{607}

Thirdly, it is impossible that state-owned or controlled companies will be relieved from any social goals and to pursue optimal profits solely.\textsuperscript{608} To separate commercial objectives from social objectives can only be carried out to some degree. In other words, the separation cannot be extended to a degree which matches the private sector.

These theoretic studies have a significant influence on enterprise reform policy making. Today, the focus of the enterprise reform is on creating rational institutional structures for state asset management and for corporate operations. More competitive mechanisms are introduced. Measures to enhance fiscal and financial disciplines are being developed. It is also officially announced that, except in the core sectors, the state shareholdings in the companies of other sectors can be further reduced. All the efforts are aimed at reducing agency costs and bringing in more incentive mechanisms as soon as possible, so as to enable state-owned and controlled companies operate as closely as private companies. With the deepening of the enterprise reform, a search for better corporate governance persists.


The understanding of corporate governance has gradually become sophisticated in China. At an earlier stage, the attention was focused on defects of state-owned enterprises. The understanding resulted in the trials of increasing managerial autonomy. As the early reform measures failed to meet the expectation of long-term prosperity of the enterprise system, the process of embracing the modern corporate system was accelerated.

However, in the course of corporatisation, the Chinese have to learn more than transplantation of a set of laws. With an increasing comprehension of how the modern corporation operates and succeeds, the Chinese gain more confidence in their enterprise reform. It is almost certain that the improvement in corporate governance will not only change the performance of Chinese companies but also change Chinese society in many ways. The enterprise reform, thus, is a far more significant event than a micro-economic revolution.
PART THREE

SOME IMPORTANT MODELS OF CORPORATE GOVERNANCE
Chapter 10

A COMPARATIVE PERSPECTIVE ON CORPORATE GOVERNANCE

All the sciences and arts build on abstractions. It should always be remembered that abstractions are not the real world but the way in which we explain the world. An abstraction may be wrong or incomplete, but can be corrected or improved. However, no matter how accurate an abstraction is, it is not more than a description of reality. Reality is beyond description. One type of abstraction is to use models to clarify relationships of factors so as to explain them. A model is a mathematical expression of a substantive theory that is created with "primary emphasis on being tractable, or readily solved". The advantage of having models is that they can present an uncluttered view of the world. By creating an abstraction of the real world, a model gives us a clearer view of reality, which enables us to understand it better. This part of the thesis will identify some of the most influential models of corporate governance in the world. This will help us to understand how corporate governance works in different systems and the essence of their success.

Some corporate systems have cultivated some of the strongest economies in human history. Yet, it is hard to say which country's corporate governance system is the best.

609 See Edgar F Borgatta & Marie L Borgatta (eds), Encyclopedia of Sociology (1992), 1222.

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Indeed the question may be excessively simplistic. However, their comparative advantages in a particular aspect can be identified. The development of corporate governance in different corporate systems in the last two hundred years offers rich resources for the Chinese to study and to make selective adoptions. Therefore, it is necessary for this thesis to consider some important models of corporate governance.

Part three will discuss the corporate governance of some most influential corporate systems, including the corporate governance systems of the UK, the USA, Germany, and Japan. It also gives some attention to the practice of overseas Chinese communities and some British commonwealth countries. There are a few reasons for focusing on these corporate governance models. These corporate systems have either created some powerful corporate economies in the world and imposed an enormous influence on the corporate development of the rest of the world, or carried out drastic corporate reforms and brought new insights to corporate development. Through the discussions and analyses of different models, the important elements of shaping the system of corporate governance can be identified. The empirical data and experience discussed and analysed in part three, then, provide a logical basis for designing a rational model of corporate governance for China, which will be carried out in part four of the thesis.

From the above introduction, it can be clearly perceived that the remainder of this thesis will heavily rely on comparative methods to carry out the research and the analysis. By tracing the historical development of some representative corporate systems, attempts to interpret and explain the existing corporate models are made. The variables that

610 Ibid.
influence the development of corporate governance are, then, identified and examined. Only based on these findings, can a workable Chinese model of corporate governance be developed. The nature of the inquiries in part three and part four of this thesis requires that the research should be carried out in a manner and a process of comparative methodology _per se_.

In fact, much corporate research is carried out in a comparative fashion. However, many of the researchers do not regard themselves as comparativists, and the comparisons are usually made in a more intuitive and less conscious manner in relation to employing comparative methods. The conscious use of comparative methods is helpful in terms of clearly defining concepts and variables.\(^{611}\) This can heighten the sensitivity of the research in varying cultural settings.\(^{612}\) For these benefits, this chapter intends to examine the comparative methods used by the later chapters of this thesis, in order to provide methodological guidance for the comparative analyses carried out in part three and part four.

**AN EVALUATION OF THE COMPARATIVE METHOD**

The comparative method as a branch of sociological method has a rather short developmental history. In fact, the concept of sociology as a social science\(^{613}\) only arose

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\(^{611}\) See Donald P Warwick & Samuel Osherson, "Comparative Analysis in the Social Sciences", in Donald P Warwick & Samuel Osherson (eds), _Comparative Research Methods_ (1973), 8.

\(^{612}\) _Ibid_, 10.

\(^{613}\) The domain of social science is society, human groups. Thus, social science concerns the activities of man in relation to group or groups with which he associates. See Wilson Gee, _Social Science Research Methods_ (1950), 4.
at the beginning of the 19th century. The rise of social science was based on the human desire to understand and control the social world. The methods of sociology arose in the meantime. It is believed that, through applying scientific methods, the patterns, regularity and order of society can be found out, and the changing society can be understood, so that predictions can be made. The important methods of sociology developed, including the experiment, the survey, participant observation and life histories, and the comparative method. These methods can be used in combination. Among them, the comparative method has been regarded as the core method of social science. This is because all empirical social research involves comparison of some sort. Thus, Grimshaw said that it makes sense to say that all good sociology is comparative. Consequently, the method of comparison claims an important position in the science of methodology. However, the nature of social science decides that each method mentioned has its limit in analyzing social phenomena, so does the comparative method.

Enormous theoretical and practical difficulties are associated with the experimental method. As a result, social experiment is mainly possible to be carried out in the field of

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616 *Ibid*, 4-119.

617 *Ibid*.

social psychology involving small groups, and to be carried out by computers through simulation.\textsuperscript{620} The survey concerns accumulating facts or data and making statistics. It does not explain social phenomena in historical context. Participant observation and life histories involve a person who acts as a participant observer, or reporter, or interviewer to fill out the story by asking people about their relation to the event and set up hypotheses.\textsuperscript{621} These two methods lack scientific rigour, because while participant observation is intuitive, artistic and not open to public scrutiny, life histories are impossible to be generalised.\textsuperscript{622} The comparative method as the dominant method also faces certain difficulties. The method has to encounter the problem of making generalisation from historically unique phenomena.\textsuperscript{623} Nevertheless, the comparative method has its distinct strength. The strength of the comparative method lies in its capability to make logical analysis in order to interpret specific cases and address historical specificity. Hence, the comparative method has been in a state of constant development.

\textsuperscript{619} See Allen D Grimshaw, "Comparative Sociology: In What Ways Different From Other Sociologies", in Michael Armer & Allen D Grimshaw (eds), \textit{Comparative Social Research: Methodological Problems and Strategies} (1973) 3, 3.


\textsuperscript{621} \textit{Ibid}, 87-104.

\textsuperscript{622} \textit{Ibid}, 104-5.

\textsuperscript{623} \textit{Ibid}, 106-119.

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The Concept of the Comparative Method

The term "comparative method" refers to the social scientific analysis concerning "observations in more than one social system, or the same social system at more than one point in time". Comparative methods are used to fulfill the tasks of comparative sociology. The essential task of comparative sociology is to "distinguish between those regularities in social behavior that are system-specific and those that universal". In other words, comparative sociology concerns making generalisations about what is true of all societies and what is true of one society at one point in time and space.

The comparative method was traditionally used to study history for the purpose of understanding and solving contemporary problems. It involved abstracting historical events in order to find laws of history. This tradition was further developed to include the attempt of foreseeing the future through generalising the trends of the past, and to include the study of different contemporary societies for searching for universal laws of human behaviour. Through history, the comparative method was developed by a number of users. It was used by a number of theorists include Comte, Karl Marx,

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624 See Donald P Warwick & Samuel Osherson, “Comparative Analysis in the Social Sciences”, in Donald P Warwick & Samuel Osherson (eds), Comparative Research Methods (1973) 3, 8.


Spencer, Ogburn and some others in the course of developing their ideas of laws of history.

The fact that the comparisons used by the above people resulted in their different deductions of historical laws led to the awareness of problems inherent to the comparative method. Max Weber was the first person to point out that there was difficulty to generalise historical laws from history, due to the uniqueness of historical phenomenon which resulted in lack of comparable cases. He attempted to avoid the difficulty by using the concept of the “ideal type”, an abstraction of the essence of historical phenomenon (actions or thoughts) which may not exist in any empirical situation.

Since then, the concept of the ideal type has been extensively used in sociology. However, it does not solve the problem caused by the uniqueness of historical phenomena either. A person who uses the concept of the ideal type in his or her comparative research can hardly avoid the criticism of being arbitrary.

Today, after about a century’s development, the comparative method has become more analytical and functional. It is widely used by comparativists to define and limit the investigations of their own fields.

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630 See Max Weber, Methodology of the Social Sciences (1949, translated by E Shils and H Finch), 60.


633 Ibid.
The Application of Different types of Comparative Method

The comparative method, like other scientific methods, is used to solve scientific problems. A scientific problem involves identifying an outcome from empirical phenomena and asking under what conditions the outcome happens. The comparative method involves searching for and organising the conditions to provide explanations. An important way of organising the conditions is to classify the conditions into parameters and operative variables. Parameters are conditions that are assumed not to vary in the investigation, while operative variables are conditions that are allowed or made vary in the investigation. For example, if maximization of shareholders’ profits is treated as the parameter, the board structure, the legal protection for shareholders and the shareholding structure can be treated as operative variables. The corporate efficiency of different systems is decided by the different situations of these conditions. The comparative method, in fact all scientific methods, seek to explain the empirical phenomena through systematically manipulating and controlling parameters and operative variables.


635 Ibid, 44.

636 Ibid.

637 Ibid, 45.
Comparative methods can be divided into the positive comparative method and the negative comparative method. The positive comparative method is used to identify similarities in conditions associated with a common outcome.\textsuperscript{638} For example, given that some countries have developed successful corporate economies, the inquiry about what characteristics these corporate systems had in common is an application of the positive comparative method. The negative comparative method is used to identify conditions that result in different outcomes.\textsuperscript{639} For example, in some transitional economies such as China, the enterprise reforms were carried out with considerable smoothness, but in some other transitional economies the situation is opposed. An inquiry about in what aspects the former differs from the latter is an application of the negative comparative method. There are other types of division used by the comparative method, such as static or dynamic quality of comparative analysis. As they are not used by the later comparative analyses of this thesis, they are not discussed.

As mentioned before, a distinct characteristic, or the inherent defect of comparative social science is the split of qualitative work and quantitative work.\textsuperscript{640} A quality work studies cases as wholes, and compares whole cases with each other.\textsuperscript{641} This kind of work is also historically interpretive. It studies and generalises specific historical outcomes or sets of comparable outcomes or processes in order to ascertain their historical

\begin{footnotesize}
\begin{enumerate}
\item \textit{Ibid}, 52.
\item \textit{Ibid}.
\item See Charles C Ragin, \textit{The Comparative Method: Moving Beyond Qualitative and Quantitative Strategies} (1987), 6.
\item \textit{Ibid}, 3.
\end{enumerate}
\end{footnotesize}
significance for current institutional arrangements or current social life.\textsuperscript{642} A quantitative work investigates and generalising relationships among conditions without interpreting specific historical outcomes.\textsuperscript{643}

The comparative method is essentially a qualitative research strategy.\textsuperscript{644} It usually asks questions about empirically defined, historically concrete, large-scale social entities and processes, which necessarily lead to detailed analyses of relatively small numbers of cases.\textsuperscript{645} The nature of the question requires the investigation to be carried out through applying the comparative method. This is because, firstly, the number of cases does not allow researchers to establish statistical control over the conditions of the social phenomena. Secondly, the outcome of a social phenomenon may result from several different combinations of conditions, a situation termed as causal complexity or multiple conjunctural causation.\textsuperscript{646} When searching for the cause of a social phenomenon, especially, when identifying historical causation across a range of cases, it is not easy to identify the decisive causal combinations, unless the social phenomena can be created in experiments in which different combinations of causal conditions are displayed and

\begin{itemize}
  \item \textsuperscript{642} \textit{Ibid}, 3 & 35.
  \item \textsuperscript{644} \textit{Ibid}.
  \item \textsuperscript{645} \textit{Ibid}.
  \item \textsuperscript{646} For example, A, B, C, D are conditions. The outcome X can result from the combinations A + B + C, or A + B + D, or B + C + D.
\end{itemize}
In reality, such social experiments are impossible to be carried out. Hence, the research has to rely on the comparative method.

The strength of the comparative method lies in that it can work only with small, theoretically defined sets of cases. It compares cases with each other as wholes to reach modest generalisations about historical origins, paths and outcomes. By identifying similarities and specifying particularities, the comparative method is capable of interpreting specific cases and addressing historical specificity. By studying and comparing cases as wholes and by considering and understanding the different conditions together to make up a single case, it is able to address causal complexity.

However, comparativists rarely solely rely on the case-oriented comparative method – comparing cases as wholes. Most comparative researches are carried out by using the qualitative approach and the quantitative approach in combination. The quantitative approach used in the comparative research is called the variable-oriented comparative method. This approach concerns with conditions and their relationships. It focuses on testing the hypothesis and makes little attempt to understand specific outcomes, therefore tends to bring in widest possible population as the basis for the test. It allows the use of statistical control and is best used to reject alternative explanations.

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650 Ibid.
While case-oriented comparative method is suitable to identify causal complexity, the variable-oriented comparative method prefers to generality and is best suited for making probabilistic arguments.\textsuperscript{651} Hence, the two approaches are complementary. To jointly use the two approaches can mitigate the biases inherent in each approach and enable the investigator to give appropriate consideration to both complexity and generality. The strategies can be: to apply the two approaches to a specific problem, or to integrate several features of the two approaches.\textsuperscript{652} An example of the application of the combined method is Shorter and Tilly’s \textit{Strikes in France, 1830-1968}.\textsuperscript{653} In this research, the theory about causes of strikes was to be tested and the history and course of strikes in France were to be revealed. For carrying out historical analysis of France strikes, Shorter and Tilly used statistical methods to analyse the department data in France. For testing the theory, they compared the result with other industrialised countries. Ragin did a comprehensive research to present a variety of examples of the application of the comparative strategy that combines the case-oriented method and the variable-oriented method.\textsuperscript{654}

In terms of corporate law research, there are some works adopted a comparative perspective. Professor John H Farrar did comparative investigations on ownership and

\textsuperscript{651} See Charles C Ragin, \textit{The Comparative Method: Moving Beyond Qualitative and Quantitative Strategies} (1987), 69-163.

\textsuperscript{652} \textit{Ibid.}


\textsuperscript{654} See Charles C Ragin, \textit{The Comparative Method: Moving Beyond Qualitative and Quantitative Strategies} (1987).
control of listed public companies and on institutional investment in “Ownership and Control of Listed Public Companies Revising or Rejecting the Concept of Control” and “The Impact of Institutional Investment on Company Law”.

55 The two studies involve using data control to test hypothetical theories. Professor Roman Tomasic made comparative investigations on insolvency in Southeast Asia and Chinese company law. The two works evaluate the laws and practices concerned by making references and commentary on comparable laws and practices. In short, the trend of comparative method has been developing towards making the effort that enable researchers to study more cases and avoid making simplifying causal assumptions at the same time.

THE RELEVANCE OF THE COMPARATIVE METHOD TO THIS THESIS

The research goals and tasks of this thesis determine the inevitability of the use of comparative methods. The goal of the thesis is to search for a suitable model of corporate governance for China. This involves examining the successful models and identifying the conditions that determine the success of these models. At first, the historical development of the corporation and corporate governance in these systems and in China are studied and, then, used as a guide for understanding current issues. These, then, lead to the establishment of the hypothesis, or the general argument about the possible look of the


suitable model. In this process, the case-oriented comparative method, the variable-oriented comparative method, and the combination of the two approaches are applied extensively. This overlaps with the use of the positive comparative method and the negative comparative method. The details are as follows:

Part three investigates the models of corporate governance operated in some successful corporate economies. The models selected are representative. All of them are regarded as successful corporate models, while three of them (the US, German, and Japanese models) are operating in the strongest corporate economies in the world. They basically represent influential corporate governance models. While UK and US models represent external market-based outsider models, German and Japanese models represent insider-based models. The overseas Chinese corporate system provides an example of the best use of the form of family firms and networks.

The conditions explaining the success of each case are identified. These cases are studied as wholes in their specific historical contexts. In other words, each case is examined as configurations or conjunctures. In doing so, the causal complexity and the historical specificity of each case are adequately interpreted. Meanwhile, the conditions that result in the divergence of corporate models are also distinguished. The results of the investigations of part three are to be used in part four for testing the general argument about the conditions (determinants) that shape a corporate governance system and the common characteristics of the successful corporate systems.

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In part four, determinants that shape corporate governance are discussed and tested. The common aspects of the successful models are identified. The initial conditions of corporate development in China are compared with those in other models, so that similar and different elements can be found out. A suitable model is proposed. The model is based on the above comparative results on the one hand, and is tested by these identified conditions on the other.

Part four identifies that the economic situation, the political preference, and cultural and legal traditions are the important conditions that shape a country’s corporate system. Countries with similar conditions are likely to produce similar outcomes of corporate development. The investigation of successful corporate models illustrates that large shareholders, financial institutions, and sufficient legal protection of corporate actors are the common aspects of these models, which are crucial to their success. Apart from these, the development of a corporate system in a specific country should be studied in its own historical context, as the outcome of corporate evolution can result from conjunctural causation. In this respect, the path dependence theory is employed to do the analysis.

With the fulfillment of the foregoing comparative analyses, a suitable model of corporate governance can be deduced. However, the suitable model of corporate governance is a model in theory, or is a hypothesis. Thus, to some degree, searching for such a model amounts to building an “ideal model”. This is a process of bridging this researcher’s ideas and evidence, which are inevitably influenced by the researcher’s values. Therefore, though best efforts are made in order to make the research as scientific as possible, the final design cannot be entirely free from arbitrariness. Furthermore, as the corporate system is in the domain of micro-economy, it is influenced by the vicissitudes
at the macro-economic level. This adds further complications in relation to predicting the adaptability of the proposed model.

CONCLUSIONS

Using social science research methods to study corporate law and corporate behavior has attracted increased interest. Recently, with the growth in international trade and the development of corporate globalisation, the comparative method, as the dominant research method in social science, gains increasing importance in corporate studies.

Comparisons are made frequently in various corporate researches for different purposes. For example, when talking about a current case, relevant precedents are referred to. When talking about corporate reforms, reformers turn to other jurisdictions' experience for insights and inspiration. Corporate systems of the world provides us different models which have not only been proposed but also been tested. If these models serve as inspiration for researchers to develop new theories and new designs, they also serve as useful tools for testing the new ideas.

Adequate attention to the comparative method is necessary for making good comparisons. The comparative method enhances our ability to select the right data out of an immense social reality and helps us to make scientific generalisations. The old Chinese saying says, “if you want to successfully complete a task, you have to know how

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to take advantage of the tools”. An understanding of the comparative methodology definitely contributes to the credibility of the analyses of this thesis. It should be emphasized, however, that the purpose of comparison here is simply to identify distinctive features of the major models that can provide positive and negative lessons for China in developing its own model of corporate governance.
Chapter 11

THE UK MODEL

As the first country to industrialise, the British created the earliest corporate economy. From the early stage of capitalism until prior to the Second World War, the influence of British corporate practice and corporate law was significant. They were generally received by British colonies around the world and served as a model to other countries, especially to those with the common law tradition. Hence, the UK system of corporate governance deserves a close study.

THE OVERALL PICTURE

The belief in individualism and freedom of contract inspired the effort of industrialisation and international trade at an early stage in Britain. The ability to gain a personal fortune through corporations was an opportunity open to everybody with capital to invest. Hence, it has been the established notion that a company is directed to maximise its owners' economic profits. In the UK, the working of many institutions reflects a

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traditional preference for an adversarial approach. Committees, co-operation, and combinations are distrusted, for fear that they will act to their own advantages. The principle behind the adversarial approach is to maintain the accountability of the social institutions.

A company is defined as a private rather than a public body. It operates to maximize shareholders’ economic interests. Corporate governance primarily concerns about the relationship between the owner and management, for the purpose of preventing abuse of power by management. In the course of maximising its owners’ profits, a company must strive to limit the costs created by the conflict of interests between shareholders and other players, chiefly the “agency cost”. Hence, employees and managers are all in a position potentially adverse to shareholders. Directors are delegated the power to supervise the management, but with a risk and a cost relative to maintaining accountability. The law is made to formalise and regulate certain existing practice so as to reduce the social costs generated by the practice to a reasonable degree. As long as the overall economic gains exceed the overall costs, the law has been prepared to give

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663 *Ibid*.


665 *Ibid*.

666 *Ibid*.

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enough bargaining power to individual players. This policy has been accommodated by the flexibility of the common law. Under principles of fairness and equity, the courts exercise their judicial discretion. It has been a tradition that the common law has been reluctant to intervene in business decisions, lest it frustrates business confidence and leads to a perverse economic consequence. These are the primary theorems and principles of the corporation in the UK which have guided corporate practice in the country for so long.

The corporate practice and corporate law in the UK have developed in a fashion of gradual evolution. The UK has one set of corporate laws for all types of companies. The essence of the law in relation to corporate governance is that owners appoint agents to run business, and directors oversee management. After the fundamental accomplishment in the mid-19th century, the development of the UK company law has mostly been reactions to shortcomings and deficiencies arising from implementing the current law, so as to be more effective in protecting investors and preventing fraud. The manner has been that, about every twenty years or so, a Committee is appointed to review the company law and to bring forward its recommendations for amending the Companies Act. The old and the new laws are then consolidated into a comprehensive new Companies Act. The most recent consolidation happened in 1985. Hence, since the mid-19th century, the development of the UK company law has been a process of constant

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667 Ibid.

addition of new rules to the existing legal framework. While the law grows in bulk and complexity, until recently, no adequate attempts have been made to re-examine the fundamental principles and policies. In the meantime, UK corporate laws are developing in accordance with the EU directives, under the harmonisation program in the EU.

The corporate governance system in the UK is characterized by the separation of ownership and control, and the one-tier board with some non-executive directors. The defect of the unitary board is that the board is required to fulfil two incompatible functions. The board is the supreme executive body on the one hand, and the supervisory organ on the other. The possibility of abuse of executive power by management and doubts on the accountability of the directors are high. Originally, the problem was foreseen and a disclosure system was introduced to improve the lack of accountability caused by the arrangement of one-tier board with two functions. In addition, the UK has developed one of the most mature stock exchange markets of the world, which imposes strict disclosure rules on listed companies.

However, with the increase in size and complexity of the company, the disclosure system seems not an adequate solution of disciplining the board. It has been seen that the disclosure system is sometimes misused for the purpose of misleading shareholders.

Ibid.


Moreover, the dispersion of ownership gives little incentives for individual shareholders to analyze the financial information received in order to monitor the board. As a result, the recent development has seen the monitoring role of auditors, non-executive directors, and institutional investors emphasized.\textsuperscript{672}

THE SYSTEM OF SELF-REGULATION

The operation of corporate governance in the UK heavily relies on self-regulation. The tradition of self-regulation is built on the fundamental belief among UK business leaders that a self-regulation system will effectively function.\textsuperscript{673} Such a faith is, sometimes, observed with awe by the people of other systems.\textsuperscript{674} The outcome of the implementation of self-regulation demands more their admiration. The fact is that, without the intervention of the government and the threat of litigation, substantial progress has been achieved in the UK in several areas of corporate governance.\textsuperscript{675}

The City of London Takeover Code is a classic example in the UK's long history of self-regulation.\textsuperscript{676} Recently, the self-regulation system has been firmly upheld by the two highly influential documents concerning corporate governance, the Cadbury and Greenbury reports. The Cadbury Committee was set up in 1991 by the Financial


\textsuperscript{674} \textit{Ibid}, 110.

\textsuperscript{675} \textit{Ibid}, 112.
Reporting Council to examine the financial aspects of corporate governance. It published the Draft Report on 27 May 1992. The final version of the Cadbury Report was published on 1 December 1992. At the heart of the Cadbury Report was the Code of Best Practice, which was designed to achieve the necessary high standards of corporate behavior. The Cadbury Report saw a balance between directors' freedom of action and board accountability needed to be struck. It believed that a legislative approach would bring negative outcome and thus preferred the voluntary self-regulatory approach.

After the publication, many companies embraced the recommendations of the Cadbury Report to different degrees. The survey carried out by times in 1994 showed that the number of non-executive directors increased. Around 94% of top 100 UK companies had auditor committees and 53% of them had a nomination committee. The London Stock Exchange requires its listing companies to disclose information about compliance.

In 1995, a study group on directors' remuneration was appointed to explore the issue of directors' remuneration, which was not dealt with in detailed terms by the Cadbury

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Report. The committee produced the Greenbury Report. The Greenbury Report again emphasised that corporate governance should basically rely on a self-regulation system. The important recommendation made by the Greenbury Report was that the remuneration committee should comprise solely non-executive directors.

The Cadbury Report and the Greenbury Report were all restricted to their remits. While the former primarily concerned financial reporting, the latter focused on directors’ remuneration. They did not deal with corporate governance in its entirety. After their publication, there was the expectation in the UK that the whole range of issues of corporate governance should be addressed. Meanwhile, both the Cadbury and Greenbury reports recommended that a committee should be established to assess the progress of the implementation of the two reports. Thus, the Hampel committee was appointed in 1995. The committee produced the Hampel report in 1998. The Hampel Report raised the concern that the findings of the Cadbury and Greenbury reports were too prescriptive and had led to “box ticking” practice. Hence, the Hampel Report moved away from further regulation and provided a number of important principles of

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682 The full name is: Directors’ Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury.


686 Ibid, Section 1, para. 1.11 & 1.12.
corporate governance for public companies. These principles together with relevant parts of the Cadbury and Greenbury reports have been embodied in an overall statement of Principles of Good Governance and Code of Best Practice (Combined Code), and was introduced by the London Stock Exchange in June 1998.

While the Hampel Report is another self-regulatory code of conduct, it raises the threat of legislation if corporate governance does not become more open, transparent and accountable. However, the threat may have a positive effect in relation to stimulating companies to improve self-regulation and enforce better corporate governance.

In September 1999, the Institute of Chartered Accountants in England and Wales’ Internal Control Working Part, chaired by Nigel Turnbull, published a guidance on the implementation of the internal control requirements of the Combined Code (Turnbull Guidance). Now, the London Stock Exchange requires listing companies to fully comply with the Guidance and the Combined Code. This reflects the current situation of self-regulation in the UK.

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688 See Adrian Davies, A Strategic Approach to Corporate Governance (1999), 43-44.
THE SEPARATION OF OWNERSHIP AND CONTROL

Separation of ownership from control is one of the main characteristics of the modern British corporation. Although the separation of ownership and control is a general tendency of corporate development, the situation is highlighted in the UK. Compared with continental countries, the number of listed companies in the UK is high and listing is frequent. Many small companies are also listed. British banks have traditionally sought to avoid direct involvement in companies' operations and have preferred short-term lending. Hence, the securities market has been seen as a primary source for companies to raise new capital. In practice, portfolio investors tend to diversify their portfolios by holding a range of shares rather than to concentrate their investment in one company. This results in dispersed ownership in UK companies. Dispersed ownership further discounts the control incentives from owners and results in a higher degree of concentration of controlling power in the hands of management. Consequently, the problem of separation of ownership and control become more acute.


692 Ibid.


694 Ibid, 23.

695 Ibid, 16.
The separation of ownership and control leads to the divergence of objectives of owners and management. Therefore, to press management to give priority to shareholders’ interests, and to enhance the board’s accountability are the major tasks of corporate governance. Methods have been introduced to increase the board’s independence and to enforce its accountability to shareholders. These will be discussed in the next section. Apart from that, the stock market is seen as an active and effective power of monitoring corporate management. The securities market is believed to have the function of transferring assets from the companies with poor performance to successful companies, so as to improve resource allocation efficiency.\(^{696}\) Management under the threat of takeover has to take heed of the interests of shareholders. Due to the traditionally predominant role of the stock market in corporate control, the UK corporate system has been seen as a market based corporate system.\(^{697}\) During the 1980s, merger and takeover activities in the UK grew and the market for corporate control became extremely active. However, recent discussions express concerns about the impact of short-termism caused by market control on the country’s corporate development.

It is said that the threat of takeover forces management to give priority to short-term objectives. Boards may raise dividends at the expense of long-term objectives such as investment in fixed assets, research and development.\(^{698}\) As a result, the corporations loose out in growth and long-term economic efficiency. Compared with the situation in

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\(^{697}\) See Nicholas Dimsdale, “The Need to Restore Corporate Accountability: An Agenda for Reform”, in Nicholas Dimsdale & Martha Prevezer (eds), \emph{Capital Markets and Corporate Governance} (1994) 13, 14.
the UK, German and Japanese companies with more stable shareholders are believed to be in a better position to pursue long-term objectives.\textsuperscript{699} Hence, many people in the UK perceive that the whole subject of corporate governance concerns the need for the corporation to achieve long-term economic efficiency, so as to survive in international competition.\textsuperscript{700} This requires improvement in macro-economic policies and the environment. At micro-economic level, it is believed that institutional investors' active participation is an important balancing power in relation to improving the current situation.\textsuperscript{701}

Compared with individual investors, institutional investors are in a better position to get access to corporate information, as they have the professional expertise. Although, currently, institutions are inclined to hold diversified shareholdings and play a passive role in corporate governance,\textsuperscript{702} with the growth of institutional investment, institutional investors may find it difficult to exit and be forced to play a role of active owner in corporate governance. The increasing dominance of institutional investment makes disposition of shares become more and more difficult. One institutional investor may successfully dispose of its shareholdings, but institutional shareholders as a whole, cannot

\textsuperscript{698} Ibid, 25.


\textsuperscript{700} Ibid.


sell all their shares. Eventually, institutional investors have to actively participate in corporate affairs so as to ensure a better economic return. It is expected that with certain legal and policy support, institutions as an emerging force will bring about changes to corporate governance in the UK. This is reflected in the Cadbury Report, as it states:

Because of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders' Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the Code.

THE ONE-TIER BOARD

In the UK company, in addition to the shareholders' meeting, there is only one board - the board of directors. Unlike the supervisory board in the European system, the board of directors in the UK system can exercise managerial functions. Sometimes, directors are managers (executive directors). When this happens, the supervisory capacity of the board of directors decreases considerably. The impressive performance of German companies and the favorable comparison of the German two-tier board system are perceived. However, the UK has not been willing to embrace the two-tier board system. The strong reason against the two-tier system is that such a board structure will bring in the worker participation system, which contradicts the very logic of the traditional mainstream corporate theory. For solving this problem, the practice of appointing a


705 The conflict of function further increases where the roles of chief executive and chairman combined.
majority of outside directors or non-executive directors and independent auditors has been introduced, which is an alternative to the two-tier board.\textsuperscript{706}

The Cadbury Report upholds the view that the one-tier board is capable of reconciling its two conflicting functions. This argument is essentially based on the important role of the non-executive director in relation to monitoring the board and the executive. Thus, the Cadbury Report recommends that non-executive directors be mandatory in quoted companies.\textsuperscript{707} For enhancing the monitoring function, it proposes the practice of setting up nomination, audit and remuneration committees of the board. The membership of the committees should be confined to non-executive directors.\textsuperscript{708} The committees are responsible for advising on the appointment of new directors, recommending and deciding board remuneration, appointing auditors, and ensuring the integrity of the company’s financial statements.\textsuperscript{709}

Thus, board members are divided into two categories, executive directors who have full-time executive responsibilities and non-executive directors who are part-time members and have no executive responsibilities with respect to companies’ day to day operations. A non-executive director is expected to make a contribution to improving the accountability of the board by review of the performance of the board and executive


\textsuperscript{708} Ibid, para 4.29.

\textsuperscript{709} Ibid, para 4.34.
It is anticipated that non-executive directors, having distanced themselves from managerial tasks, are more ready and able to exercise the monitoring function over management. With increased attention paid to corporate governance, the duty of the non-executive director become increasingly onerous. As Professor John H Farrar comments:

In the past having a number of non executive company directorships has been compared by Lord Boothby with having a nice warm bath. It has not exactly been an onerous pursuit. The law was prepared to tolerate an unreasonable amount of inactivity, absenteeism and incompetence. However, the modern tendency is the other way, towards greater business professionalism; more responsibilities, more matters to consider, more time demanded.711

Today, the role of non-executive directors is required to be such that their views will carry significant weight in the board’s decisions.712 The UK law has never restricted the duties of the non-executive directors to that of solely monitoring.713 Thus, non-executives have to work closely with executives in formulating and implementing company policies on the one hand, and be independent monitors on the other. The challenge of the job is how to retain independence. As part-time board members without the involvement of day to day operations, non-executive directors have to depend on the board for information.714

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710 Ibid, para. 4.6.


commitments as their principal jobs, and some of them hold multiple directorships. Under such circumstances, it is difficult for non-executive directors to provide truly independent advice.715

However, a non-executive director may attract the same legal liabilities of an executive director.716 In respect of non-executive directors’ legal liability, English statutes are silent on this issue.717 The development of the case law tends to make no distinction between the executive director and the non-executive director.718 In *Dorchestre Finance Co Ltd v. Stebbing*, this may be unjust to non-executive directors, as they receive less salaries and benefits than executive directors and rely on the board for information and yet take the same risks in terms of liability for breach of directors’ duties.719 The UK law may need to go further to clarify the extent of duty of care and skill owed by non-executive.

The recent judgement in the case *Re Barings plc and Others (No 3), Secretary of State for Trade and Industry v. Baker and Others*720 made an important development in the area of non-executives liabilities. In this case, Mr Norris who was a former executive director of Barings and was disqualified under s 6 of the *Company Directors*

715 Ibid.
716 Ibid.
717 Ibid.
720 [1999] 1 All ER 1017.
Disqualification Act 1986, following the collapse of Barings caused by the notorious unauthorised trading activities of a single trader in Singapore. Mr Norris applied for leave to continue to act as director of three companies. He was granted the leave. One of the grounds was that he remained non-executive and unpaid, and that he did not enter into any contract of employment. Sir Richard Scott V-C said:

The court in considering whether or not to grant leave should, in particular, pay attention to the nature of the defects in company management that led to the disqualification order and ask itself whether, if leave were granted, a situation might arise in which there would be a risk of recurrence of those defects. In a case like the present, there seems to me to be virtually no risk at all of such a recurrence. Mr Norris' continued membership of the board of JBEL will not place him in a position in which an inadequate discharge of executive responsibilities, of the sort that justified the disqualification order made against him, will have any possibility of occurring. Nor will his continued member of the board of CCC do so. In neither case does his directorship carry with it any executive responsibilities at all. 721

The decision of the case indicates that the court may apply different standards when considering whether to grant a leave to a disqualified director applying for continuing to act as director of a company, depending on the application is made for the continuation of an executive directorship or a non-executive directorship.

In other common law jurisdictions, distinction is made with respect to the standard of care owed by an executive director against a non-executive director. For instance, Australia courts recognise that there is a distinction to be drawn between the responsibilities of executive and non-executive directors. 722 In the case AWA V. Daniels,

721 Ibid, 1024.

Rogers CJ recognised that executive directors had more powers than non-executive directors, and non-executive directors are not expected to discharge directorial duties in a detailed and knowledgeable manner.723 Hence, the non-executive director in the case was found not negligent. In Daniels v. Anderson,724 it was recognised that an executive owed a higher standard of care. Consequently, an executive had a more onerous task to show that his or her reliance on management was reasonable.

CONCLUSIONS

In the UK, people have traditionally viewed the creation of a public stock company as a means of increasing individual wealth by investment. It was a source of profit. Therefore, companies were shareholders' companies. They should be run for, and only for, the interests of shareholders.725 The delegation of the controlling power to directors was initially based on the belief that a director can be trusted as a steward, a just and honest man acting for the good of others.726 Later, the agency theory was developed. The agency theory has equated the relationship between shareholders and directors with the one between principals and agents. An agent will act with self-interest and cannot be expected

723 See the comments made by Rogers CJ in AWA V. Daniels (1992) 10 ACSR 759, 832-833, 865-868 & 878.


to behave in a manner assumed in the stewardship model. It is based on this theory that the current corporate governance system is developed in this country.

The UK formally adopts a one-tier board structure. The practice of non-executive directors has been introduced to ensure the effectiveness and dynamics of the board since the 1970s. In terms of industrial relations, it has always been a prevailing view that the interests of employees and shareholders are potentially in conflict. It is of interest to see, with further integration of the corporate laws within the EU, whether the corporate governance system in the UK will move closer to a two-tier board system in relation to employee participation.
Chapter 12

THE US MODEL

As an early colony of the UK, the US inherited the common law tradition. Compared with the practice in other jurisdictions, especially the continental countries, the two nations’ corporate systems share more common characteristics. As a result, when talking about corporate models, they are usually treated as in one family and labeled as the Anglo-American system. However, it can be disastrous to believe that the two systems are identical.

The corporate development in the US has been shaped by its own historical conditions, and thus has its own distinctiveness. Especially, after World War II, the US has risen as the super power of the world economy. Its corporate ideology and practice have had a far-reaching influence on other systems since. Today, it has replaced the UK in providing corporate thinking and the corporate model for other jurisdictions. Any discussions of corporate governance models will be incomplete, without giving due attention to the case of the US.

THE OVERALL PICTURE

The first impression of the American corporate law is its multiplicity. The USA possesses the largest number of corporate codes. Every State has its own corporate code, each a
little different from the others. The situation has its historical cause. The US has a tradition of limiting the role of the federal government. The federal government can only exercise the legislative power where the Constitution states so. At the time when the Constitution was drafted over 200 years ago, incorporation was not a significant business phenomenon as to attract due attention of the funding fathers to give a definite statement relating who, states or the Federation, had the power of incorporation. The silence of the Constitution on this matter was later interpreted as that both the federal and state governments had the right to regulate corporate activities. Over the next century, states formed their idiosyncratic patterns of legislation and bureaucracies governing corporate affairs. In the meantime, the federal government’s movement to regulate corporate organisations was slow. As a result, state control over corporations was firmly established. This resulted in another distinctive trend of development of the US corporate law, the race for laxity or liberality.

To attract business, each state is under pressure to make its corporate law more permissive and less restrictive. This results in the corporate laws of some states consistently racing toward laxity. In this race, the winner is Delaware, which, with a

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727 See Alfred F Conard, Corporations in Perspective (1976), 4.  
728 Ibid, 6.  
729 Ibid, 7.  
730 "Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. The states jointed in advertising their wares. The race was one not of diligence but of laxity." See the opinion of Justice Brandeis in Liggett Co. v. Lee, 288 U.S. 517 (1933).
corporate code offering most liberties, has tempted half of the top 500 companies of the USA to be registered there.731

As the strong state involvement and legislative tradition have long been established, the federal government has to impose its authority through other channels. The major mechanism of this kind is the Securities and Exchange Commission (SEC). Because the USA has a highly developed securities market, the SEC can exert enormous pressure over corporate organisations national wide. In 1933 and 1934, the Securities Act and the Securities Exchange Act came into effect. Since then, a regime of close federal supervision over corporate behaviour and securities markets has come into existence, which grants the federal government an all powerful mechanism to exercise influence over corporations.732

The vigorous development of the securities market and consequently powerful securities regulation in the USA find their causes in the conventional lack of bank involvement in corporate operations of the country. Historically, American governments preferred to ban national financial institutions from having close relationships with industrial firms.733 The legislation has curbed banks from holding significant stocks in companies.734 As a result, large US companies have had to rely on the securities market

731 See Alfred D Chandler, Scale and Scope: The Dynamics of Industrial Capitalism (1990), 383-592.
734 Glass-Steagall Act of 1933 prohibited banks from underwriting stock. The Bank Holding Company Act of 1956 restricts bank holding companies from owning control blocks in companies not closely relating to
for fund raising. This inevitably resulted in the scattered share ownership in large corporations, which eventually causes separation of ownership and control. With the increase of the numbers of shareholders in each corporation, the capacity of each shareholder to exercise control diminished. 735 Eventually, firms were effectively controlled by salaried managers with specialised technological and managerial skills. Thus, management controlled firms became dominant in the economic life of America. 736 Management gained the dominant position in corporate governance in the US. As a result, CEOs usually overshadow the board of directors, as described by Herzel and Shepro:

A reader unfamiliar with American company boards who walked into a board meeting might be surprised and disappointed. Under ordinary circumstances, what would be going on in the boardroom would correspond very little to the Delaware and other state law procedures. The CEO would probably be the chairman of the meeting and completely in charge. Generally, he controls both the agenda and the flow of information to the directors. He dominates the meeting and the board plays a quite secondary role. 737

The shift of control from owners to managers and the dominant role of management in corporate governance characterizes the American capitalism as "managerial banking. There are provisions in the trustee law and other laws which make banks feel easy to hold fragment shares and difficult to associate with other institutional shareholders.


736 At this point, Berle and Means provided a list of 200 largest nonfinancial corporations who held 49 per cent of nonbanking corporate wealth in their books. Later surveys also confirm that large, public owned corporations control large economic bulk in the USA. See Adolf Berle and Gardiner Means, The Modern Corporation and Private Property (first published in 1932 1991), 18-46.

capitalism". The danger of strong managers and weak shareholders in corporations is that the incentives of maximising shareholders' profits for traditional owner managers have disappeared and the professional salaried managers are likely, instead of maximising shareholders' profits, to promote the interests of their own.

It was Adolf Berle and Gardiner Means who first discussed the impact of dispersed ownership on the corporate control in large US firms in 1932. Since then, restraining managerial power through limiting the diversification of the interests between shareholders and management has been the main topic which dominates the landscape of corporate governance of the country.

The stock market has been an important mechanism of corporate control in the US. Meanwhile, attempts to enhance internal control over management have been made through introducing outside directors and setting up more committees on the single board. The law has also broadened the fiduciary duties of directors. In addition, the US corporate law has provided a comprehensive set of rules to protect small shareholders.

THE SEPARATION OF OWNERSHIP AND CONTROL

There are two important elements that have decided the development of the separation of ownership and control and the managerial capitalism in the US. Firstly, the increasing complexity in technology operated in modern enterprises enables non-owner, professional managers to grab more powers. As the growth of the firm has enlarged

738 See Alfred D Chandler, Scale and Scope: The Dynamics of Industrial Capitalism (1990), 383-592.
managerial hierarchies, the complexity of decision-making has thus increased. Firms have no choice but to rely on managerial teams in the process of operation. Secondly, the operation and expansion of large firms requires huge capital inputs. Since, traditionally, the US has curbed banks from operating nationally and holding significant stocks in companies, large firms have had to rely on the equity market for fund raising. As the funds of large corporations are raised from a great member of investors, the share ownership in these corporations inevitably becomes scattered. The portion of each shareholding becomes smaller. The small, dispersed shareholders lack information, skills and incentives to monitor managers. Therefore, the control over large public companies with dispersed shareholdings have separated from their owners and shifted to professional management.\footnote{See Adolf Berle and Gardiner Means, \textit{The Modern Corporation and Private Property}, (1932 reprinted in 1991), 78-111.}

The separation of ownership and control creates a threat to the fundamental, traditional belief that corporations should be run for maximising shareholders’ profits. The incentives for traditional owner managers do not exist any more and salaried managers may prefer to promote their own interests instead of that of shareholders. This results in the increase of agency costs.

However, the scattered ownership makes takeovers easier than where some big blocks of shares of a company are possessed by a few financial institutions with some kind of relationship with the company or by a few interlocking industrial companies. dissatisfied

\footnote{Such as to promote their personal goals. See Roberta Romano, \textit{The Genius of American Corporate Law} (1993), 2.}
shareholders are likely to sell their shareholdings on stock markets and that increases the opportunities for hostile takeovers. Hence, takeovers as a side product of dispersed ownership have been very helpful in relation to compensating shareholders’ decreased surveillance over management, caused by separation of ownership and control. They shift back certain powers from managers to shareholders. America, like the UK, has used it as an effective external control over management. At the early stage, unless affected by the provisions relating fiduciary duties and equal opportunities in the antitrust law or rules, takeovers were basically given a free rein. Not until the 1960s, was there any comprehensive law governing takeover activities.

THE ONE-TIER BOARD

Like the UK, the structure of corporate governance in the US is designed to comprise three organs, the shareholders’ meeting, the board of directors, and managers. Shareholders are the owners of the corporation. Directors are the agents of the shareholders, responsible for the management of the firm. With the decline of shareholders’ control over public corporations, the Americans see their corporate system as “board centred accountability”. The key issue is how to make the board more accountable. Directors may promote their own interests. They may direct their loyalty to the chief executive officer (CEO) instead of shareholders, especially in the case where the head of the board is the CEO. It is always problematic when one body of an institution exercises both supervisory duties and managerial duties. One method of compensation is

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to appoint outside directors into the board. Outside directors do not take part in companies’ daily management. This enables them to be in a position distant from management, therefore, to be impartial.\textsuperscript{742} They are expected to give wise advice to the board and provide useful information to shareholders.\textsuperscript{743} Over the past twenty years, the ratio of outside directors in the US board has increased steadily.\textsuperscript{744}

A further innovation made by the Americans is to make the unitary board contain one or more committees, including the auditor committee, the executive committee, the compensation committee, and the nomination committee. Nearly all companies have audit committees\textsuperscript{745} and most companies have executive committees or compensation committees. This means 85\% boards have two committees and more than half of them have three.\textsuperscript{746} While the executive committee and the auditor committee are delegated the power of daily management and financial control, the compensation committee and the nomination committee, composed wholly or mostly of outside directors, are basically conferred the power of oversight and surveillance over executive directors and managers. A board containing the compensation committee or the nomination committee obviously


\textsuperscript{743} Ibid.

\textsuperscript{744} Ibid.

\textsuperscript{745} It has been a compulsory requirement of the New York Stock Exchange that every listed company must have an audit committee since 1978. See Robert A G Monks and Nell Minow, \textit{Corporate Governance} (1995), 203.

goes one step further towards the two-tier board structure. These arrangements have significantly improved the effectiveness and accountability of the US one-tier board. 747

**LEGAL INNOVATIONS**

The American corporate law gives a wider range of powers to the board of directors and smaller scope of authority to the shareholders’ meeting. 748 As a result, managers in the US companies are perceived as over powerful. The US corporate law represents one of the most relaxed legal regimes in the world for management. The judicial intervention in business is limited. While the law is strict in policing self-dealing, directors are sheltered by the “business judgement rule” from liabilities for negligence, if the conditions for its operation are fulfilled.

The business judgement rule is a legal device of the US law, which requires proof that the directors of a corporation acted on an informed basis, in good faith, for a rational purpose and in the honest belief that the action taken was in the best interests of the company. 749 Once these are established, directors are immune from negligence liability. The establishment of the rule is to encourage management to make risk-taking decisions. 750 It is based on the understanding that courts are ill-equipped to examine


749 *Smith v Van Gorkom*, 488 A 2D 858, at 872.

business decisions. The rule is also a confirmation and reflection of the common law tradition that courts have been reluctant to second-guess business decisions. The rationality of the rule lies in the nature of corporate business. It should be borne in mind, entrepreneurial business has a hazardous and uncertain character. Directors and managers chosen by investors are not supposed to be risk averse persons, but should be accustomed to the business and to speculation. Thus, the corporate law should not be made to encourage risk aversion under the name of maintaining board accountability, but should encourage legitimate risk taking managerial activities. Hence, the business judgment rule provides a safe harbour for negligence liability in the course of business.

However, adoption of the business judgment rule requires the introduction of balancing mechanisms to tighten disclosure obligations and to strict loyalty obligations, so as to curtail corporate fraud and secure investors' interests. At this point, the US corporate law has devised many mechanisms to prevent the possible misuse of the rule. Firstly, the US corporate law has a broad fiduciary duty regime. The business judgement rule is applicable only when directors and managers have fulfilled their fiduciary obligations. Fiduciary duty requires that directors and managers must act with loyalty to

751 Ibid.
752 Ibid.
753 Overend and Gurney Co v Gibb (1872) LR 5 HL 480 at 495.
the corporation by protecting corporate interests over their own. In the meantime, the US law requires companies to make full disclosure to shareholders on issues of significance.

The US law provides a comparatively adequate regime of shareholder suits. Shareholders can bring two types of lawsuits against directors and managers, derivative actions, brought by shareholders on the corporations’ behalf, and direct actions, brought by shareholders in their own rights. Direct actions may be brought by shareholders individually or as a class. The latter are also called class actions.

The problems of shareholders’ actions lie in the cost of bringing a lawsuit and the free rider problem. While those who bring an action not only bear the cost but also take the risk of dismissal, the benefit from the outcome of the litigation has to be equally shared by all the shareholders whose rights were affected. To mitigate this difficulty, the US law provides that successful plaintiffs are awarded substantial counsel fees. This not only brings relief to shareholders, but also provides a financial incentive to the lawyers involved in shareholders’ lawsuits to monitor management. Data show that lawyers play the key role in shareholder litigation. Many claims are settled before litigation, as

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756 See Arthur R Pinto & Gustavo Visentini (eds), The Legal Basis of Corporate Governance in Publicly Held Corporations, A Comparative Approach (1998), 266.

757 Ibid, 269-270.


759 Ibid, 55.

attorneys' fees are always recovered in settlements. This reveals the principal/agent problem with the arrangement, *i.e.*, lawyers' incentives do not necessarily coincide with the shareholders' interests. In many cases, attorneys' fees are the only settlement recovery received in shareholder litigation. Hence, critics point out that lawyers are the true beneficiaries of shareholder litigation.

Nevertheless, shareholder litigation serves as a useful monitor of management. It is particularly helpful for large block shareholders who are not insiders to monitor management. As the recovery received by a shareholder with a large enough block of shares in the litigation is likely to exceed the lawsuit cost, these shareholders have a strong incentive to use this monitoring mechanism. The interaction between the above legal devices enables a pro-business legal regime to function well.

**CONCLUSIONS**

The corporate development in the USA has produced a classic economic model of the public firm, with the feature of strong managers and weak shareholders. The legal system has strived to restrain the divergence of interests between owners and management, so as to maintain business prosperity. Given the historical political preference for banning national financial institutions from having close relationships with industrial firms, and

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761 In a settlement, the defendant routinely agree not to oppose petitions for fee. See Roberta Romano, "The Shareholder Suit: Litigation without Foundation?" (1991) 7 Journal of Law, Economics, and Organisation 55, 55 & 60-65.

762 Ibid.

763 Ibid.
the fact that states’ power of regulating corporate activities has been firmly established, the American corporate law regime, therefore, has developed along a path characterized by multiple corporate codes, the rigorous federal securities law, a dynamic takeover regime and promotion of outside directors. The law and practice are inclined to provide a favourable environment for business. Managers in the US are perceived as powerful. Although, measures of enhancing corporate governance are taken, there are still doubts about the accountability of management and whether the law has done enough to discipline CEOs.765 Some have begun to suggest that the USA may be better off if it moved to adopt the German corporate model.766 However, others have questioned the proposition on its grounds.767 It is found that both German and Japanese systems have the elements of serving noncorporate governance functions, comparable with the US situation.768 Furthermore, there is evidence that US firms are more productive than their German and Japanese counterparts.769

764 Ibid.
768 Ibid, 2036.
769 Ibid.
Chapter 13

THE GERMAN MODEL

German corporate governance system has pursued a path quite different from the Anglo-American model. However, it has nurtured one of the most successful corporate economies in the world. In Germany, banks, instead of the market, have played an important role in the corporate control. The economic performance of Germany has stimulated academic argument that the close financial ties and relationship between corporations and banks may be a more efficient corporate governance structure than the US model of market control, in terms of reducing agency costs.\textsuperscript{770} The view claims that the German system makes corporations less affected by the pressure of short-termism and more concerned about the long-term shareholder values, and thus stands in a better position for sustainable corporate development. Although many are not convinced by the view,\textsuperscript{771} it is universally acceptable that the success of German corporate economy has proved that there is more than one way to achieve efficient corporate control.


THE OVERALL PICTURE

Traditionally, German business people gain their social respect by portraying themselves as “solid citizens” and paternalists. Their prestige was obtained by producing quality products for social good and by showing a social responsibility towards their workers. This position was strongly supported by the State.

In Germany, the public has had a different attitude towards financial authorities and the social function of corporate organisations. The Germans regard companies as not merely a device to pursue entrepreneurs’ business interests, but more importantly, a human system which will “produce a general benefit for the community as a whole”. The German Constitution enunciates that the use of property should serve the public good. Therefore, companies should not only serve shareholders’ interests for profits, but also take the interests of employees and customers into account. This genuine social belief is the fundamental element in determining that the German corporate approach is cooperative. Once one understands the attitude and ideology, it is to be expected that the Germans have taken a cooperative approach in constructing their corporate governance system.

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774 Article 14(2) of the German Constitution.

775 In contrast to British and American approach which is seen as to be of confrontation.
The historical conditions for corporate development in Germany are unique. If the capitalist or industrial revolution in the UK was a result of a slow and inevitable process, the industrialisation in Germany came in a far more organised manner. As a late industrialised country, the German government was willing to provide all possible institutional support for making Germany a strong nation in the world.\footnote{See Jurgen Kocka, “Entrepreneurship in A Late-Comer Country: The German Case”, in Keiichiro Nakagawa (ed), Social Order and Entrepreneurship (1977) 149, 156-157.} As a result, the government has played an important role in shaping the German corporate pattern. The government promoted industry as a matter of national pride.\footnote{See Johannes Hirschmeier, “Entrepreneurs and the Social Order: American, Germany and Japan, 1870-1900”, in Keiichiro Nakagawa (ed), Social Order and Entrepreneurship (1977) 3, 13.} Entrepreneurs relied heavily on the government for assistance.\footnote{Ibid, 36.} During the wartime, the degree of governmental intervention in business increased. After the Second World War recovery period, the government only saw an enhanced need for its involvement in corporate development. Therefore, the German corporate system is not only “co-operative” but also “organised”.\footnote{See Jonathan Charkham, Keeping Good Company (1995), 7-8.}

There are a few elements that determine the essence and outlook of today’s German corporate law. Firstly, banks have close relationships with industrial corporations.\footnote{Ibid, 35-43.} Unlike the Americans, historically, the German people have had no hostility towards banks. Banks have been regarded as important in nursing industry and resisting inflation. In the industrial revolution, in order to rapidly industrialise the country and to catch up

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\footnote{776 See Jurgen Kocka, “Entrepreneurship in A Late-Comer Country: The German Case”, in Keiichiro Nakagawa (ed), Social Order and Entrepreneurship (1977) 149, 156-157.}
\footnote{777 See Johannes Hirschmeier, “Entrepreneurs and the Social Order: American, Germany and Japan, 1870-1900”, in Keiichiro Nakagawa (ed), Social Order and Entrepreneurship (1977) 3, 13.}
\footnote{778 Ibid, 36.}
\footnote{779 See Jonathan Charkham, Keeping Good Company (1995), 7-8.}
\footnote{780 Ibid, 35-43.}
with the UK as soon as possible, German industries needed a large amount of capital.\textsuperscript{781} The public could not supply such an amount of capital. As a result, the industries relied on banks for capitalisation.\textsuperscript{782} Furthermore, the inflation and depression after the two world wars, gave banks little choice, but to take up shareholders’ position in corporations. Banks as major investors and lenders have thus developed a close tie with industrial companies and had a significant influence over companies’ management. Banks have been the important capital suppliers of industrial companies, through lending and direct shareholding. The German Constitution allows banks to enjoy a high degree of freedom from regulation. Traditionally, they have provided a wide range of services for companies.\textsuperscript{783} The role played banks has substantially affected the ownership structure of German firms. Contrary to the diffused ownership pattern in large public corporations in the UK and the USA, the ownership structure in large German companies has constantly shown a tendency towards concentration.\textsuperscript{784} As a result, banks usually control big blocks of voting stocks in companies. In addition, banks’ voting power is further strengthened by proxies which have been traditionally entrusted to them by other shareholders.\textsuperscript{785}


\textsuperscript{782} See Jonathan Charkham, Keeping Good Company, A Study of Corporate Governance in Five Countries (1995), 36.

\textsuperscript{783} Ibid, 36-38.


\textsuperscript{785} There are some reasons for German shareholders to authorize banks to deal with shares for them. For example, most German shares are in the form of bearer share which have to be presented when receiving dividends; and banks are regarded to have the ability to deal with shares at the best price. See Jonathan Charkham, Keeping Good Company, A Study of Corporate Governance in Five Countries (1995), 38.
role of banks in supplying capital has moderated the need of raising funds from outside investors, and lessened the necessity of developing a strong securities market.  

Consequently, Germany has fewer listed public companies and larger financial institutions with larger voting blocks in companies, compared with the UK and the USA.

Secondly, German corporations have developed a different system of governance. German corporate law imposes a mandatory two-tier board structure. The two boards are supervisory board and management board. The creation of a supervisory board was originally a design for maintaining state control in business organisations. Later legislative development has made the supervisory board an organ of representatives of shareholders and employees. Members of the supervisory board are elected by shareholders and employees. The function of the supervisory board is to supervise the management of the company, whereas the management board is responsible for managing the company. The law strictly separates the functions of the two boards in order to improve their performance. A supervisory board brings management under close scrutiny, so as to enhance the company’s supervisory strength over managers. From the viewpoint of the law and economics theory, having a watch-dog organ on top, the management of a German company is under closer surveillance, compared with its

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788 Ibid.
counterpart in the Anglo-American system. The supervisory board is also a handy instrument for German banks to exercise their influence.

Thirdly, corporate management in Germany is further checked by another system, the co-determination system. Co-determination requires that a certain proportion of members of the supervisory board must be elected by employees. These employee representatives, through their influence on the composition of management board and certain decisions, make sure that the employees' interests will not be neglected. In Germany, the public has had a different attitude towards the social function of corporate organisations. As we have seen, the Germans regard companies as a human system which will "produce a general benefit for the community as a whole". Therefore, in the course of profit making, companies should take the interests of employees and customers into account. This social belief is the fundamental element in determining the invention of Co-determination.

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790 German bankers use their votes to elect bank nominees to the supervisory boards of 96% of the 100 largest German Firms, and in fourteen cases, a banker chairs the supervisory board. See Investigative Report by Monopoly Commission of German Parliament, July 16, 1990.


792 The law requires that a stock corporation (public company) or a limited liability company (private company) has between 500 to 2000 employees must have a supervisory board with one third employee representatives. If the employee numbers of the company increases to more than 2000, the employee representatives should make up half of the board.


794 In contrast to British and American approach which is seen as to be of confrontation.
Corporate evolution in Germany proves that the classic economic model of the listed public corporation and its economic domination do not universally apply. In Germany, the phenomenon of "strong managers and weak shareholders", which has plagued US industry, does not exist or at least is not so evident as to be a concern. In Germany, because of the involvement of banks and other institutional investors, inefficient managerial performance may be corrected quickly. The interaction between banks and managers reduce the chances of takeovers. In addition, the system of worker participation in company affairs is designed to further prevent managers from straying too far from corporate interests.

The disadvantage of the German system is its rigidity. While stable shareholdings and worker participation foster long-term development and stability, they make it difficult for the company to change direction. The reaction to business opportunities and the decision making process of the board are likely to be slower than in a company with a single board. Some are concerned that, from a long-term point of view, this may result in a less competitive environment.

Globalisation also brings pressure on the German corporate governance system. International institutional investors may not approve the low returns of the German securities market, although it seems not a problem for domestic investors. With the

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795 Most mergers are friendly for the purpose of enhancing performance or other business concerns.


797 Ibid.
increasing involvement of foreign investors, the German corporate governance system has to move towards the direction of active monitoring from shareholders.\textsuperscript{799}

THE TWO-TIER BOARD SYSTEM

The two-tier corporate governance system is meant to be a more efficient system than the single board system. The two-tier board comprises a supervisory board (Aufsichtsrat) and an executive or management board (Vorstand). While the members of the executive board are responsible for the management of the company, the members of the supervisory board discharge their duties of controlling and monitoring the executive board. The supervisory board is conferred a range of rights that are essential to its monitoring authority, including to appoint and dismiss the members of the executive board, to call shareholders' meetings, to examine the annual financial statements and provide a written report on the result of the audit for the shareholders' meeting, and to represent the company in its dealings with the members of the executive board.\textsuperscript{800} The supervisory independence is ensured by the explicit provision of law that the two boards have absolutely separate functions and the supervisory board cannot take over any managerial duties.\textsuperscript{801} The law requires that a public company, Aengesellschaft (AG), with whatever size and labor force and a limited liability company, Gesellschaft mit

\textsuperscript{798} Ibid.

\textsuperscript{799} Ibid.

\textsuperscript{800} See AktG, 111.

beschrankter Haftung (GmbH), with more than 500 employees, must have a supervisory board.

The key to the successful operation of the German corporate governance system has been the supervisory board.\textsuperscript{802} However, its effectiveness has been questioned in recent years. The major weakness of the supervisory board is found in its relying on the executive board to provide information for decision-making and its infrequent meeting arrangement which undermines its actual control power over management.\textsuperscript{803} With a wave of insolvency since the 1980s, German lawmakers have taken the criticisms into their consideration. Amendments of the company law were proposed. The most notable proposed reforms include introducing certain mechanisms to ensure that the supervisory board and auditors will effectively exercise their powers.\textsuperscript{804}

THE CO-DETERMINATION SYSTEM

Co-determination means that a certain proportion of members on the supervisory board must be made up of the representatives of the employees.\textsuperscript{805} These employee representatives, through their influence on the composition of management board and certain decisions, make sure that the employees' interests will not be neglected. The

\textsuperscript{802} See Alfred F Conard, \textit{Corporations in Perspective} (1976), 81.


underlying ideology is that workers participation in decision making process will promote trust, cooperation, and harmony. 806

Co-determination on the supervisory board includes three kinds of situations, full-parity co-determination, quasi-parity co-determination, and one-third co-determination. 807 Full-parity co-determination refers to the situation where the representatives of shareholders and employees on the supervisory board are equal in number. The employee representatives must include at least one worker and one non-manual employee. This type of co-determination only applies to AGs and GmbHs in coal, steel and mining industries with more than 1,000 employees. The chairman of the board must be a neutral person who is supported by a majority of both shareholder bench and employee bench.

The situation in the board of quasi-parity co-determination changes. The difference lies in the composition of the employee bench. Two seats of the employee bench must be reserved for union representatives. 808 The representatives of the company’s employees must be distributed among three employee groups including workers, non-manual employees and managerial employees, according to their proportions in the company. 809 Quasi-parity co-determination applies to all AGs and GmbHs with more than 2,000 employees.


808 Ibid, 1005.

809 Ibid.
employees. In addition, the chairman of the board of quasi-parity co-determination is not neutral. If a two-third majority of the board cannot be reached, the shareholder representatives elect the chairman.

One-third co-determination refers to the situation where shareholder representatives hold two-thirds of the seats on the supervisory board. One-third co-determination applies to all non family dominated AGs with less than 500 employees and were registered before August 10, 1994. It also applies to all AGs with more than 499 employees and GmbHs with more than 500 but less than 2001 employees, which are non family dominated and are not subject to full-parity co-determination.

At the early stage, the practice of co-determination met some strong reaction from management. It was predicted that labor representatives would undermine management power and increase conflicts of interest. The fear resulted in resistance from management. Some firms found their ways to bypass the labor representatives. With time passes by, managers have gradually accepted the idea of co-determination.

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810 Ibid, 1006.
811 Ibid.
812 Ibid.
814 Ibid. 68.
815 Ibid.
and more of them regard the practice of co-determination in Germany as a system of promoting trust, cooperation and harmony, rather than confrontation.\(^{816}\)

Notwithstanding, negative comments on the efficiency and economic rationality of co-determination are heard now and then. One argument is that co-determination has structural weakness.\(^{817}\) It brings the potential of division between management and operation. Furthermore, when there are dominant shareholders, the board is likely to be taken over by shareholders' representatives. There are inadequate provisions in law regarding the responsibilities of the supervisory board.\(^{818}\) In addition, works councils rely on the executive board for information. In reality, there are cases where the council rubberstamps management decisions and even rely on the management board for suggestions as to filling vacancies on the council.\(^{819}\) Some argue that the weakness of the German securities market is partially resulted from the co-determination system, as practice of co-determination undermines the diffusion of ownership. As diffused shareholdings may force them to face either a labor dominated board or a weak board, shareholders prefer to hold large block of shares to "balance power".\(^{820}\)


\(^{817}\) See Detlev F Vagts, "Reforming the 'modern' Corporation: Perspectives From the German" (1966) 80 *Harvard Law Review* 23, 52.


\(^{819}\) See Detlev F Vagts, "Reforming the 'modern' Corporation: Perspectives From the German" (1966) 80 *Harvard Law Review* 23, 52.

\(^{820}\) *Ibid.*
CONCLUSIONS

The German corporate governance system has its own characteristics. The concentration of ownership in German companies is relatively strong. Shareholders and managers have a close relationship. The stock market has a limited role to play in disciplining management. Corporate performance is monitored by a wide range of stakeholders including managers, employees, creditors, suppliers and customers. However, like the situation elsewhere, despite its strength, the German corporate governance system will inevitably move in the direction that leads to convergence with the Anglo-American system to some extent.  

With the increasing degree of economic globalisation, the German corporate system is encountering some new situations. For example, the increase of foreign investment in German companies, has resulted in an increasingly important role of foreign shareholders in corporate governance. International investors including US investors may not favor some arrangements in German companies, such as placing more emphasis on the long-term viability of the corporation, but less emphasis on shareholder returns. If German companies want to attract more foreign capital, they may need to make some changes in their corporate governance system, such as embracing more diffused ownership structure and a stronger market influence.

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Chapter 14

THE JAPANESE MODEL

Japan is one of the latest industrialised countries in the developed world. When Britain finalised the framework of modern corporate legal regime and its companies traded world-widely in mid-19th century, Japan was still in the final stage of a feudal society controlled by the Shoguns. However, the Japanese corporate economy has created an economic miracle within a short time. The distinctive feature is that Japan’s economic success is unparalleled in world history, as it “embodies an experience rather at odds with Western experience”.

The Japanese corporate system has developed along a path of importing organisational models, managerial methods, and production and distribution technologies from the West into a fundamentally different social and economic environment, with necessary adjustments and adaptations. With the success of this process, the Japanese corporate system provides another significant model and is admired by other systems.

THE OVERALL PICTURE

The corporate development in Japan came as part of the country’s effort to modernise. The process started since the Meiji period (1868). Sensing the backwardness of Japan’s

technology, the Meiji government was in earnest to industrialize the country. Seeing the success of Western industry that was largely produced by private owned companies, the Japanese aspired to similar prosperity.\textsuperscript{824} However, according to traditional Confucian ethics, pursuing profits was not a morally honourable trade, and business was thus an inferior occupation in traditional Japanese society. Hence, both the government and the new entrepreneur group needed to find an ideology to justify commercial activities. The result was the promotion of the notion of firm-as-family.\textsuperscript{825} Every member of the firm was a member of the family. As the company grew, the family prospered. And to take a wider view, the whole of Japan could be a big family.\textsuperscript{826} The idea of familism has been important in shaping Japanese corporate behavior. With the understanding of familism, Japanese firms regarded stability and growth, not profitability, as their first priority. Familism also helped to create a favourable capital-labor relationship. New entrepreneurs portrayed themselves as modernisers and dedicated to the cause of industrialising the country. Therefore, their primary goal was not profit maximisation but the success of industry in the interest of the nation as a whole.\textsuperscript{827}

While acknowledging that the Japanese corporate system is praised as a distinctive and successful model, it is interesting to know that the formation of the system is the outcome of genuine emulation of successful Western firms. Since the early stage of


\textsuperscript{825} Ibid, 41.

\textsuperscript{826} Ibid.

\textsuperscript{827} See Hohannes Hirschmeier, “Entrepreneurs and the Social Order: America, Germany and Japan, 1870-1900”, in Keiichiro Nakagawa (ed), Social Order and Entrepreneurship (1977) 3, 16.
corporate development, Japanese enterprises have been intentionally emulating successful Western firms.\textsuperscript{828} Initially, the corporate form was imported “unshorn, uncropped and as one piece” from the West.\textsuperscript{829} Later, it was realised that a great deal of adaptation and adjustment were needed to make Western institutions fit into the local environment.\textsuperscript{830} As a result, the Japanese corporate system has developed along a path of modelling itself on Western corporate experience but combining significant elements of Japanese circumstance and culture.\textsuperscript{831} Basically, the Japanese corporate system possesses the following five distinctive characteristics:

Firstly, there is a close relationship between companies and banks. At the early stage of corporate development, individual savings in Japan were not great enough to finance corporations. Firms saw banks as the major fund supplier. Meanwhile, the Japanese government was keen to enhance the role of banks in financing corporations. Over time, a relationship between corporations and banks was developed. By directly lending, acquiring shares, and cross-holdings, banks have controlled big blocks of share and have exerted influence on companies at every crucial moment. The usual practice is that a company will have a main bank that provides the largest share of lending and holds the substantial share of the company’s equity.\textsuperscript{832} In doing so, an implicit contract relationship


\textsuperscript{829} Ibid, 4.

\textsuperscript{830} Ibid.

\textsuperscript{831} Ibid, 6.

is concluded between the corporation and the bank. The bank will see itself as in a long-
term relationship with the company and is obliged to provide support at a time when the
company is in trouble. This relationship determines the important role of the main bank
in Japanese corporate governance. Bank domination results in the highly concentrated
ownership structure in Japanese companies and relatively underdeveloped stock
markets. About 99% Japanese companies are unlisted and they are likely to see the
bank system as the only source of external capital.

Secondly, there is a distinctive corporate group system in Japan. Most Japanese
companies survive collectively. In other words, a typical Japanese company usually
belongs to a group, a conglomerate of companies and financial institutions. The core of
the group is usually a powerful bank. Around the bank, many companies are bound
together by the common ties to the bank, interlocking shareholdings and trading
relations. The strength of these corporate groups lies in cooperation through lending,
inter-group trading and exchanges of directorships. It is generally recognised that the
group structure of the Japanese corporate system increases information flows and reduces

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833 See Hideki Kanda, "Trends in Japanese Corporate Governance", in Klaus J Hopt (ed), Comparative

834 See Jonathan Charkham, Keeping Good Company: A Study of Corporate Governance in Five Countries

835 This mainly refers to horizontal corporate groups.

836 See Kenichi Miyashita & David W Russell, Keiretsu, Inside the Hidden Japanese Conglomerates

of Forms of Economic Resource Co-ordination and Control”, in Stewart R Clegg & S Gordon Redding
(eds), Capitalism in Contrasting Cultures (1990) 79, 88.
incentive problems faced by arm-length contract dealing, thus effectively increases the efficiency and reduces the cost of corporate governance.

Thirdly, in Japanese companies, shareholders are basically friendly or passive shareholders. A friendly or passive shareholder is a stable shareholder. A stable shareholder expects a return from the company’s long-term prosperity. To become a stable shareholder implies that the shareholder forgoes some of the property rights associated with the shareholding, including the exercise of the right to sell the shares to third parties, particularly hostile take-over bidders, and to consult or give notice to the company when selling or intending to sell the shares. A company must offer certain incentives to induce a shareholder to become a stable shareholder. In Japan, this is achieved by the operation of the main bank system and the corporate group system, which, by creating the relationship link between the bank and the company and the cross-shareholdings among group companies, has basically guaranteed the incentives for the main shareholders of a company to be stable.

Fourthly, the board is a hybrid system and all the members of the board are insiders. Inspired by the German two-tier board, the Japanese corporate law devised the system of

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statutory auditor (kansayaku), which takes on some functions of a supervisory board.\textsuperscript{841}

The company law requires a company to have a board of directors. If the company is listed, it must have one to three statutory auditors who have the duty of monitoring the management of the company. A kansayaku is elected by the shareholders’ meeting. The managerial function is delegated to the board of directors. Therefore, the Japanese corporate system stands somewhere between a one-tier board system and a two-tier board system. It has one board and a supervisory organ which, however, does not consist of a supervisory board like the one in the German corporate system.

An important characteristic of the Japanese corporate governance is that the board of directors is mainly composed of incumbent managers.\textsuperscript{842} To appoint the directors from management ranks has been a long-standing practice in the Japanese enterprise system. The incumbent managers mainly come from two sources: the life-time employees of the company and the ex-employees of banks, affiliated companies, or government ministries.\textsuperscript{843} In either case, these board members are full time employees of the company.\textsuperscript{844} Surveys show that about 80\% Japanese companies have no outside directors,

\textsuperscript{841} When translating the term “kansayaku” into English as a statutory auditor, it must be distinguished from a professional auditor who has accountant or other professional qualification. The device is embodied in Taiwan’s corporate law and is termed in Chinese as “jian cha ren”. The proper English translation is a “supervisor”.


\textsuperscript{843} Ibid.

\textsuperscript{844} Ibid.
and other 15% have less than two outside directors.\textsuperscript{845} Hence, the Japanese board is labelled as an insider board. It is a usual practice for the main bank to transfer its managerial staff to sit on the boards of its customer companies. It is also a usual practice for interlocking companies to exchange their board members. In many cases, the retired bureaucrats from the regulatory authorities sit on the boards of banks and companies. By doing so, the ties between banks and companies, between government authorities and companies, and between related companies are strengthened.

Fifthly, there is a life-time employment system. In Japan, it is a common understanding that companies as social institutions are, in fact, owned by employees and run in the best interests of the employees.\textsuperscript{846} Employees join firms after school or university and are supposed to stay with the companies until retirement. Their living, professional achievement and life accomplishment are all connected with the success of the companies. Almost all managers in Japanese companies are promoted from employees. The life-time employment system, together with the connection with banks, the linkage with affiliate companies within groups, and the reality that companies are treated as social institutions are all incentives for managers to consider their companies' long-term interests and continuity of property as their strategic priority.


THE MAIN BANK SYSTEM

The Japanese main bank system involves an informal set of practice relative to corporate finance and governance.\(^{847}\) It refers to a close relationship between banks and firms. Almost every Japanese company has a main bank relationship.\(^{848}\) The most distinctive characteristic of the system is that a company has a bank that is its “largest lender, one of its largest shareholders, and sometimes supplies one or two board members”.\(^{849}\) In this case, the bank is the main bank of the company. There may be other banks that extend loans to and hold the shares of the company (sometimes the loans or equities may exceed that from the main bank), but do not assume the role of the main bank. Except loans and stock holdings, a main bank provides bond-issue related services and information services, manages cash flow receipts and payments, and supplies management resources for the company.\(^{850}\) By providing the above services, the main bank stands in an extremely advantageous position in terms of obtaining the company’s information and exercising influence and controlling power over the company. The supply of management staff by the main bank to the board of the company also achieves the purpose of


\(^{848}\) Ibid.


transferring management know-how in the absence of a competitive market for labor and managers caused by the life-time employment system.\textsuperscript{851}

In an external market finance system, namely the Anglo-American system, the monitoring functions are separately exercised by different institutions. While \textit{ex ante} monitoring is performed by all kinds of investors, interim monitoring and \textit{ex post} monitoring are mainly exercised by the board of directors, the takeover market and the court-led bankruptcy procedure.\textsuperscript{852} However, in Japan, all the three monitoring functions are performed by the main bank. This arrangement has been complementary to the structure of the Japanese corporate governance characterized as a team oriented production system, and thus is particularly effective in the Japanese corporate system.\textsuperscript{853} The benefits of the main bank system are perceived to be avoiding duplicative \textit{ex ante} and interim monitoring costs, enabling the main bank to intervene in management with a high degree of certainty, and increasing the range of actions that can be implemented \textit{ex post} thus reducing the chance of liquidating temporarily depressed but potential productive companies.\textsuperscript{854}

\begin{flushleft}
\textsuperscript{851} Ibid, 16.
\textsuperscript{853} Ibid, 109-141.
\textsuperscript{854} Ibid, 121-28.
\end{flushleft}
THE CORPORATE GROUPS

The main bank system is complementary to the Japanese corporate group system. It is an important part of the corporate group. In Japan, the word *keiretsu* is used to refer to corporate groups. There are two types of *keiretsu*, vertical *keiretsu*, a series of subcontractors organised under a principal company, and horizontal *keiretsu (kigyo shudan)*, a group of larger corporations from diverse industrial, commercial and financial sectors. The two types of *keiretsu* may overlap. The arrangement of *kigyo shudan* is the most innovative practice. Companies can be identified as within a *kigyo shudan* if they connected by a common main bank relationship, interlocking shareholdings, a certain degree of reciprocal business transactions, board members’ exchange, and, at least for core companies, common membership in a presidents’ council meeting. Companies benefit from the above group arrangements. Close relationship between banks and companies, interlocking shareholdings among banks and companies, and board members’

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exchange, even presidents’ council meetings increase informational flows among group companies, as well as reduce incentive problems of monitoring.\(^{858}\)

Experience shows that it is advantageous to be a member of a *kigyo shudan*. A member company of a *kigyo shudan* has a much louder voice in the business community than it would if it was independent.\(^{859}\) It can access greater political leverage when necessary.\(^{860}\) It will not be taken over by a hostile raider.\(^{861}\) It has easy access to credit.\(^{862}\) Moreover, the performance of a member company tends to be smoother than that of an independent company.\(^{863}\)

The origin of *keiretsu* can be traced back to the *zaibatsu*. As a development of family business, the *Zaibatsu* was born at the end of 19th century. A *zaibatsu* was a family or group of families which, acted as holding companies and formed the core of a group of business enterprises.\(^{864}\) Since the 1920s, the *zaibatsu* grew rapidly and provided

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\(^{860}\) *Ibid.*

\(^{861}\) *Ibid.*

\(^{862}\) *Ibid.*


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important support for the Japanese war effort.\textsuperscript{865} The role played by the zaibatsu during the war-time led to their forced dissolution during postwar US Occupation.\textsuperscript{866} However, the ties bonding the members of the ex-zaibatsu were so strong, that they regrouped themselves again once the Occupation ended in 1952. The new enterprise groups were called keiretsu. Since then, the keiretsu has dominated the landscape of Japanese industry.

The deregulation of the corporate bond market since the late 1970s and the following economic recession put the corporate group system and the main bank system under test. This has weakened the ties between banks and companies, and troubled vertical keiretsu.\textsuperscript{867} Although some predicted the “end of Japan’s golden age”,\textsuperscript{868} it is unlikely that the corporate groups will eventually break up. On the contrary, with Japan’s trading relations with the international community becoming more complex and more politically influenced, the role of corporate group as a policy coordinator becomes even more important.\textsuperscript{869}


\textsuperscript{866} \textit{Ibid}, 33-34.

\textsuperscript{867} \textit{Ibid}, 199-202.

\textsuperscript{868} \textit{Ibid}, 126.

\textsuperscript{869} \textit{Ibid}, 199.
THE LIFE-TIME EMPLOYMENT SYSTEM

The term of life-time employment carries two messages. Firstly, an employee should join the company right after school and stay there until retirement. Secondly, employment rewards link to age and length of service. Although the practice could be found in traditional Japanese family business (house), it appeared in modern industry only since the 20th century.

Initially, the system was developed in response to special labor market and social conditions. Around World War I, factory production in Japan grew very fast. There was a shortage of labor, particularly skilled labor. Many workers were villagers and only worked in factories seasonally. The working conditions in factories were harsh and the payment was low. Under such circumstances, for stabilizing skilled labor, large enterprises move to establish the life-time employment system. Under this system, enterprises and employees were bound by joint responsibility for the enterprises’ long-term prosperity. While employers expect loyalties, employees were given security and a sense of belonging. During the period of the two world wars, the life-time employment system was firmly established.

871 Ibid.
The economic rationality of the life-time employment system lies in that it can achieve labor efficiency and can maintain discipline while keeping wage levels down.\textsuperscript{874} However, there are costs and disadvantages associated with the system. The life-time employment system brings difficulty to acquisitions or mergers. As companies are related to employees in a real sense, selling or buying companies, in a sense, amounts to selling or buying people.\textsuperscript{875} Hence, it is hard for management to make decision on acquisitions. Regarding merger, the trouble is almost insurmountable, since merger means to combine two entrenched work forces.\textsuperscript{876} As a result, Japanese firms basically cannot take the advantage of entering into a new business area by acquiring a firm in the new sector.

**CONCLUSIONS**

The corporate development in Japan illustrates the fact that a country’s corporate system grows out of its particular historical background and strongly reflects its culture. The Japanese corporate governance system works through a range of implied contractual relationships and ensured employment, and is protected by cross-holdings from the takeover attack and monitored by the main bank to safeguard viability.\textsuperscript{877} This distinguishes it from other models.

\textsuperscript{874} Ibid.


\textsuperscript{876} Ibid.

The Japanese practice, especially the main bank system and the corporate group system, has been argued by many, during certain stages of economic development, as being more efficient and less expensive than the securities market in evaluating investment and lending, monitoring corporate performance, and rescuing distressed companies.\(^{878}\) It thus provides a valuable alternative model for transitional economies and developing economies.

Chapter 15

THE CORPORATE GOVERNANCE MODEL OF OVERSEAS CHINESE COMMUNITIES

Overseas Chinese communities spread throughout all continents. However, when talking about their business behavior or economic culture, people generally refer to the overseas Chinese communities in East Asia, basically including those Chinese in Hong Kong, Macau, Singapore and Taiwan, as well as those ethnic Chinese in Thailand, Malaysia, Indonesia, and the Philippines. Among them, Singapore and Taiwan are two members of the four “dragon economies”. Hong Kong is praised as an economic miracle. These three plus Macau are seen as Chinese in terms of population, economy and politics. In the other mentioned Southeast Asian countries, ethnic Chinese account for a significant proportion of the population and, moreover, become an important power in these economies.

The dynamic economic growth and the impressive economic performance of East Asia over the past two to three decades put the overseas Chinese communities in the region under the spotlight. Recently, the overseas Chinese approach to corporate governance has attracted more and more attention. It is found that the overseas Chinese approach to

corporate governance is utterly different from all the other influential models. It contradicts orthodox economic theories and principal corporate governance models.

It is the general rule that firms will grow in scale, and the growth will demand pooling public wealth and professional managers, and will inevitably and eventually transfer the managerial power to salaried professionals. However, the story is different in the case of overseas Chinese companies. It is a tendency that the average size of overseas Chinese companies has been consistently stable or dwindling. The general picture is that overseas Chinese companies are small scaled, relatively simple in organisational structuring, and normally focused on one product or market. They are usually family owned, controlled and managed. People have seen that for retaining family domination, these companies would rather sacrifice scale economies and avoid massive manufacturing and capital intensive projects. Yet, they have produced and are still producing impressive economic performance, which fascinates many scholars.


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THE OVERALL PICTURE

The existence of the Chinese population in East Asia outside the territory of Chinese sovereignty is the result of hundreds of years of immigration. Most of these overseas Chinese have an origin in the coastal provinces of Southern China, the most commercially active place in traditional China. They left China in waves following the events of economic downturns, political turmoil and wars. Initially, they had comparative advantages in commercial skills over indigenous residents. Over years, they have had startling economic success. It is estimated that, with around 40 million people, the overseas Chinese in East Asia generate an GDP equivalent of about US$450 billion. In the meantime, they have basically preserved their Chinese identity or Chineseness, which, in turn, provides a basis for generalising their business behavior, as well as analysing the reason for their economic success. In recent years, a literature on overseas Chinese business culture has grown rapidly. It is found that the success of overseas Chinese business largely lies in the effective utilisation of family firms and networks.

While family firms and networks constitute the dominant characteristic of the overseas Chinese economy, it is everyone’s question why overseas Chinese cling to these


885 See East Asia Analytical Unit, Overseas Chinese Business Networks in Asia (1995), 1.


887 See East Asia Analytical Unit, Overseas Chinese Business Networks in Asia (1995), 1.
practices. The search for the internal and external causes of the practice has gone beyond economic rationality and come into cultural and historical context.

There are deep cultural roots responsible for the family centred corporate system of overseas Chinese communities. Traditional China endeavoured to establish an order of social behavior and an internal balance of the economy. The government chose to promote ethical rituals, instead of legal rules, to guide social conduct for the purpose of maintaining social order.\textsuperscript{888} Confucian political philosophy was the source of the ethical rituals. It designed a set of role-related rules for different people to follow.\textsuperscript{889} Families were seen as the basic units of establishing Confucian social order. By establishing family order and relative behavioural principles, everyone was put in a web of relationship-rules which provided immediate judgement on individual’s behavior.\textsuperscript{890} A person’s identity was inseparable from his family. The family had an influence on his social status and his good or bad deeds would have an impact on the family.\textsuperscript{891} In a family, the father was the centre and authority. His authority was based on his obligations and role-related behavior. His role would bring internal coherence to the family.\textsuperscript{892} The children’s conduct was guided by the rules of filial piety. As a result, a sense of dependence between families and individuals was developed. In traditional China, this “familism” penetrated every aspect of social life, including business behavior.


\textsuperscript{889} See Qu Tongzu, \textit{Law and Society in Traditional China} (1961), 236.


\textsuperscript{891} \textit{Ibid.}

\textsuperscript{892} \textit{Ibid.}
Commercial activities did not find blessing in Confucian doctrines. They were regarded as a rejection of the Confucian standard of social behavior such as balance, reasonableness, and instinctive benevolence. The old saying "no merchants without tricks" reflected the general sentiment toward business people. Therefore, virtue was associated with agricultural work, and supremacy went to scholar-gentlemen type mandarins. Merchants were excluded from social elite groups. With little political power and legal protection, their survival and fortune depended on the policy of the government. Taxes and licence fees might be increased and trade restrictions might be imposed at anytime if the government felt justified. Hence, the knowledge of uncertainty and insecurity of the outside environment persisted. Under these circumstances, Chinese merchants understood that they had to look after themselves and rely on an institution that they could depend on, that was their families, which might be further extended to include an informal business network. This was a system that they could control and its stability would not be affected by outside environmental changes. The established family rituals and mentality served the purpose of family business well. Business secrecy was kept within family members. Business was run paternalistically and efficiency was obtained through members' dedication and managerial flexibility.

When Chinese people drifted abroad, they brought their business instincts with them. The new environment did not offer them more security. If they were not hated because

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893 Ibid, 122.
894 Ibid, 36.
895 Ibid.
they were businessmen, they were resented because they were Chinese. Repeated massacres happened through the centuries, in the hands of Dutch colonizers, the Japanese and the locals in Indonesia, Malaysia and the Philippines. Furthermore, the political and legal infrastructures in these systems were inadequate to sustain normal business activities. Under such hostile circumstances, Chinese business people intuitively clung to their traditional business strategy, the owner controlled family business. Usually, business was carried out in a network where families with long-term cooperative relationships seek long-term mutual gains. The business network mitigated the disadvantages such as lack of resources and outlets, which happened to single firms. Under such a harsh environment, the overseas Chinese business people also learnt to conceal their success. They resorted to taking a low profile business strategy, by avoiding huge organisational operations and operating at lower channels of distribution. They are usually found in the operation of making components for others, sub-assembling, wholesaling, financing, sourcing and transporting.

After the Second World War, a genuinely supportive environment for entrepreneurship has gradually been established in East Asia. However, political uncertainty and racial tension still exist in many areas of the region. There is also the


899 Also see East Asia Analytical Unit, Overseas Chinese Business Networks in Asia (1995), 125.
element of inertia. The overseas Chinese may prefer to continually follow their traditional business practice. There has been no reason for them to disdain a business culture which has turned out successful.

THE FAMILY ORIENTED BUSINESS

Apart from the social environment and cultural preference, Chinese family owned firms have certain advantages in term of economic efficiency. An important operational advantage of a family owned firm is fast decision making. It derives the efficiency of corporate governance from intense managerial dedication, decision-making flexibility, and creating a working environment which matches the expectation of employees from the same cultural background.901

A typical Chinese family owned firm does not separate ownership from management. This is seen as essential to the long-term family prosperity. The dominant executive comparatively has a greater authority and a greater personal role to play, which enables him/her to make efficient, effective and fast moves in a fast changing environment.

The relationship between management and employees is paternalistic. An overseas Chinese firm usually recruits its employees from ethnic Chinese, sometimes clan members. With the same cultural background, a role-oriented relationship is well understood by both the employer and employees, which strongly encourages the

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901 Ibid, 3.
employees’ loyalty to the firm.\textsuperscript{902} The employer is keen to provide a paternalistic organisational climate and is willing to play a supportive role in the needs of the employees.\textsuperscript{903} The practice is further enforced by promotion through seniority.\textsuperscript{904} Hence, the working environment and the governance structure of a Chinese family owned firm is favorable for cultivating the long-term attachment and loyalty of the employees to the firm.\textsuperscript{905}

The overseas Chinese have sufficiently exploited the economic efficiency of the family owned enterprise. However, with further economic development, it is hard to say that the choice is optimal. The most obvious weakness of a Chinese family firm lies in its incapacity to undertake large-scale production and its lack of stability. A Chinese family owned enterprise may face the problem of further finance, thus has limited capacity of expansion. The highly personalised decision making structure usually limits the business to be carried out in one particular field.\textsuperscript{906} Moreover, when the ownership and control of the business is vested in family members, there is the possibility that the business will split into smaller sized firms.\textsuperscript{907}

\textsuperscript{902} See East Asia Analytical Unit, \textit{Overseas Chinese Business Networks in Asia} (1995), 133.


\textsuperscript{904} See East Asia Analytical Unit, \textit{Overseas Chinese Business Networks in Asia} (1995), 133.

\textsuperscript{905} Ibid.


In addition, many Chinese family firms see non-family executives as a threat, and thus cannot embrace the idea of hiring competent professional managers. A family may not be able to supply management talents to ensure business continuity. The business may shrink when senior business talents depart from the firm. For instance, many firms are dogged by the third generation problem. It seems that while overseas Chinese entrepreneurs enjoy their current success generated by family oriented business, they are facing the challenge of future growth and sustainable development.

It is noteworthy that family business exists in every economy, and close holdings are a common phenomenon in many corporate systems and other overseas communities, because retaining control is a natural desire. What distinguishes overseas Chinese family firms is their uniqueness of combination of features, that is “the cultural heritage which leads to such characteristics and which permeates the way they operate in practice.” For instance, many cultures foster paternalistic organisations. However, the Chinese form of paternalism is unique. In overseas Chinese family firms, paternalism is combined with strategic flexibility, and with cost-sensitivity, and with environmental networks, and with narrowness of focus. Furthermore, these firms are prepared to adhere to the practice of family business even at the expense of further expansion.

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909 Ibid.
910 Ibid, 206.
911 Ibid.
THE OVERSEAS CHINESE NETWORK

Overseas Chinese family enterprises operate in personal networks. They link strongly but informally with related but legally independent organisations handling key functions such as parts supply or marketing. Business networks have been an important factor in determining overseas Chinese business success. As a family owned enterprise is likely remain small and operate in one field, a network of mutual supporting firms ensures a reciprocal business advantage.

Doing business through business networks can also find its roots in Chinese culture and history. In traditional China, the practice of facilitating a market economy through state created and legally protected institutions did not happen. Instead, a culture of regulating market behavior through self-regulated kinship and commercial associations was established. Unlike Western organisations, a Chinese business organisation was basically a network with no formal boundaries and people were linked together through social relationships. Through these business networks, the complexity of transaction was mitigated and people could invest in a range of businesses. With the expansion of Chinese business, the business networks expanded to East Asia.

As mentioned, the boundary of a business network is ambiguous. For different purposes, it can link members of family lineage and can also extend to include people from the same region or speaking the same dialect. Hence, the network relationship needs

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to be redefined all the time. The informal and flexible business network functions through personal trust and ethical obligations. 914 There are adequate reports on how a great deal of importance the Chinese business people attach to their business reputation and personal honor. 915 In a Chinese business network, breach of obligations may result in massive damage. 916 This, in turn, provides discipline and moral justification to the system.

In relation to economic rationality, an overseas Chinese business network is an institutional species of informal cooperative business strategy. The business network is an economic device that is allocated between the market and the firm for the purpose of achieving greater economic efficiency. Because the market is imperfect, there is a cost associated with the use of market. Firm production can reduce such a cost by internalising the transactions. However, expansion of the firm in some situations may increase organisational costs due to scale diseconomies and loss of control. The business network is, therefore, designed to cope with market failure and internal organisation failure. 917 Sometimes, transactions within the business network are more efficient than transactions through the market or transactions through the internal organisation of the

913 Ibid.
914 Ibid.
916 See East Asia Analytical Unit, Overseas Chinese Business Networks in Asia (1995), 5.
Hence, firms within networks have a better chance to reduce transaction costs and achieve greater allocative efficiency and competitive advantages, vis-à-vis other firms in the same market. The characteristic of the overseas Chinese business network lies in that they link together through social relationships and are without formal boundaries. There are two important forces that foster the system. One is the ethic of trust among the members of the network, and the other one is the relatively greater authority of the key actors.

CONCLUSIONS

The corporate practice of overseas Chinese communities has evolved as a distinct model. It is inspired by Western modern corporate concepts and adopts some traditional Chinese commercial activities, and thus provides as excellent example of adaptability and survival. It has achieved economic efficiency by using family owned companies and reduced transaction costs by using informal networks. The fact that the corporate practice contradicts orthodox economic theories and the principal corporate governance models adds extra glamour to their success and excites more and more research interest.

Ibid.


The success of the overseas Chinese firm illustrates the strength of the Chinese cultural heritage. The experience provides a useful reference for China’s enterprise reform. In the process of reforming the Chinese enterprise system, not only the cultural heritage needs to be taken into account, but also the power of cultural influences needs to be fully considered.
Chapter 16

THE CORPORATION AND CORPORATE GOVERNANCE IN SOME SELECTED COMMONWEALTH COUNTRIES

This chapter sets out to examine some key aspects of the development of corporation law in Canada, New Zealand and Australia. These three countries are selected because they are all British commonwealth countries and all subject to increasing US influence. Their corporate systems and corporate governance systems are in the big family of the Anglo-American system. In recent decades, these jurisdictions have carried out and are carrying out vigorous reform programs in relation to corporate law and practice, which bring further divergence and evolution within Commonwealth regimes. The increasing modernisation, communications and globalisation have been the driving forces behind these corporate reforms.922 A close examination of these corporate systems may provide an evolutionary insight in the course of studying corporate models and their development.

THE CANADIAN EXAMPLE

The Constitution of Canada grants the regulatory power over corporations to both provincial and the federal jurisdictions. According to the Constitution, each province has

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the power of making laws in relation to creation of companies with provincial objects, whereas the Federation has the power to make laws relative to the creation of companies with the right to operate throughout Canada. As a result, there are eleven corporate statutes in Canada, one federal statute and ten provincial statutes.

The corporate law and practice in Canada in the early stage was strongly influenced by English legislation and precedents. Before the 1970s, all provinces and the federal jurisdictions adopted corporate laws based on English corporate law model. Since 1967, Canada moved to modernize its corporate laws. In 1967, the federal government appointed Robert W V Dickerson to form a committee to study and report on corporate law. The committee produced Proposals for a New Business Corporation Law for Canada (the Federal Proposals) four years later. The Federal Proposals aimed at modernising Canadian corporate law, but not proposing a fundamental change in legislative policy. This was clearly stated in the Federal Proposals:

[W]e do not in this report have anything to propose which would fundamentally alter or replace the corporation as we know it. Although we are critical of (and propose changes in) almost every corner of the field of corporation law, we have not invented a new legal creature.

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923 See s. 92(11) the Constitution Act 1982.
924 See s. 92(15) the Constitution Act 1982.
926 Ibid, 49.
928 See para. 5 of Proposals for a New Business Corporation Law for Canada.
The Dickerson Committee report was widely discussed and, in amended form, was introduced as Bills in Parliament, and was passed as the *Canada Business Corporations Act* (CBCA) in 1975. The CBCA made extensive and innovative amendments on Canadian corporate law.

Ghana's Companies Code 1963, drafted by Gower, and US corporate laws had a significant influence on the draft work of the CBCA. The CBCA codifies directors' duties and corporate dissolution, and recognises the validity of pre-incorporation contracts and one-person companies. Corporations are allowed to purchase their own shares. Unanimous shareholder agreements are valid. Mandatory authorised capital and par value are eliminated. Shareholders' remedies are widened. Partly-paid shares are prohibited.

The CBCA uses innovative approaches to eliminate the *ultra vires* doctrine and constructive notice. It abandons the concept of restricted corporate capacity built on the objects clause by stating that a corporation has the capacity of a natural person.929 Although a company may restrict its business by having provisions in its articles of incorporation, third parties are protected from any consequences of business restriction. A third party is not to have constructive notice of the company's restricted business for the reason that the restricted business is stated in its articles.930 Hence, the notion of restricted business is confined to the internal operation of the corporation. In other words, a corporation may impose business restrictions on itself by having prohibited provisions

929 See Section 15(1) of the CBCA.
in its articles. However, the restriction does not affect the validity of any action in breach of them.\footnote{Ibid.}

Another innovative reform made by the CBCA is to abolish the distinction between private and public corporations. Traditionally, the distinction served the purpose of enabling small business to use the corporate form without triggering much expense in compliance with the regulatory requirements designed for widely held companies. However, the traditional conditions designed to distinguish a private company from a public company were regarded as not adequate. For example, traditionally, the members of a private company were limited under fifty. It was argued that fifty was big enough for forming a public company.\footnote{See Frank Iacobucci, Marilyn L Pillinkton & J Robert S Prichard, \textit{Canadian Business Corporations: An Analysis of Recent Legislative Developments} (1977), 62.} Hence, the CBCA abolishes the traditional distinctions and replaces them with the criteria built on "functional rather than doctrinal grounds".\footnote{Ibid, 71.} As a result, the CBCA does not distinguish between the traditional private and public company with respect to certain matters and, for the rest matters, it makes the distinction in different ways for different purposes.\footnote{Ibid, 71-73.}

\footnote{See E Jacobs, "Conceptual Contrasts – Comparative Approaches to Company Law Reform" (1990) 11 \textit{Company Lawyer} 215, 215.}

\footnote{Ibid.}
Since the enactment of the CBCA in 1975, efforts have been made to harmonise the provincial statutes with the federal regime.\textsuperscript{935} Over years, provincial laws have been moving towards the federal model. However, divergence in details remains. A notable example is British Columbia which used to resist the change to the CBCA model but, later, embodied many features of the federal model and thus evolved into "an anomalous hybrid".\textsuperscript{936}

The geographic proximity with the US determined that Canadian corporate law would inevitably move closer to the US model. Canada adopted a mandatory securities regime which is "very much American in concept and approach".\textsuperscript{937} Although the law has move towards the US model, there are significant differences between the two systems relative to corporate governance.

An important difference is that corporate ownership structures of the two countries vary. Instead of dispersed shareholdings, most Canadian companies are controlled by a principal shareholder. Among the top 400 companies, 382 companies are controlled by a majority shareholder.\textsuperscript{938} Among the 100 largest companies only 15 are widely held by


numerous shareholders. The controlling shareholders, through board representation, have a powerful influence on corporate direction.

The concentration of corporate ownership structure in Canada, then, results in other differences of corporate practice. Some point out that because of the corporate ownership structure, Canadian corporate system has not fostered the competition among provincial and the federal jurisdictions for corporate charters, as the US system does. Since with voting control, management does not need statutory discretion to operate a firm “because it has the votes to change statutory default rules as it pleases”.

The concentration of ownership also affects the country’s corporate litigation patterns. The controlling shareholder has greater incentives to monitor managers for breach of the duty of care. Furthermore, with a controlling shareholder, the firm is not easily subject to takeover bids. Hence, the number of takeover disputes is small. These conditions reduce the need for access to the courts. As a result, two important shareholder lawsuits, derivative actions and class actions, are of little concern to the majority of Canadian companies. Hence, compared with the US law, the Canadian law does not provide great incentives for shareholder litigation.

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939 Ibid.
940 Ibid.
942 Ibid.
943 Ibid, 126-127.
In addition, unlike the US which exclusively confines the regulatory authority to the Federation, in Canada, there is no federal securities law, and each province has its own securities law. In sum, Canada looks to US law and practice as the model for its corporate reform. However, the Canadian situation does not necessarily resemble US experience.

The corporate law reform in Canada has had a far-reaching affect in other jurisdictions, especially some Commonwealth countries. It was used as a model by New Zealand for its corporate law reform in the late 1980s and the early 1990s. However, given many innovations of Canadian corporate law, the Canadian corporate system is still accommodated within the Anglo-American corporate system, as the following remarks stated:

[T]he new corporations legislation ... Does not challenge the traditional assumptions that the object of the business corporation is the maximization of profit and that the role of corporations stature should be to enable it to do so in a fair and effective manner. The statutes require that decisions and actions taken on behalf of the corporation be taken in accordance with and in the best interests of the corporation. They impose no obligation to act in the public interest, whatever that might be, apparently assuming that the public interest in a free enterprise economy is best served by the pursuit of profit.  

Canada has three important codes of corporate governance in relation to self regulation. The first one is Where Were the Directors: Guidelines for Improved Corporate Governance in Canada (Dey Report) by Toronto Stock Exchange Committee on Corporate Governance in Canada. The second one is Corporate Governance Standards by Pension Investment Association of Canada (PIAC) which represents 47 public pension funds and 78 corporate pension funds. The third one is The Governance

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944 Ibid, 9.
Practices of Institutional Investors (Kirby Report). After the release of the Dey Report in 1994, Toronto Stock Exchange (TSE) made a requirement for all TSE listed companies to file public documents showing how they are complying with the guidelines for corporate governance put forward in the report.\textsuperscript{945} If a company chooses to not comply with guidelines, it must state why. The Kirby Report recommended that the same degree of disclosure in the Dey guidelines should apply to all mutual funds in Canada. Hence, Dey guidelines should be adhered to by all mutual fund companies in Canada.\textsuperscript{946}

**THE NEW ZEALAND EXAMPLE**

Before the 1990s, New Zealand corporate law closely followed the UK model.\textsuperscript{947} New Zealand Companies Acts 1933 and 1955 were essentially a local version of English Companies Acts 1929 and 1948.\textsuperscript{948} Although some suggested that some defective aspects of the English Acts should not be perpetuated in New Zealand, the view of making improvements was dismissed on the ground that uniformity within British Commonwealth should be obtained as far as possible, so that decisions of English Courts should be applicable in New Zealand as they are in England.\textsuperscript{949} It was further explained:

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\textsuperscript{946} Ibid.


If the criticisms of the imperial Act, made in text-books, legal journals, and elsewhere, prove to be well-founded and substantial, they will inevitably be followed by amending legislation in England, and it will then be a simple matter for the New Zealand Legislature in its turn to adopt those amendments.950

In 1978, New Zealand had opted to follow the Australian Uniform Companies Acts,951 but inspired by North American corporate and securities legislation, it enacted a separate securities law. These were the first important moves to break with the English legislative tradition. By 1986, the view that it was necessary to comprehensively reform the corporate law became widespread in New Zealand.952 In searching for a model for the corporate reform, the New Zealand government, in spite of the Closer Economic Relations Agreement with Australia, rejected the model of the Australian Companies Code 1981 as too complex and favored the Canadian models of the CBCA and *Ontario Business Corporate Act* which “represent a half way house between the UK and the US models”.953 In 1987, the New Zealand Law Commission published a discussion paper with proposals of overhauling the company law. In 1989, the Commission produced its first report on company law, which contained a draft Bill. The report stated its reform policies for the company law:

- provide a simple and cheap method of incorporation and company organisation which is flexible enough to meet the needs of diverse organisations

950 Ibid.


• clearly identify the duties and powers within the corporate structure in an Act designed for use by directors and shareholders and not just lawyers and accountants

• provide for better accessibility to company law by setting up the Act as the statement of first recourse in identifying rights and duties within the company

• ensure that regulation to prevent abuse is appropriate (that is to say, directed at the abuse of corporate structure of limited liability) and is commensurate with the risk of abuse so as not to frustrate the economic and social benefits of the company form

• maintain and build upon a distinction between the aims of company law and securities law: company law being concerned with the incidents, benefits and abuses of the corporate form; securities law having a wider concern with the integrity and efficiency of capital markets.954

In the draft Bill, the concepts of par value and nominal capital were proposed to be abolished. It enabled companies to buy their own shares or finance the acquisition of their shares. Directors’ duties were fully codified. A comprehensive system for protection of minority shareholders was established. Minority shareholders were given the rights of buyout where class rights are affected. The Bill also simplified the liquidation rules. After other three years’ work, a Bill was introduced in Parliament late 1990 and resulted in the enactment of the Companies Act 1993 (NZ). The new law came into effect in July 1, 1994. It allowed a transitional period for existing companies which may chose to continually operate under the 1955 Act until mid-1997.

Under the Companies Act 1993, incorporation becomes simpler and faster. Rules relating to company names and amalgamations of companies have been greatly simplified. Majority shareholders are given greater freedom to make decisions, while

minority shareholders are given wider remedies. Many uncertain areas including shareholders’ derivative suits and indemnities given by companies to the directors are clarified. It is clear that the new corporate law of New Zealand strongly reflects the North American influence, as the Report No 16 of New Zealand Law Commission states:

The Model Business Corporations Act [was] of great assistance, as was the work of the Dickerson report which preceded the Canada Business Corporations Act.955

However, the departure from the English tradition has created wide differences between the New Zealand company law and Australian company law. The two neighbors entered into an agreement in 1988 to harmonise their commercial laws. When New Zealand made radical departure from the English tradition, Australia was still clinging to its “idiosyncratic version of the English company law model.”956 However, this did not affect New Zealand’s determination. After the enactment of 1993 Act, there were widely expressed feelings in New Zealand that “we have been spared the English and Australian models”.957 Hence, it has become clear that it is up to Australia to make efforts to narrow the gap between the two corporate regimes.

As a small country, the New Zealand corporate governance system is based on relatively close contacts and relationships. Institutional investors are well received by corporations.958 The law requires directors to purchase shares in the company, in an

955 See New Zealand Law Commission, Company Law Reform: Transition and Revision, Report No. 16 (September 1990), xvii.


amount pre-determined with the company, before appointment.\textsuperscript{959} The reform program has put emphasis on improving the disclosure of directors' outside interests and corporate performance.\textsuperscript{960} The Institute of Directors of New Zealand Inc has recommended the \textit{Statements of Best Practice} for member directors as a standard for good corporate governance.

\section*{THE AUSTRALIAN EXAMPLE}

Before the formation of the Australian Commonwealth, each Australian state had its own company law. Most of the states' company laws were modeled on the British \textit{Companies Act} 1862.\textsuperscript{961} Among the States, Victoria was the most innovative in terms of corporate legislation. It introduced the no liability mining company in 1871\textsuperscript{962} and compulsory auditing and financial information requirements for public companies in 1896\textsuperscript{963}.

In 1901, the Commonwealth was created under the Australian Constitution. The ambiguity of the Australian Constitution on the Commonwealth's power over corporations resulted in lack of uniformity of corporate legislation in Australia before 1978. Also, it has added complexity to the corporate legislation and operation of the country.

\begin{thebibliography}{99}
\bibitem{Footnote 959} Ibid, 318.
\bibitem{Footnote 960} Ibid.
\bibitem{Footnote 962} See \textit{Mining Companies Act} 1871.
\bibitem{Footnote 963} See \textit{Companies Act} 1896, s. 24.
\end{thebibliography}
According to the Constitution, the Commonwealth has those powers specified in section 51 and the states have the residual or remaining powers. The power of regulating corporations is not among those specified powers. However, section 51(xx) states that the Commonwealth has the power over foreign, trading and financial corporations. This is the troubled starting point. Whether the power includes creation of corporations and how to define a trading or financial corporations are not clear.

In 1909, the High Court decision in *Huddart Parker & Co. v. Moorehead*[^964^] adopted a narrow interpretation of the power in section 51(xx) as not including the creation of corporations. As a result, the power of regulating corporations was basically left to the states. The divergence of the states’ corporate laws created inconvenience and inefficiency for interstate commerce.[^965^] Since the 1960s, efforts to coordinate corporate legislation were made by the states. Since the 1970s, a cooperative scheme was developed by the Commonwealth and the states. In 1962, the *Uniform Act* came into force. Then, a scheme of making Commonwealth corporate legislation without the cooperation of the states was proposed and developed. A national *Corporations Act* was passed in 1989. However, the High Court challenged the Act on constitutional grounds in *NSW v Commonwealth*[^966^] in 1990. Following the High Court decision, the commonwealth and the states reached an agreement to adopt the uniform legislation. The national scheme was made operational in 1991.

[^964^]: See *Huddart Parker & Co. v. Moorehead* (1909) 8 CLR 330 at 354 per Griffiths CJ.


The *Corporations Act* 1989 has been regarded as one of the most complex and detailed corporate statutes in the World.\(^{967}\) Professor John H Farrar has said that “it stands as an obese monument to complexity and confused thinking”.\(^{968}\) The legislative complexity provoked a simplification program in the 1990s. In 1995, the *First Corporate Law Simplification Bill* 1994 was passed. Provisions concerned share buy-back were simplified. The creation of one-person companies was permitted. The notion of small proprietary company was introduced to replace the complex notion of exempt proprietary company. The requirements relating to company registers were also simplified. However, despite these changes, the Bill was still regarded as a move to catch up UK legislation.\(^{969}\)

At the time of enactment of the *First Corporate Law Simplification Bill* 1994, the *Second Corporate Law Simplification Bill* was introduced for comment. With the Coalition’s election, the Bill was replaced by a new Bill, the *Company Law Review Bill*, in 1997. Half a year later, the *Company Law Review Act* 1998 came into effect. It was followed by the *Corporate Law Economic Reform Program Act* 1999 (CLERP Act).

Under the new legislation, procedures for incorporating and operating a company have been greatly simplified. The memorandum and articles of association have been

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abolished and replaced by the constitution.970 The shareholders’ meeting of the proprietary company is simplified. Par value is abandoned.971 Reduction of capital and share buy-back become easier. Prohibition against a company to give financial assistance for acquisition of its own shares is relaxed. A business judgement rule is adopted together with revised provisions concerning directors’ duties of care and related areas.972 Requirements on financial reports are reduced considerably. Companies can now chose to give full or concise annual reports for sending to members. The new legislation makes it possible that proprietary companies may raise funds from the public under certain circumstances. As a result, traditional distinctions between a public company and a private company are becoming blurred.973

From the above discussions, one should have little doubt that the Company Law Review Act 1998 and the CLERP Act have sought for their sources of inspiration in the New Zealand corporate law and North American corporate laws. Consequently, Australia has taken a significant step forward to embrace the North American style corporate law. The new legislation aims to improve market freedom, information transparency, cost effectiveness and regulatory neutrality and flexibility, so as to foster an environment

970 See s. 136 of the Company Law Review Act 1998

971 Ibid, s. 254C.


which encourages high standards of business practice and ethics. However, more improvement is required in relation to departing from the complex style of legislation. Professor John H Farrar has made insightful comments on the latest Australian corporate law:

The policy is sound; the implementation unsound, still relying on piecemeal reform and an overtechnical style of drafting. The result has been further complication but some sporadic attention paid to the clearer and simpler New Zealand reforms which were more comprehensive in scope. CLERP continues now as the latest reform juggernaut, trampling other reform proposals in its path. It is only a capacity for endurance by the business and professional communities and an ability to cope with endless, often gratuitous, change which makes a poor system work with moderate efficiency but at considerable expense.

It is noteworthy that institutional ownership in Australia is significant. Most large financial institutions own an average of two to ten per cent shareholdings in most of the largest companies. Labor affiliated directors are found in many government funded companies, the result of powerful labor unions in the country.

Australia has a developed self regulation regime. The Stock exchange of Australia (ASX) through its listing requirements in the ASX Listing Rules and the statements of accounting practice, sets up governance standards for listing companies. Meanwhile, Australia has an equivalent of the UK Cadbury, Greenbury or Hampel Reports,

974 See CLERP A.
977 Ibid.
"Corporate Practices and Conduct" (CPC). The CPC is concerned about reviewing board functions, giving guidance to listing companies for compliance with ASX requirements and giving advice to directors on governance matters. In addition, the association for the major investment organisation in Australia, the Investment and Financial Services Association (IFSA), recommends the *Corporate Governance – A Guide for Investment Managers and Corporations* to its members, which provides the framework of a sound approach to corporate governance for the investment community.

**CONCLUSIONS**

The corporate reforms carried out in the above jurisdictions illustrate the trend of corporate development, while different systems move towards convergence, variations always remain. Commercial globalisation and economic integration bring pressure on corporations and corporate systems. Every system faces the task of making its corporate law and practice more economically rational and user friendly in the changing environment. It is against this background, these countries initiated their corporate law reforms. Although the reform goals of these countries were comparable, their different

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979 Ibid.

980 Its predecessor is the Australian Investment Managers' Association (AIMA).

corporate development paths decided that they chose different strategic approaches to reform their corporate systems. This, in turn, affected the reform outcomes.

Their experience is valuable to China. At the time of transitional development, China needs to pay attention to these jurisdictions for dynamism and innovation. China's company law maintains many traditional provisions, such as par value, the *ultra vires* doctrine, and the memorandum and articles of association. In the meantime, it is ambiguous in many areas including directors' duty of care and shareholders' remedies and lawsuits. For future corporate law reforms, it is beneficial for the Chinese to make a close examination of these reform experiences.

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PART FOUR

DESIGNING A CHINESE CORPORATE GOVERNANCE MODEL
Chapter 17

THE DETERMINANTS WHICH SHAPE THE DEVELOPMENT OF A CORPORATE GOVERNANCE SYSTEM

The main task of Part Four of this thesis is to address the issue of what kind of corporate governance system is best for China at its present stage of development. Two elements determine the rationality and comprehensiveness of the proposed model of corporate governance: The economic rationality and developing path of the Chinese enterprise system. The former requires building an economically efficient institutional framework. The latter requires that institutional changes need to take China's particular conditions, including economic, political, cultural, historical, and legal conditions, into account. To design a desirable model of corporate governance requires balancing the two elements. It is essential that the proposed model possesses the qualities of high efficiency and low cost. The research will be carried out in the following sequence:

Chapter 17 examines the important determinants which shape a corporate governance system. Chapter 18 discusses the necessity of enhancing macro-economic policy support in the process of improving corporate governance. This is because any enterprise reform without macro-economic policy support runs the risk of being self-defeating. Hence, in the course of the enterprise reform, China needs to further improve its market economy framework, so as to establish a competitive business environment which fosters good corporate governance. Based on this, chapter 19 proceeds to analyse the current practice
of corporate governance in China and examine the limited literature on the issue of a desirable corporate governance model for China. In doing so, the governance problems existing in the current Chinese enterprise system are identified and possible solutions are proposed. A general argument about a suitable Chinese corporate governance model is advanced. Then, in chapter 20, the future development of the Chinese corporate governance system is analysed. This gives a clear idea about whether the ideal model proposed in chapter 19 may be consistent with the design of future enterprise reform in China.

The systems of corporate governance are divided by national boundaries. A corporate governance system concerns a set of commonly accepted and understood business behaviors in relation to directing corporate activities in a society. These business behaviors are developed in the particular economic, political, legal and cultural backgrounds of that particular society. In other words, the evolution of a corporate governance system does not happen in isolation. It interacts with the development of other social systems. Hence, the formula of a corporate governance system is usually the outcome of interaction and interdependence among a number of social forces. In reality, based on different styles of capitalism and cultural and legal traditions, different systems of corporate governance have developed their distinctive characteristics. Economic reality, politics, culture and legal tradition all play important roles in molding corporate governance systems. Therefore, in the course of seeking a practicable model of corporate governance, it is important to identify and examine these economic, political, and cultural determinants that play a consequential role in shaping a corporate governance system. This helps us to gain an understanding of whether the proposed corporate governance
system in chapter 19 will fit in the Chinese social context or how far Chinese society can
go to adapt itself to a corporate governance system which is supposed to produce
economic benefits at a low social cost.

THE ECONOMIC DETERMINANT

The economy has always been the major driving force of corporate development. Firstly,
it shapes the general direction of the development of corporate governance. Corporate
history has illustrated this fact. When technological development enables firms to
manufacture at an ever large-scale and the industrial sector becomes the major
contributor to national wealth, there is a need to pool large amounts of capital to facilitate
the operation. A wide range of investors are invited to invest in firms. The increase in the
number of investors makes the traditional owner/management relationship unworkable.
The intensification in specialisation requires professional managers’ contribution in
corporate management. These result in the separation of ownership and control. When
this happens, the conflict between supervision and management becomes real. This is
about whose interests the corporation is run to further and in whose interests the
corporation should be run.982 This is the core issue of corporate governance of all
corporate systems.983

Secondly, the economy acts as the main factor in determining the characteristics of
each individual corporate system. The variation of economic conditions in different

982 See Philip L Cochran & Steven L Wartick, “Corporate Governance – A Review of the Literature”, in
countries makes individual corporate governance systems adopt different strategies of corporate governance. First of all, the economic situations of different countries at the initial stage of corporate development caused these countries to adopt different approaches to develop their corporate economies. For example, as the earliest industrialised country, the UK followed the path of gradualism and freedom of trade in the course of building its corporate economy. However, the corporate development in those late industrialised countries such as Germany and Japan, usually happened in a more organized fashion. This is because, as the earliest industrialised country, the UK could afford a gradual process of corporate evolution. However, to a late comer to industrialisation who faced tougher competition, the success of the business, especially at the initial stage, relied much more on the government’s financial support and policy guidance. In the UK, at the early stage of corporate development, the company was seen as a means of increasing investors’ wealth. However, in a country like Germany or Japan, the company was seen as an instrument of advancing the national economy. This more or less reflected a catching up mentality of a late comer.

After the initial stage, a country’s economic base decides the structure of its corporate system. A country with a strong economy and a great industrial strength is more capable of fully exploiting the economies of scale and operating capital intensive industries. Such an economy is more likely to nurture large corporations with numerous investors, employees and executives. In these corporations, the control problem caused by

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983 Ibid.

984 Large manufacturing works applying the new technologies can produce at lower unit costs than can the smaller works. See Alfred D Chandler, Scale and Scope, The Dynamics of Industrial Capitalism (1990), 8.
separation of ownership and management is more acute. The USA and the UK fall into this category. However, a country of limited national wealth and feeble technological and industrial foundation tends to be restricted in relation to developing large-scale corporations. Most corporations in such an economy are likely to be closely held. These corporations, usually, are not troubled by the separation of ownership and control but by shortage of capital, difficulty of cash flow, and restriction of further expansion. As a result, countries have different priorities when coping with different corporate problems.

However, the patterns are not always followed elsewhere. For instance, although Germany has developed a strong corporate economy like the USA, the ownership of its large corporations is not so dispersed as US companies. Hence, the separation of ownership and control is not a major issue of corporate governance in Germany, and likewise in Japan. The fact that countries with a similar economic base do not necessarily generate the same organisational problems and solutions, tells us that the economic factor cannot alone explain the difference of corporate governance systems. There are other determinants shaping the features of a corporate governance system. These determinants have been identified by recent studies. They are, chiefly, politics, culture and legal traditions.

**THE POLITICAL DETERMINANT**

The study of political economic theory shows that the political attitudes of a country can deeply influence the ways of organising the nation's financial institutions so as to determine the corporate ownership structure of its large firms. By analysing the role of financial intermediaries in the USA, Germany and Japan, the three wealthiest nations of
the world, Mark Roe explained why the ownership structures of large public companies in the three countries are different. He attributed the dispersed ownership structure in large US companies to the fact that American politics has deliberately fragmented financial institutions, their portfolios, and their ability to aggregate stocks into influential voting blocks. The federalism of America has historically fostered small and fragmented banking. To protect local banks, every state has excluded branches of banks of other states. A national wide banking system has never been really established. Thus, banks' ability to facilitate large corporations is limited. Banks' capacity to make equity investment is further weakened by extensive deposit insurance. As a result, large companies of the USA cannot obtain the vast amount of equity capital from banks and have to pool the capital from scattered investors. The dispersed ownership thus shifts power of control from investors to managers.

In contrast to the US case, financial institutions in Germany and Japan have been the important financiers of their firms. In Germany, the law allows banks to enjoy a high degree of independence. German banks have developed close ties with industrial companies and have been entrusted for a wide range of services for the companies. They usually control big blocks of stocks in the companies by direct shareholding. In addition, the banks' voting power is further strengthened by proxies which have traditionally been

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986 Although the USA did set up national banks at the end of 19th century, the power of those banks was restricted by law.

987 See Article 14(2) of the German Constitution.
entrusted to them by other shareholders.\textsuperscript{988} As a result, German banks usually vote more than 10\% of the stocks of a large company.\textsuperscript{989} The role of German banks in supplying capital to large firms has moderated their need to raise funds from outside investors. Therefore, the shareholdings of German companies are comparatively concentrated. With some significant voting power, the financiers, usually the banks, are able to influence the board of a company. The agency problem caused by the separation of ownership and control thus does not constitute the major concern of corporate governance in Germany.

The ownership structure of large Japanese companies is similar to that of German companies, where financial institutions hold concentrated blocks of voting rights and share power with managers. A Japanese corporation usually belongs to a \textit{keiretsu}. A \textit{keiretsu} is a group of companies and financial institutions bound together by cross-shareholdings.\textsuperscript{990} In a \textit{keiretsu}, banks, as the major financiers, are the core of the group.\textsuperscript{991} They hold big blocks of shares of other companies. Typically, the largest bulk of shareholdings of a Japanese company are concentrated in the hands of a few shareholders.

\textsuperscript{988} There are some reasons for German shareholders to authorise banks to deal with shares for them. For example, most German shares are in the form of bearer with required to be presented when receiving dividends and banks are regarded to have the ability to deal with shares at the best price. See Jonathan Charkham, \textit{Keeping Good Company, A Study of Corporate Governance in Five Countries} (1995), 38.


\textsuperscript{991} See Kenichi Miyashita & David W Russell, \textit{Keiretsu, Inside the Hidden Japanese Conglomerates} (1996), 9
who are either banks or other related companies. Concentration characterises the pattern of ownership structure of Japanese companies.

A comparison between American corporate structure on the one hand, and German and Japanese corporate structure on the other, shows that similar economies do not necessarily produce similar corporate ownership structure. The political preferences of these countries in relation to the role of financial institutions have significantly diversified the ownership structure of their large corporations.

THE CULTURAL DETERMINANT

Culture has a significant influence in molding a corporate governance system, because corporations are run by people who are shaped by different cultures. Redding points out that "economic explanations are more convincing if they acknowledge culture". The economic actors of the same culture share their common beliefs of behavior norms and values. As a result, cultures have an effect in molding preferences in favor of certain forms of corporate governance. Corporate development in Japan can be an example. When talking about Japanese corporate governance, one may summarise a few distinctive characteristics including "groupism", "familism", lifetime employment and the ideology that a corporation should be motivated towards national service rather than profit maximisation. These characteristics have deep roots in Japanese culture.

992 Ibid.
994 See Hiroshi Hazama, "Industrialisation and Groupism", in Keiichiro Nakagawa (ed), *Social Order and Entrepreneurship* (1977) 199, 199-223. Also see Johannes Hirschmeier, "Entrepreneurs and the Social
Traditional Japan was a feudal society with well-established social order under Confucian doctrines.\textsuperscript{995} Two basic moral principles formed the essence of Confucianism, loyalty to the emperor and filial piety. Loyalty to the emperor equaled loyalty to the nation, and filial piety required one's commitment to the family. Loyalty and filial piety as basic moral tenets pervaded all kinds of social relationships, such as teachers and students, masters and servants, and communities and individuals. They formed the traditional value system in Japan.\textsuperscript{996} A Japanese person saw himself as responsible for the continuity of the family and the group of which he was a member.\textsuperscript{997} Profit making through business did not fit into traditional values. Therefore, business people had to defend their morality by declaring that the aim of their business activities was to promote the continuity of the family or the firm but not simply to make profit (although making profit was crucial to the continuity of the family or the group).\textsuperscript{998} The norm predominated the traditional business form, house (le). At the time of industrialisation, the ideology was developed to promote business activities in the interests of the nation.\textsuperscript{999} Loyalty and filial piety were directed to companies. The continuity of the company became the goal of all corporate players. As a result, the Japanese corporate governance reflects strong cultural influence.

Order: America, Germany and Japan, 1870-1900”, in Keiichiro Nakagawa (ed), Social Order and Entrepreneurship (1977) 3, 3-41.

\textsuperscript{995} See Rodney Clark, The Japanese Company (1979), 25.


\textsuperscript{997} Ibid, 203.

\textsuperscript{998} Ibid, 207-209.
Thus, in a modern Japanese company, it is generally perceived by both managers and employees that the goal of the business is to pursue the continuity of the company. Speaking from this point of view, there should be no conflict of interest between management and employees, but a coincidence of interest. A strong company-consciousness thus developed among employees and managers. Managers are to be promoted from employees. Shareholders are investors but not controllers. The priority of the board is to pursue the continuity and long-term interests of the company, instead of maximising shareholders' profits. The board is an insider board appointed from management ranks.

The evolution of overseas Chinese business firms in the Pacific Region is regarded as another prominent example where culture has paved a different path for corporate governance. Corporations of overseas Chinese in Hong Kong and other jurisdictions of the region are typically family centred and small. A typical overseas Chinese company is family owned and with owner entrepreneurship. The company may be a

1000 See Hiroshi Hazama, "Industrialisation and Groupism", in Keiichiro Nakagawa (ed), *Social Order and Entrepreneurship* (1977) 199, 212.
1001 Ibid.
1004 Data shows that most firms in manufacture sector have a workforce which is fewer than 100 employees. The firms owning more than 500 employees only count for 10% of the total workforce in the sector. See *Hong Kong Monthly Digest of Statistics*, June 1987.
public company. However, family control is maintained by restricting outside equity to a minority voting power, inviting equity investment by other family companies and family individual members, and by cross holdings or cross directorships with related companies associated with the family group.\textsuperscript{1005} In contrast to Japanese group oriented corporate culture, an overseas Chinese company is family oriented. The company is the property of the family and will be managed to advance the family's interests. Efforts have been made to retain family control even at the expense of further expansion.\textsuperscript{1006} In contrast to the trend of exploiting firms' economics of scale in other industrialised economic systems, overseas Chinese firms have consistently showed the tendency of dwindling in size.\textsuperscript{1007} Familism in these companies has become a barrier for increasing managerial effectiveness and for integrating employers and employees.\textsuperscript{1008} Despite the anomalies, overseas Chinese firms have achieved an economic miracle. The economic success presents a puzzling contrast between the governance model of overseas Chinese firms and the mainstream corporate theories and models, and demands an explanation.

Many believe that it is rational to partly attribute the persistent clinging to family-centric corporate practice by overseas Chinese firms to Confucianism which is deeply rooted in Chinese culture. At least, the Confucian familism evolved from the Chinese


\textsuperscript{1007} \textit{Ibid}.

\textsuperscript{1008} \textit{Ibid}.

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cultural tradition has assisted overseas Chinese entrepreneurs to find their own way of arranging corporate activities, which has led them to an economic success.

Recently, with the prevalent acknowledgement of "economic culture" and "embeddedness of economic action", an increasing interest in cultural influence over corporate behavior has been developed. The economic rise of East Asia has further excited the exploration. However, the cultural power to shape corporate systems should not be over estimated. After all, it is still economic development that determines the fundamental pattern of corporate economy and the corporate governance system. This view has been emphasized by some writers. For instance, in relation to cultural forces shaping Japanese corporate development, there is the following observation:

Culture was an essential element in the crucible of industrial change and contributed critically to the creation of an alloy that could bend and adapt itself admirably to a changing political-economic environment. But it was the conflicting interests of diverse stakeholders that were the hammer and anvil used to shape the final corporate form. In this regard, the modern Japanese corporation shares a heritage with corporations of other industrialised nations. It is, in the end, still an economic institution whose behavior is susceptible to explanation and prediction by models rooted in classical microeconomic axioms of purposeful, self-interested action by individuals. So too is its evolution.

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Moreover, cultural forces can be manipulated by politics. One may notice the importance of political promotion relating to cultural effect in the process of Japanese industrialisation. As a late industrialised country, Japan is a case of organised capitalism. It was the government's initiative to promote industrialisation at the early stage.\textsuperscript{1012} By creating a business class with administrative subsidies and guidance, the Japanese government had a strong influence in relation to promoting the business morality of advancing the national interest and other corporate behavior.

While knowing that the family oriented corporate practice in overseas Chinese communities has an origin in Chinese culture, one should also be aware that the unique political and social environments have played an important role in fostering overseas Chinese business behavior. Overseas Chinese entrepreneurs did not have the experience of being politically and financially supported by a government as their counterparts in most industrialised countries in Asia, at the initial stage. They went through a path of self-training and self-development.\textsuperscript{1013} In this process, family units provided the most reliable business environment. The family units promoted sobriety, education, the acquisition of skills and a sense of responsibility to contribute in tasks, job and other obligations.\textsuperscript{1014} With traditional values as the cohesive and strengthen force, family capitalism has been exerted to a degree of excellence by overseas Chinese business people. The shortcomings such as limited scale and negligence of human resources inherent to family firms were


considerably made up by informal business networks and other innovations. By exerting family business mechanisms, overseas Chinese entrepreneurs have proved their ability of adapting particular political, economic, geographic, and market environments to realise an economic gain.

One should also notice that family firms are not the unique practice of overseas Chinese. They have also been adopted by other overseas communities such as Italian and Jewish communities to build their empires of wealth. Similar political and economic position seems has generated similar business behavior. Hence, cultural preference has to fit in the particular political and economic atmosphere in determining the adoption of corporate structure.

THE LEGAL DETERMINANT

The corporate governance system is also influenced by legal traditions. The law of industrialised countries basically originated from two dominant legal traditions, the common law tradition and the civil law tradition. While the common law system is adopted by English speaking countries, most continental European countries and former socialist countries have civil law origins. To identify the differences of the two systems requires a voluminous work. However, in brief, the differences lie in culturally and

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historically conditioned attitudes about the nature of law, the role of law in society, and the belief in how law is or should be made, applied, studied, perfected, and taught.¹⁰¹⁵

The civil law tradition gives supreme value to certainty.¹⁰¹⁶ This is reflected in the effort of making comprehensive and prescriptive codes in order to limit judicial selection or discretion in the exercise of jurisdiction.¹⁰¹⁷ By contrast, the common law tradition recognises that certainty is one of a number of legal values. Particularly, certainty and flexibility are seen as competing values.¹⁰¹⁸ By giving the force of law to judicial decisions, the common law tries to achieve certainty without abandoning flexibility.¹⁰¹⁹ A judge of the common law tradition can interpret law under certain principles such as fairness and equity to solve a particular dispute. These diversities in legal tradition have an affect on the corporate governance systems of different countries. Anglo-American corporate law reflects the ideology of freedom of contract among contractors with judicial intervention for the purpose of preserving justice and equity. Although corporate laws in the common law tradition countries are moving in a statutory direction, the principles and ideology of the common law and equity are retained.

Germany, as a distinct contributor to the civil law system, has developed a corporate law of a far more prescriptive and self-contained model.\textsuperscript{1020} It sets up separate bodies of law for public companies, closely held companies, and group companies. By introducing the two-tier board, it adopts a model of division of power for internal governance. German corporate law has followed a path of tight control and of giving little room for judicial interpretation. The violent political history of the country in the past century provided more occasions for German policy makers to take extreme steps to propose drastic changes to their corporate system. The corporate law has been developed along the path of facilitating those changes. German jurists have had the chance and duty to make the most elaborate bodies of corporate laws. They tend to set their legislative activities in a broad social and economic context, and they are more likely to take a future view in the legislative process.\textsuperscript{1021} The law is intended to cover all possible incidences in future practice. Hence, the company law in Germany is prescriptive and tight. Although German corporate law is regarded as lacking flexibility compared with Anglo-American corporate laws, its scientific and comprehensive approach makes it a distinctive and influential system with a far reaching influence on many other jurisdictions. Its two-tier board structure is widely adopted and is a key ingredient that the European Union has endeavored (so far without success) to introduce into the Company Law Harmonisation Program.


\textsuperscript{1021} Ibid.
PATH DEPENDENCE AND CORPORATE GOVERNANCE

From the above discussions, it becomes clear that the corporate governance system is influenced by many factors. Although the role of each important factor was discussed respectively, there are still things cannot be explained by applying the rationality reviewed in these discussions. For instance, economic conditions, and political and cultural preferences usually cause a country to choose to develop its corporate governance in a particular fashion. However, there is the situation where none of these factors are relevant to the decision. Corporate reforms happen in many jurisdictions. In this process, methods can be introduced to guide people’s attitudes and preferences in order to choose an optimal model of economic efficiency. However, many reforms are not carried out in this way, but choose to bring piece meal and technical changes to their current systems. Some of the reforms may only serve as adding new complexities to their current systems. This needs to be explained. The theory of path dependence in law and economics can be used to serve this purpose.

The theory of path dependence in law and economics is the result of application of scientific theories including chaos theory, path dependence theory and punctuated equilibrium theory into corporate studies. It tries to establish the argument that the development of corporate governance systems much relies on some evolutionary accidents. The co-existence of a variety of corporate systems proves that there is

1023 Ibid.
always more than one way to achieve corporate goals. It also suggests that the inertia adhering to the initial path has a strong impact on the development of a corporate system. Every system has evolved in particular social circumstances. The creation of a corporate system was usually caused by a need at a particular historical moment. The incident may not be relevant to today's life anymore and the choice may not be the best from today's point of view. However, the system survived as a result of a range of development after the initiation. At this point, the path dependence theory has provided the following metaphoric interpretation and lifelike description. When a path was formed, it might or might not be the shortest, straightest and the most convenient one. However, it has been consequently used and developed. There must be a reason for why it was so created. However, the reason is no longer relevant to the people's life in today. The important thing is how much it affects life today. If it is very inconvenient, the community may think to modify it or to build a new path. The key question is how much this will cost. If the cost of building a new path is low, the community will go ahead to build the new path. If the cost of reconstruction exceeds the cost of the inconvenience, people may choose the alternative solution, to modify it. If the cost is still excessive, the community will prefer status quo. In other words, path dependence can lead to efficient results and

1024 For example, when cutting a path through a wood, the builder of the path might have a few options. One was to cut a straight path but must cross a den of wolves. One was to cut a winding path for avoiding the danger of encountering the wolves. The builder may choose the latter option. Late, the path was developed as a road and shops and other buildings were built along the road. Today, the wood has disappeared and the threat of wolves does not exist. However, the road is still winding. The inconvenient condition may be overcome by improving road condition and transportation system, or by building a straight road. However, the costs of rebuilding may exceed the cost of inconvenience. For this reason, the community may choose to improve the condition of the old road or do nothing instead of reconstruction. See Mark Roe, “Path Dependence, Political Options, and Governance Systems”, in Klaus J Hopt (ed), Comparative Corporate Governance (1997) 165, 167-168.
inefficient results.\textsuperscript{1025} The inefficient results may persist for the reasons of high costs associated with changes and other social, economic and political impediments.

The corporate development in different systems demonstrates the fact that the effect of path dependence exists in these corporate systems. For example, the corporate structure with strong managers and weak owners in the US is partly due to path dependence. The historical rejection of powerful financial institutions has resulted in less concentration of ownership in US corporations. Consequently, the corporate governance in the US has developed down a particular path. Instead of reforming the banking system, the system has chosen to develop new legal and economic institutions to balance the strong management, including high quality securities markets.\textsuperscript{1026} In some other economies where strong financial institutions were initially developed, the corporate governance has evolved along a different path. The co-existence of diversified but equally successful corporate economies states the fact that “path dependence helped to create the institutions; adaptations reduced their functional failures”.\textsuperscript{1027}

THE CORPORATE DETERMINANTS IN THE CONTEXT OF DESIGNING A CHINESE MODEL OF CORPORATE GOVERNANCE

China is in the process of establishing a corporate system. At this stage, apart from economic rationality, designing a Chinese model of corporate governance must take

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{1025} See Mark Roe, “Path Dependence, Political Options, and Governance Systems”, in Klaus J Hopt & Eddy Wyneersch (eds), \textit{Comparative Corporate Governance, Essays and Materials} (1997) 165, 170.
\item \textsuperscript{1026} \textit{Ibid}, 168-169.
\end{enumerate}
\end{footnotesize}
China's particular social circumstances into consideration. This decides the feasibility and effectiveness of the model.

Under the planned economy, China developed an enterprise system of public ownership and centralised management. This system once delivered admirable economic performance in China's history and made a great contribution to the economic recovery during the early stage of the People's Republic of China. For this reason, the Chinese are aware of the rationality of public ownership. The reform efforts are widely understood to introduce market mechanisms into the current enterprise system in order to eliminate the irrational elements in the system so as to improve the performance of the enterprises. Meanwhile, China does not have a comprehensive social insurance and welfare system. The commercial operation of the banking system also needs further improvement. Under such circumstances, an extensive privatisation will increase social costs and cannot serve the purpose of the economic reforms. The basic economic structure and the public preference determined the continual dominance of state-owned or controlled companies in the national economy. Hence, the corporate system in China has to adapt to this situation by creating new institutions that serve the operations of state-owned and controlled companies for the purpose of increasing their economic efficiency. The establishment of the Administrative Bureau of State Assets and state asset management companies is part of the effort. However, to make the system function efficiently, more work needs to be done.

1027 Ibid, 179.
The current enterprise reform constitutes one part of China’s economic reforms. The economic reforms in China have occurred in a top-down fashion where the government produces initiatives. This means that the government plays a dominant role in guiding and directing the development of the enterprise reform. The country’s economic situation has inspired the ambition of the government to develop a corporate system for a large-scale economy. Developing corporate groups and utilizing group hierarchical chains as a corporate control mechanism are the important strategies that enable the government to exploit the large scale economy and retain corporate control without excessively increasing control costs at the same time. This strategy is expected to be widely adopted by the state-owned and controlled companies, as well as by non-state companies.

Banks have been used as the important control leverage in assisting the enterprise reform by the government. The government has been fully aware of the potential of banks in corporate control. The current reform in banking system is expected to result in the establishment of a strong banking system that will strengthen the government’s capacity to direct and monitor corporate activities. Banks’ monitoring function is particularly important to state-owned or controlled companies where the significance of stock market in corporate finance is limited.

China has nearly 50 years of socialist tradition where workers are told that they are the real masters of the country and where people believe that labor’s active attitudes can improve productivity.\textsuperscript{1028} Many Chinese want to see workers’ positive participation in

\textsuperscript{1028} China officially is still a socialist country. However, it has undergone a lot of changes since the economic reforms in 1978. Many practices such as life employment established before the reforms have been reformed or replaced by new systems.
corporate governance. Besides, the experience in the past tells the Chinese that conflicts
between capital and labour are counter-productive and may destabilise society. For the
above reasons, the Chinese Company Law adopts a co-operative model of corporate
governance based on the co-determination system of Germany. Recently, there are
increasing discussions of the importance of human capital to the corporate development
in China. With a fraternal cultural tradition and a socialist experience, worker
participation in corporate governance in China is expected to produce a positive outcome.

In summary, choices of enterprise reform strategies in China are determined by its
economic situation, people’s political attitudes, legal and cultural elements, and its
particular path of development. This, in turn, decides the direction of corporate
development of the country. The examination of these determinants and their significance
in the Chinese context is helpful to designing a suitable model of corporate governance
for China. It is important that the proposed model gives necessary consideration to all the
important elements that have an influence on corporate governance.

CONCLUSIONS

To explain an economic outcome is a complex process, because it is influenced by many
elements. In terms of explaining corporate development, economic explanations are more
convincing if they acknowledge other factors such as culture, history, politics and legal
tradition. Conversely, cultural, historical, political and legal explanations are more
convincing if they acknowledge economics.

The evolution of corporate governance in every system occurs under its particular
social circumstances. The pressure of globalization deprives a developing country like
China of the opportunity to develop a corporate economy in a gradualist fashion. Thus, China’s corporate development is predestined to happen at a great speed under the government’s guidance. The public sector, banks and the law are the basic instruments of the government to direct the enterprise reform and corporate development. Meanwhile, the domination of the public sector brings particular problems to the Chinese corporate system, and, in turn, requires particular solutions. Any attempt to design a Chinese system of corporate governance has base itself on an adequate understanding of China’s economic, political, cultural, legal and historical situations, so as to avoid lack of credibility and failure.
Chapter 18

CREATING A COMPETITIVE MARKET ENVIRONMENT FOR CORPORATE DEVELOPMENT

China is striving to solve the deep-seated institutional problems of its state-owned enterprises by establishing a modern corporate system. Corporate development in China thus becomes an important subject. This thesis has used most of its length to discuss the development of the corporation and corporate governance in China, and to investigate what sort of model of corporate governance is suitable for China. However, experience has shown that simply introducing corporate mechanisms into an enterprise system cannot solve many problems. The operation of a modern corporate system needs a supportive macro-economic environment. Hence, in the case of China, to simply convert the state-owned enterprises into corporations does not guarantee the establishment of a modern enterprise system. Supporting reforms in relevant areas, especially, the supporting reforms at a macro-economic level, are required. These supporting reforms mainly include financial sector reforms, pricing system reforms, labor policy reforms and legal reforms. The central aim of these reforms is to foster a market-oriented competitive environment for enterprises. A sound system of corporate governance can help to bring a sound outcome of economic performance, only when it is planted in a rational,
competitive market economy. To create a competitive economic environment is the key to the success of corporate economy. To give a detailed discussion about what has been done and should be done in China to create a competitive market environment is out of this thesis's scope. However, it is necessary to give a general introduction to the significant role of macro-economic environment in enterprise reforms and a brief overview about how the Chinese understand this. This can remind us of the fact that the practicability of a well designed system of corporate governance rests not only on its internal rationality, but also on the support of macro-economic policies and conditions.

THE IMPORTANCE OF IMPROVING ECONOMIC FRAMEWORK TO FOSTER MARKET COMPETITION

A reform at the micro-economic level cannot succeed without a favorable macro-economic environment. Experience shows that the most effective way to improve enterprises' economic efficiency is to require the enterprises to maximise their profits in a competitive environment. This means that institutional changes toward nurturing profit maximising behavior must be supported by a market oriented economic environment. In other words, economic efficiency cannot be achieved by simply adopting a modern enterprise system, but requires macro-economic assistance.

State-owned enterprises are usually burdened by excessive non-commercial objectives, such as providing social services, creating jobs, and supplying low price

products. They are impeded by administrative interventions and thus, lack of incentives to improve managerial performance.\textsuperscript{1031} In exchange, they are protected from market competition, and are favorably treated in terms of access to low-interest bank loans, government subsidies and tax exemptions.\textsuperscript{1032} Merely reducing governmental intervention in management by corporatising the enterprises without reducing their social burdens and reforming price, financial and taxation policies, cannot expose these enterprises to true market competition.

To change the situation, the government is responsible for finding a new approach to carry out the non-commercial objectives that were historically assigned to state owned enterprises. In the meantime, the government should reform its financial and price policies. The enterprises should be subject to strict financial disciplines and be able to decide their products’ prices according to economic costs. In doing so, banks need to be commercialised. An arm’s-length relationship between the government and the enterprises needs to be established.\textsuperscript{1033}

State-owned enterprises also face disadvantageous labor policies. They usually have redundant workers and low paid managers. This reduces the economic efficiency of the enterprises and results in less stimulated management. It is the government’s responsibility to introduce a rational labor policy.

\textsuperscript{1031} Ibid.

\textsuperscript{1032} Ibid.

Furthermore, in the course of the organisational reform, it is important to improve the country’s legal structure to support market competition and managerial accountability, strengthen macro-control, improve social security and promote social progress. The separation of government and the management of state owned enterprises makes it particularly necessary to use laws to standardise and regulate the relationship between the government and the enterprises.

For achieving the goal of enterprise reform, a country has to strive to build up such an economic environment. Only in this way, can corporatisation and privatisation serve their initial purposes. Hence, how the Chinese perceive the relationship between their enterprise reform and macro-economic reform, and what strategies have been and will be used by them to improve their economic environment, are important to the success of China’s enterprise reform.

CREATING A COMPETITIVE ENVIRONMENT SO AS TO INTRODUCING MORE COMPETITIVE MECHANISMS INTO THE SYSTEM OF CORPORATE GOVERNANCE IN CHINA

The Chinese have clearly understood the fact that market competition can significantly improve economic efficiency of enterprises. It is believed that when being exposed to market competition, an enterprise is pressed to develop its marketing skills, pay close

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attention to service, improve technology, and reduce control costs.\textsuperscript{1035} Hence, creating an economic environment that fosters market competition is crucial to the success of China’s enterprise reforms.\textsuperscript{1036} The country has made constant efforts to achieve the goal since the enterprise reform.

Firstly, since 1998, the Communist Party of China Central Committee and the State Council have made a number of strategic arrangements to expand demand and boost economic growth, so as to improve the macro-economic environment for the enterprise reform. Meanwhile, the process of opening to the outside world is continuing. China’s imminent access to the World Trade Organisation (WTO) raises the expectation that state-owned enterprises will operate in a more competitive environment, when then they face international competition.

Secondly, China has been developing a social security system so as to separate social welfare from production. Up to July 1999, the government had raised the minimum of unemployment insurance and lowest income urbanites by 30%. A framework for a social security system consisting of pensions, unemployment, and medical insurance came at the end of 2000.\textsuperscript{1037} This is an effective method of easing the social burden of state owned enterprises. Establishing a comparative comprehensive social insurance system in China now is written in the tenth Five Year Plan.


\textsuperscript{1036}Ibid.

\textsuperscript{1037}See Editor, “SOEs Improve Economic Efficiency”, People’s Daily Online (December 31, 1999), <http://english.peopledaily.com.cn/home.html>.
Thirdly, the government calls for establishing a sound legal system which supports a standard environment for enterprise development. President Jiang Zemin stressed that, to push ahead with the reform and development of state enterprises, it is necessary to improve the awareness of the importance of reforming and developing state enterprises according to law. With the development of a market economy and the deepening of the enterprise reform, efforts should be made to formulate laws and regulations for improving and maintaining market order, strengthening macro-control, improving social security, and promoting social progress. It is expected that law making and law enforcement will be enhanced in the areas such as anti-monopoly, fair trading, protecting state assets, and standardising the state-owned enterprises, so as to improve economic efficiency and realise rational allocation of resources, as well as to prevent the loss of state assets.

Fourthly, calls for commercialising the service of intermediary organisations increase. The enterprise reform requires efficient and fair intermediary services. These intermediary organisations should dissociate themselves from government departments in order to provide commercial decision-making services.

With further reform efforts at macro-economic level being carried out, more competitive mechanisms will penetrate China's corporate system. Further opening up will

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impose more external pressures on state-owned and controlled companies, by challenging their monopoly status and increasing the degree of diversification in the corporate system. Easing the social burden of state-owned enterprises, commercialising intermediary services and enhancing regulatory strength are all necessary for creating a favorable economic environment for genuine market competition. In spite of the current efforts, China still needs to continually improve its macro-economic environment to guarantee the success of the enterprise reform. At the moment, more efforts need to be made in terms of improving its labor policies and price policies.

In summary, the outcome of the enterprise reform and the improvement of the corporate system in China depend on the overall economic development of the country. Building up a perfect system of corporate governance is a social project that requires persistent efforts of the society as a whole.

CONCLUSIONS

The efforts to build a perfect model of corporate governance without adequate support from macro-economic policy runs the risk of being self-defeating. A desirable corporate governance system only works in a competitive economy. Therefore, when discussing the model of corporate governance, one should always bear in mind that the success of the model not only depends on its innate rationality, but also responds to the macro-economic environment, within which it exists. The operation of the corporate governance mechanisms is predicated on the improvement of the overall economic environment in China.
Chapter 19

THE CHALLENGES IN SEEKING A PRACTICABLE CHINESE MODEL OF CORPORATE GOVERNANCE

Just as the economic efficiency of an enterprise does not necessarily get improved simply because it adopts the corporate form, merely introducing modern corporate governance mechanisms into a company does not necessarily guarantee the company is better governed. This is because a good governance model may have little to do with practicability. An economic model is usually built on the assumption that society and individuals, based on perfect information about the costs and benefits of alternative choices, can make rational decisions. However, the reality is that we live in a society of incomplete information, with a complex environment, and where individuals hold their own subjective perceptions of the external world. Hence, there are gaps between a model based on rational choices and efficient market hypotheses, and the practicability of the model. The development of a model in a particular system is shaped by social, ideological, economic, historical and cultural conditions of that particular system. Therefore, to select a system of corporate governance requires balancing a number of considerations. To adopt a model giving insufficient consideration to the special social situations of a particular society will increase the cost of the institutional change and the cost of reception of the model. Consequently, its adoption becomes undesirable. The
most desirable choice is a choice that represents the best economic efficiency after balancing the economic benefits and the cost of reception.

Bearing the above understanding in mind, this chapter attempts to seek a desirable model of corporate governance for China. This involves examining the limited literature on the issue and analysing the current practice of corporate governance in China.

THE WORLD BANK AND SOME OTHER OPINIONS ABOUT THE SUITABLE MODEL OF CORPORATE GOVERNANCE IN CHINA

China’s enterprise reform has attracted worldwide attention. Comments and discussions of China’s enterprise system have been increasing. Some discussions in China make attempts to address the issue of developing an effective corporate governance system. Outside China, the World Bank has closely watched China’s economic reforms and has produced a comparatively rich literature on the ongoing enterprise reform. In its publications, the World Bank gives considerable attention to policy recommendations relative to China’s enterprise reform. In its recent studies, the World Bank addressed the problems of corporate governance in China and recommended strategies for improvement.


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The World Bank has been exerting its influence to assist and press countries, especially the former socialist countries and third world countries, to corporatise and privatise their public sectors in the past two decades.\textsuperscript{1043} It recommended corporatisation and privatisation as enterprise reform strategies to China as early as in the early 1980s.\textsuperscript{1044} It draws lessons and experience from the enterprise reforms of different systems and has constantly sharpened its analytical studies. Given the importance of the role of the World Bank in influencing world economic development and the fact that it has been vigorously promoting enterprise reforms in many countries, the opinion of the World Bank, in relation to the development of corporate governance in China, deserves a close study.

At a time of massively transforming state owned enterprises into corporations, the World Bank sees the challenges faced by China. It points out that China's enterprise reform is a difficult one, as the country is trying to introduce market incentives into the enterprise system at a time when the institutional framework for its market economy is still developing.\textsuperscript{1045} The World Bank has diagnosed four major problems existing in China's current corporate governance system. Firstly, the supervisory strength of the State over the corporatised state-owned enterprises is weak. The corporations, thus, are controlled by managers and face the problems caused by insider control.\textsuperscript{1046} Although

\textsuperscript{1043} See Roger Wettenhall, “Public Enterprise in an Age of Privatisation” (1993) 69(9) \textit{Current Affairs Bulletin} 4, 4-5.


\textsuperscript{1045} See the World Bank, \textit{China’s Management of Enterprise Assets: The State as Shareholder} (1997), 49.

\textsuperscript{1046} \textit{Ibid}, 50.
efforts to clarify ownership are being made, confusion among government departments still exists in terms of responsibilities over the corporations. This has put the government in the position of lack of sufficient information about the managerial efficiency and corporate performance of these enterprises. As a result, the managers of the corporations seize control. Insider control can expose the corporations to many costs and risks including asset stripping, poor investment decisions, decapitalisation through excessive wage increases, and increases in other private benefits. The situation is exacerbated when monitoring from other stakeholders remains inadequate, due to the problems such as a weak credit system.

Secondly, the operation of China’s banking system undermines banks’ rights as creditors. The long time exercise of a planned economy before the economic reforms has resulted in the domination of banks in China’s financial sector. After twenty years of economic reforms, banks still account for three-quarter of households’ financial asset holdings and enterprises’ external funding sources. In the meantime, the government has been having firm control over the banking system. Consequently, banks are obliged to make banking policy according to the State’s macro-economic plans and objectives. It has been common for banks to allocate funds and extend loans not as a result of commercial decision making but at the behest of governmental authorities. For instance, following the government’s reform objectives at a macro-economic level,

\[1047 \text{Ibid, 51.}
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\[1048 \text{See the World Bank, } \textit{China, Weathering the storm and Learning the Lessons} (1999), 26.
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\[1049 \text{See Nicholas R Lardy, } \textit{China’s Unfinished Economic Revolution} (1998), 83.
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instead of forcing loss making enterprises into bankruptcy, banks may have to continually extend loans to the enterprises. This has illustrated the situation that, as creditors, banks’ capacity to discipline enterprises is weak. There is no strong legal backing for banks to exercise their creditors’ rights either. With the increasing withdrawal of the administrative intervention by the State, it is crucial to enhance the monitoring function of banks. Since the late 1990s, the reform of the financial system has been accelerated. More incentive mechanisms are to be introduced into the banking system, in order to enhance banks’ creditor role. However, more commitments are required from the government, banks and enterprises to ensure an effective creditor incentive system.

Thirdly, since the economic reforms, the problem of asset stripping has become severe. State assets have been drained in many ways. It is very likely to happen, when state-owned enterprises are converted into joint ventures, joint stock companies and other forms of cooperative enterprises. It is reported that the annual loss of state assets has been about 50 billion yuan (RMB) since the early 1980s. At a time when state intervention in management is diminishing and effective internal and external monitoring mechanisms are yet to be put in the place or to have effective effects, this problem is inevitable.

Parallel with asset stripping is the fourth problem, wage diversion and tax avoidance. When wage growth is more rapid than labor productivity, profitability is

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1050 See the World Bank, China’s Management of Enterprise Assets: The State as Shareholder (1997), 52.
1051 Ibid, 53.
1052 See the Editor, “State Asset Drain Must End”, China Daily (December 13, 1995).
1053 See the World Bank, China’s Management of Enterprise Assets: The State as Shareholder (1997), 53.
likely to decline. Where managers gain de facto control over the enterprise, the chance of excessive wage payment increases. In the case of China, the situation is worse. As state control over state-owned enterprises loosens and effective monitoring mechanisms have not taken full effect, the State as the owner of the enterprises is likely to suffer from double losses, wage diversion and tax avoidance.

Regarding the solutions of these problems, the World Bank recommended the following reform strategies: (1) increase fiscal and financial discipline; (2) encourage competition; (3) diversify the ownership of state-owned enterprises; (4) foster market-oriented mergers, acquisitions and the “market for corporate control”.

The World Bank pointed out that experience shows that the benefits of adopting a modern corporate governance system cannot be realised, unless a “hard budget” applies. The subsidies and non-performance loans to state-owned enterprises should be reduced and eventually eliminated, and the enterprises should pay economic costs for their inputs and sell their products according to market prices. Only so, can corporate management really be monitored by market mechanisms, and corporate performance and efficiency be assessed precisely. The World Bank suggests that Chinese banks should be granted power to access more information in connection with corporate finance, and should be able to impose penalties on overdue loans.

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Corporate governance can be improved when there is competition in both product and factor markets. The introduction of competition into the corporate system can effectively tackle the insider control problem. In China, many state-owned enterprises are still shielded from market competition. Some have monopoly or oligopoly status at national or provincial levels. The World Bank advises that regional and national barriers should be lifted and discriminations among firms of different ownership in relation to bank credits and material prices should be eliminated, so that the state-owned enterprises can be exposed to genuine market competition.\textsuperscript{1058}

The experience also proves that the corporate governance of state-owned enterprises can be improved by introducing different forms of ownership into the enterprises. By diversifying shares among different shareholders, the management of the enterprises will be subject to not only the scrutiny of the State, but also the supervision of individual and institutional shareholders. However, diversification of shares within a poor institutional framework can worsen the problem of insider control. The World Bank, therefore, suggests that diversification of ownership should be done with well-defined institutional responsibilities and transparent procedures.\textsuperscript{1059} And diversification of ownership should be cross-regional and cross-sectoral, and shares should be freely transferable.\textsuperscript{1060}

Furthermore, corporate governance can be improved when the management of enterprises is exposed to external market control and the real threat of takeovers. The

\textsuperscript{1058} Ibid.
\textsuperscript{1059} Ibid.
\textsuperscript{1060} Ibid.
World Bank thus advises that China should enhance and strengthen the network of transaction centres for property rights and develop an open and transparent process for acquisition and mergers.\(^{1061}\)

Parallel with the World Bank’s studies, there is academic research by scholars both inside and outside China. Inside China, the discussions about seeking corporate governance solutions in order to increase corporate efficiency have begun to gain momentum. Essentially, all the discussions concern the basic issue: how to restrain insider control caused by the control vacuum emerging from the enterprise reform. In some discussions, strategies are proposed. Basically, four important views can be summarized.\(^{1062}\) Firstly, there is the need to further reform property rights and further discipline state asset management institutions, so as to effectively enhance the owner’s supervisory function over corporate performance.\(^{1063}\) Some argue that state property should be able to be transferred, so that the State can exercise the power of disciplining agents by terminating the principal/agent relationship.\(^{1064}\) Meanwhile, the ownership right of state property should be further clarified and the management of state assets should be simplified, so that the costs caused by unclearly defined ownership rights and multiple chains of principal/agent, can be reduced.

\(^{1061}\) Ibid.


Secondly, there is the need to create an environment fostering full market competition. While state-owned enterprises should be unburdened from social services, all subsidies and protections to the enterprises should be withdrawn, so that market mechanisms can be fully introduced into the corporate governance system of these enterprises and the State can reduce the information cost of supervising the enterprises.

Thirdly, there is the need to introduce a corporate governance system that gives considerable weight to the monitoring function of banks and other financial intermediaries. From the fact that most companies, especially those state-owned or controlled companies, heavily rely on banks, instead of the equity market, for corporate finance, it is desirable to enhance the control power of banks over enterprises.

Fourthly, there is the need to establish hierarchical control chains within the enterprise system. It is suggested that state-owned or controlled companies should be controlled through hierarchical chains. The arrangement could be: state asset management institutions appoint directors to the parent companies owned or controlled by them, and the parent companies appoint directors to their subsidiaries, and then the subsidiaries appoint directors to their controlled companies and so on.

Apart from the above mainstream discussions, there are other suggestions in relation to the improvement of corporate governance. For instance, some recommend increasing

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1066 See Wu Jinglian, Modern Companies and Enterprise Reforms (1994).
workers’ involvement in corporate governance through creating employee share ownership.¹⁰⁶⁷

Outside China, the most recent academic study concerning the choice of a rational model of corporate governance in the Chinese context was carried out by Professor On Kit Tam of Monash University. In his book, he described the Chinese attempt to reform the enterprise system according to the Anglo-American external market based model on the one hand, and to try to introduce the Japanese main bank model on the other, as unrealistic and caused by lack of understanding on “key normative and positive issues relating to what corporate governance should and can achieve and for whom”.¹⁰⁶⁸ Thus, the consolidation of two distinct corporate governance models is not practical.¹⁰⁶⁹ He proposed a corporate governance model which is partly based on Turnbull’s idea of a “Corporate Senate”¹⁰⁷⁰, where the shareholders, directors, supervisors, managers and employees are all able to vote over corporate affairs. This way, the governance vacuum problem which exists in state-owned or controlled companies can be effectively tackled.¹⁰⁷¹


¹⁰⁶⁸ See On Kit Tam, The Development of Corporate Governance in China (1999), 91.

¹⁰⁶⁹ Ibid.


¹⁰⁷¹ See On Kit Tam, The Development of Corporate Governance in China (1999), 99-103.
The above outcomes of studies on China's corporate governance system by the World Bank and other academics all concern the resolution of the essential problem of corporate governance in China, insider control. Some of them provide accurate understanding of China's current corporate governance system. The strategies proposed to tackle the fundamental issue will have their influence over the thinking and future policy-making relative to the development of the Chinese corporate governance system. The task of the following sections of this chapter is to further the research of searching for a model of corporate governance which is both rational and practical for China. The existing literature mentioned above certainly provides wisdom and inspiration for the research. This research will start from the analysis of China's special situations relating to corporate governance issues. Then, it will identify the practicable reform strategies concerning the construction of the Chinese model of corporate governance, as well as an overall picture of the ideal model.

THE SPECIAL CASE OF CHINA

After twenty years of economic reforms, the proportion of the public sector in China has reduced significantly. However, the decrease of the public sector is only the result of implementing the strategy of lessening public ownership in order to increase inter-enterprise competition and bring outside monitoring functions into the enterprise. This does not mean that the private sector will replace the public sector to play a dominant role in the national economy. Instead, the public sector will remain as the backbone of the

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economy. As discussed in chapter 5 of this thesis, apart from the understanding and expectations of the public sector, the Chinese also have considerable emotional attachment toward public ownership, which makes China's case different from some other former socialist countries. Since the mid-1800s, the Chinese began to seek knowledge of modernisation from the West. However, all the attempts failed, but only socialism brought changes to China. It is understood that, as a whole, socialist China has made unprecedented achievements. This is why the government has reiterated that the public sector will remain the backbone of the country in every phases of the economic reforms. Hence, after the widely promoted corporatisation and privatisation, China will have an enterprise system where the state-owned companies, although small in number, dominate important sectors and are significant to the national economy. In some secondary important sectors, there will be a significant number of state-controlled companies where the State as the large shareholder exercises influence on the operations of the corporations through corporate governance mechanisms. Companies with diversified forms of ownership will flourish in the other sectors. State-owned or controlled companies may make portfolio investment in these companies. Hence, the future corporate landscape in China can be drawn as follows: although non-state-owned and controlled companies will flourish, state-owned or controlled companies will continue to play a dominant, or at least important, role in China's economy. When


designing a practicable model of corporate governance for current enterprise reform in China, one has to always bear in mind this premise. Based on this premise, the following sections discuss the main problems which exist in different types of companies including state-owned companies, state-controlled companies and non-state-owned and controlled companies, and then propose models of corporate governance for them respectively. In the meantime, the rationality and practicability of these models are analysed and evaluated.

CORPORATE GOVERNANCE PROBLEMS EXIST IN CHINESE COMPANIES

Main Problems in the Wholly State Owned Company

A wholly state-owned company is a company where the State is the only shareholder. Such a company does not have a shareholders’ meeting, but only the board of directors. The State entrusts authorised departments or institutions (currently the Administrative Bureau of State Assets and state asset management companies) with the power of exercising shareholders’ rights on its behalf. The relationship between the State and the entrusted institutions satisfies the definition of principal and agent relationship in the 1986 Civil Code. However, the institutions as the state’s agents can only exercise part of the shareholders’ rights provided in the Company Law, which includes the power to decide to increase or decrease registered capital, the power to appoint and dismiss

directors, the power to decide on corporate assets transference, the power to issue debentures, and the power to decide on merger, division, liquidation and dissolution.\textsuperscript{1076} The rest of the shareholders’ rights are conferred on the board of directors.\textsuperscript{1077} Hence, the board of directors of a state-owned company has a broader range of powers than its counterparts in the other types of company. The legislative purpose is to curtail administrative intervention by giving a high degree of autonomy to the board of the state-owned enterprise.

As a state-owned company is a means of retaining state control in an important sector, it is likely that the company will hold a monopoly or oligopoly position in that sector. In the meantime, the shares of the company are not freely transferable. This means that the competitive mechanisms of both product and factor markets will have less effect in such a company. External monitoring from the stock market basically does not exist. The law authorises an entrusted department or institution to supervise the operation of state assets in a state-owned company. However, the department or institution do not directly take part in corporate operations and can only influence the management via shareholders’ rights. This is a scenario of agents watching agents.

The above conditions result in the high risk of insider control in a state-owned company. In reality, it has become the severest problem plaguing state-owned companies in China. Special measures must be devised to control the situation, so as to improve the economic efficiency of state-owned companies. In addition, different from other types of

\textsuperscript{1076} See Article 66 of the 1994 \textit{Company Law.}

\textsuperscript{1077} \textit{Ibid.}
companies, it is impossible for state-owned companies to be totally free from any social
obligations and only pursue profitability. Some compensation measures have to be
introduced, in order to ensure the prosperity and sustainability of state-owned companies.

Main Problems in the State-Controlled Company

Except those most important sectors where the State retains close control by establishing
state-owned companies, state-owned enterprises in some other sectors where the State
needs to retain certain degree of control will be converted into state-controlled
companies. A state-controlled company takes one of the conventional corporate forms
(limited company or limited stock company) provided by the 1994 Company Law. In
such a company, the State holds controlling shareholdings and exercise influence through
the shareholders’ meeting and the board.

A state-controlled company has the advantages of being able to access to wider
sources of funds and to bring “outside” shareholders into the company. Different from
the State, these outside shareholders have a direct presence in the shareholders’ meeting.
It is expected that the participation of these outside shareholders will strengthen the
monitoring function of the shareholders’ meeting. However, practice has shown that
the problem of governance vacuum also exists in state-controlled companies. On the one
hand, as the controlling shareholder, the State entrusts authorised institutions (currently
state asset management companies) with the power of exercising ownership rights. The

1078 See Xu Xiangyi et al, Organisation and Management of Modern Companies (1999), 179.
1079 See Hua Guoqing, “Discussions on Constructing the State-Controlled Companies” (1998) 2 Zhong Wai
Fa Xue (Chinese and Foreign Legal Studies) 47, 49-51.
entrusted institutions send representatives to the shareholders’ meeting of company to exercise shareholders’ rights. These representatives are usually administrative bureaucrats who lack incentives and business knowledge to impose effective control over the board and management. On the other hand, the involvement of other non-state shareholders including individuals and legal entities in a state-controlled company may have limited influence on the improvement of corporate performance. An entity shareholder may be another state-controlled or state-owned company and troubled by its own insider control problem. Individual shareholders with small shareholdings have little incentives and means of imposing significant control on the board and management. In addition, state-owned shares, as well as state-owned legal person shares in such a company, are not allowed to be freely transferred. Consequently, the external market monitoring force has limited influence on the corporate governance of the company. As a result, the potential of insider control in a state-controlled company is also high.

Main Problems in the Non-State-Owned and Controlled Company

The non-state-owned and controlled company (non-state company) refers to a company that is not exclusively owned by the State and does not have the State as the controlling shareholder. They are commercial companies. With the deepening of the enterprise reform, commercial companies in China will be greater in number. The forms of ownership in such a company are diversified. The shareholders comprise individuals, companies, other entities, the State, and foreign individuals and entities. They take the corporate forms (limited companies or limited stock companies) provided in the 1994 Company Law. Although they may also have the problem of insider control, the nature
and the cause of the problem are totally different from those in a state-owned or controlled company. Theoretically, they are fully exposed to market competition. They are also subject to stock market control.

The governance problems in these companies can be mainly attributed to factors such as non-implementation of the 1994 Company Law, lack of clarity of laws, and lack of standards of corporate behavior. As corporate development has a short history in China, people participated in corporate practice may not well understand their roles and their rights and duties to the corporation. The lack of clarity of the 1994 Company Law on issues relevant to corporate governance adds further confusion to corporate activities. Malfunctioning of the shareholders’ meeting and the supervisory board is widely reported. Abuse of directors’ power is not infrequent. Mechanisms for further improvement of the corporate governance in these companies are required. Furthermore, China is still in the transitional period of establishing a market economy. The Chinese need to make more efforts to build up a business environment that fosters good corporate governance. China’s banking system, securities market, social investment funds, which have significant impacts on the corporate governance system, are all in the process of reform and development. The corporate governance will be improved with further development in these areas.

PRACTICABLE MODELS OF CORPORATE GOVERNANCE FOR CHINA

As companies of different types face different problems, it is desirable to consider their cases separately in the course of seeking a suitable corporate governance model.
The Model of Corporate Governance for State-Owned and Controlled Companies

As discussed, the major challenge of corporate governance faced by state-owned or controlled companies in China is how to make state agents exercise the shareholders’ rights and duties diligently and how to make the managers of the companies act in the interests of the shareholder (the State). Meanwhile, different from a company in the private sector, a state-owned or controlled company is not supposed to have profitability as the only goal. Sometimes, the company is required to fulfil other social goals at the expense of profitability. Hence, it is important to balance these competing interests and make the company operate as commercially as possible, so as to ensure its long-term economic prosperity.

Firstly, for better protecting the shareholders’ rights of the State, it is important to improve the skills and ethics of the staff members in the Administrative Bureau of State Assets and state asset management institutions and to introduce incentive and discipline mechanisms into these institutions. Education and training are essential. Most important, there should be methods of assessing the work of the institutions and their staff members. They should be rewarded or penalised according to their performance. For this purpose, it is feasible to have an independent, professional assessment body comprising economic, financial and legal specialists to do the work. The advantages of having such an institution of assessment are: firstly, this device can avoid the adoption of administrative mechanisms, thus reduces the risk of renewed administrative intervention. Secondly, using such an institution does not increase principal/agent chains of corporate governance, and thus will minimise agency costs in practice. The premise of setting up such a professional body is to have a clear vision of objectives for these institutions. In
addition, there should be special laws or provisions which articulate the legal duties of those to be assessed. The Bureau and the management institutions may draft their reports regarding their objectives and plans and submit them to the State Council for approval. In the meantime, it is desirable for the State Council to sign a performance contract with each of them. By this way, the economic goals, the terms of performance and the conditions of rewards and punishments can all be clarified. This will provide criteria for the assessment.

As a state-owned company does not have the shareholders’ meeting, state asset management institutions cannot use the controlling instruments associated with the shareholders’ meeting in the company. Hence, it is necessary to design a mechanism to keep the state control efficient. In some countries such as France, the governments have performance contracts with enterprises. The contracts clarify the objectives and operating framework of the enterprises. Experience has shown that by negotiating and preparing the performance targets between the two parties, the goals become specific and the costs of achieving the objectives become apparent, each side benefits from the more rational considerations.

The rationality of using the performance contract lies in that it binds corporate management to pursue the owner’s interests without direct intervention from the owner and without increasing agency chains. The economic efficiency of the enterprise system is crucial to the nation’s economic progress. Exposure to market competition and

1080 See Mary Shirley & John Nellis, Public Enterprise Reform, The lessons of Experience, 22.

1081 Ibid.
commercial decision making are important to the improvement of economic efficiency of enterprises. For this reason, the State needs to withdraw from direct intervention in corporate management. However, the State also needs to retain certain degree of control in order to be able to comprise the development of state companies into the macro-economic plan of national development, as well as to ensure the public accountability of these companies. Hence, while the companies are granted a great autonomy, it is necessary to conclude performance contracts between the government and the companies. In doing so, the two parties can establish a clear understanding in the performance objectives of the companies without increasing administrative interference in corporate management and without increasing any corporate control chains. When alterations are made to a performance contract in order to oblige a company to honor a state plan at the expense of its economic gains, the compensation scheme can be bargained in the meantime. This is helpful to accurately evaluate the economic performance of the company and to reduce the costs caused by performing non-commercial goals. Hence, the method of performance contract is worthy of experimenting in China.

Because directors of state-owned companies (as well as those board members appointed by the State in state-controlled companies) and state shareholder representatives in state-controlled companies are appointed by state asset management institutions, and they are likely to be appointed from bureaucrats, their professional ethics and competence are essential to the economic performance of the companies. Furthermore, there is the need to introduce appropriate mechanisms to prevent the problem of insider control and maintain the accountability of the board. Again, the mechanisms should not amount to inserting a control power along the organisational
hierarchical chains of the company, which will increase agency costs. Hence, it is desirable to establish an independent body comprising professional specialists to assess the performance of directors of state-owned and controlled enterprises and state shareholder representatives at annual basis. This assessment body can be the same institution which assesses the performance of the Administrative Bureau of State Assets and state asset management companies, or its branch, or a separate institution. Meanwhile, the law should provide detailed provisions about directors’ duties and penalties regarding to breach of directors’ duties. There should be special requirements about the qualifications of directors in state-owned enterprises and the qualifications of state shareholder representatives. In sum, the professional competence and responsibilities of these directors and representatives should be scrutinized by professional codes, legal provisions, and professional assessment institutions.

As state-owned enterprises are restrained from access to outside funds, they have to rely on banks for future finance. Hence, it is desirable to have a banking system that can exert certain degree of influence over the corporate governance of state-owned enterprises. The planned economy has left China with a highly centralised, state-controlled banking system. This enables the government to use banks as effective tools to guide corporate development, and provides the opportunity for developing a banking system that, somewhat, resembles the Japanese main bank model. Parallel with the development of banking system should be the development of corporate conglomerates. Using state-owned or controlled holding companies to create control chains is a way of maintaining corporate autonomy as well as enhancing corporate power. Cross
shareholdings among individual state-owned and controlled companies should be encouraged so as to increase monitoring leverages.

In addition, although the law does not have any provision for requiring a supervisory board to be established in a state-owned company, it is desirable to have supervisory boards with employee representatives in state-owned companies. Consequently, more monitoring forces can be introduced into the companies and the disadvantages of the one-tier board can be avoided.

In a state-controlled enterprise, some conditions are different from a state-owned company. A state-controlled company takes a common corporate form (limited company or stock company). However, the controlling shareholder is the State and the state-owned shares are not freely transferable. The State appoints representatives to the shareholders' meeting. By controlling majority shares, the State is likely to control the board of directors. Therefore, there is the danger that the voice of small shareholders will not be heard. Hence, it is necessary to enhance legal protection of small shareholders in these companies, so that these “outside shareholders” can truly bring a monitoring function into the company. Again, the Company Law should be further completed in relation to directors’ duties.

From the above discussions of corporate governance problems in Chinese enterprise system and analyses about methods of reducing the chance of insider control and agency costs, a practicable model for state-owned and controlled companies can be illustrated by the following diagram:
Here, the writer would like to add a few sentences to briefly explain Professor On Kim Tam’s model. This will help us to identify the differences between the model proposed in this thesis and his model, so as to understand their different theoretical grounds, perspectives and perception of China’s situations. Tam’s model is partly based on Turnbull’s idea of a “Corporate Senate”. Turnbull argued that most corporations in the Anglo-American system are inherently corrupt because their single board structures concentrate conflicts of interest and corporate power. He thus recommended Australia to adopt the two-tier board structure with a “corporate senate” to take on the roles of
The “senate” has at most three members. They are elected by and from shareholders on the basis of one vote per shareholder. The senate only has power over actions of the board in a conflict of interest situation and it only has veto power. The senate veto can be over-ridden by a vote of 75 per cent of the shares.

Based on this idea, Tam designed a model for Chinese public companies. In this model, the supervisory board functions as a “senate”. The members, except those seats reserved for employee representatives which account for about 20 per cent of the total seats, of the supervisory board are elected on cumulative voting base by shareholders. These members, after consulting professional advisers, will exercise cumulative voting power to veto actions of the board of directors in a conflict of interest situation. The senate veto can be overridden by 75 per cent of shares voted in a shareholders’ general meeting. He believed that this model can incorporate direct involvement of key government organisations and revolve barriers to the market exchange of state shares. I have attached the diagram of his model in the appendix to give a clear view of comparison of the two models.

1083 Ibid, 83.
1084 Ibid.
1085 Ibid.
1086 See On Kit Tam, The Development of Corporate Governance in China (1999), 99.
1087 Ibid.
1088 Ibid.
1089 Ibid, 102.
The Model of Corporate Governance for Non-State-Owned and Controlled Companies

The experience of the most successful corporate economies show that there are some mechanisms that are essential to good corporate governance. They are: legal protections for shareholders; large shareholders (including banks), and takeovers.\textsuperscript{1090} The fundamental issue of corporate governance is how to ensure that corporate financiers receive returns on their financial investment. Shareholders’ voting power imposes an important governance force on management. However, the voting power can be eroded in the process of practice. Dispersion of ownership, lack of information and knowledge, and lack of finance can all become the causes. The effective exercise of shareholders’ voting rights requires certain conditions. Experience proves that adequate legal protection of shareholders’ rights and interests by taking a tough stand in stressing directors’ duties and introducing sufficient remedial mechanisms, is crucial to corporate governance.\textsuperscript{1091} In addition, shareholders’ rights can be more effectively used by a shareholder who holds a substantial shareholding. A large shareholder has the incentives to collect information and monitor management. However, a high degree of concentration of ownership will generate costs and diminish corporate performance.\textsuperscript{1092} This is because, once gaining full control of companies, large shareholders are likely to use the companies to pursue their

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\textsuperscript{1091} Ibid. Also see James F Corkery, Starting Law (1999), 182-183.

\end{footnotesize}
private benefits. Under this circumstance, there should be sufficient legal protections for small shareholders to keep the balance.

Takeover is another effective monitoring force over managerial performance. No managers can ignore the fluctuation of the share prices of their companies. The threat of takeover imposes a powerful discipline on management.

In reality, these mechanisms are separately emphasized by different systems. While Germany and Japan benefit from stable larger shareholders, the US corporate system has extensively relied on the securities market for corporate control. However, recent years have seen that these systems have been moving toward each other under political and economic pressures, as evidenced by the increasing popularity of large shareholders in the US, the emergence of public debt markets in Japan, and the bank-bashing in Germany. Each system has made efforts to absorb the strengths of other systems. Their experiences provide useful sources of ideas for China in the process of developing a rational corporate governance system.

Since the early 1990s, China has endeavored to build a securities market for providing a wider range of capital sources for Chinese corporations. China’s corporate system has definitely benefited from the monitoring function of the securities market. It will be beneficial if the country sets up various investment institutions comprising pension funds, trust funds, social security and insurance companies to play the role of large shareholders

\[1093\] Ibid.

in the corporate system. In doing so, the need of the enterprise reform for establishing a social welfare and service system so as to unburden state-owned enterprises from excessive social obligations, can also be satisfied. Meanwhile, China's banking system is undergoing a restructuring process. As a late comer to the corporate economy, using banks to guide and subsidize corporate development can be a handy leverage for the government. With a careful policy scheme and a devoted program of implementation, China may establish a corporate governance system which benefits from stock market control, as well as the involvement of banks and large shareholders. Furthermore, China must have a company law that provides better protection for shareholders and creditors.

CONCLUSIONS

In the process of designing a suitable model of corporate governance, the writer of this thesis has adhered to conventional, mainstream theories and practice of corporate governance. Corporate development has created the most successful economies in human history, and the governance mechanisms of the corporation are built on rational and feasible grounds and stand the test of practice. It is these mechanisms that the Chinese need and plan to introduce into their enterprise system so as to fulfil the goals of their enterprise reform. The fact is that, corporate development has not come to a crisis which requires starting afresh, although new challenges continually appear and considerable improvement is needed. Hence, in searching for a practicable model of corporate governance relating to the case of China, this thesis has made no attempt to apply unconventional and untested theories, and, based on these theories, to recommend a
corporate model which may be less feasible for practice and have a remoter chance of being adopted.

For the above reasons, in the course seeking a model of corporate governance for state-owned and controlled companies, the focus is how to fill the gaps caused by absence of certain governance mechanisms which are available for a private company. For example, in a state-owned company, there is no shareholders' meeting and no real appearance of the owner. Shareholders' rights are exercised through agents. Furthermore, the market monitoring mechanism has a limited impact on the management. Hence, the task is to introduce alternative mechanisms into the system. When designing these alternative mechanisms, costs and practicability have to be taken into consideration. Compared with enhancing administrative intervention and increasing layers of supervision, it is less expensive and more efficient to conclude performance contracts between principals and agents and to have an independent professional body to examine the competence and performance of state agents. These strategies have been experimented with in some other systems and mixed outcomes are reported. Their experience is valuable to the Chinese in terms of designing competent performance contracts and establishing efficient professional assessment institutions. Meanwhile, it is necessary to increase worker participation in corporate decision making process and to enhance banks' monitoring capacities.

In relation to non-state companies, more well-developed mechanisms can be introduced and more mature practice can be referred to. The task faced by the Chinese is to create a business environment which fosters good corporate governance. This includes
increasing banks and institutional shareholders' involvement, protecting shareholders' rights, and improving the practice of the securities market.

In searching for a suitable model of corporate governance, this thesis has investigated the problems of the Chinese enterprise system and discussed the experiences of other systems. In doing so, a clear picture of corporate development in China has emerged. This may give some credibility for the proposed model. However, a corporate governance system is shaped not only by theoretical rationality, but also by the economic, historical, cultural and legal situations of a particular system in which it operates. Hence, the rationality of the proposed model needs to be tested against these factors.
Chapter 20

THE FUTURE DEVELOPMENT OF CORPORATE GOVERNANCE IN CHINA

On September 22, 1999, a decision concerning the reform and development of state-owned enterprises was made by the Fourth Plenum of the Fifteenth Central Committee of the Communist Party of China (the decision). The decision sets up the objectives for reforming and developing state-owned enterprises up to the year 2010. These objectives include establishing a modern corporate system, improving the economic performance of the enterprises, and ensuring that the public sector plays a better, dominant role in the national economy. The decision once again stressed the significance of the public sector in the national economy.

Following the decision, the restructuring and reforms in the enterprise system and relevant sectors have been intensified, accompanied by the newly raised discussions on the topic. This is helpful in relation to predicting the basic trend of the future development of corporate governance in China. This provides another ground for examining the feasibility and practicability of the proposed model in chapter 19.

1095 See the Decision of the Communist Party of China Central Committee on Major Issues Concerning the Reform and Development of State-owned Enterprises.
THE ROLE OF THE GOVERNMENT

There is a fresh emphasis on government's role of guidance and support in the corporate development. An article by Jiang Xiaojuan, deputy head of the Financial and Trade Research Institute of the Chinese Academy of Social Sciences, drawing a lesson from the Asian financial crisis, attaches great importance to the technological progress and industrial upgrading in Chinese state-owned enterprises. It points out that the Asian financial crisis illustrates the fact that once an economy develops to a certain level, the low-cost labor superiority begins to decline. If a country fails to strengthen its technological development capacity and its enterprises' profit-making capability, its financial system and economy will face serious threats. Hence, enhancing technological strength is the basic guarantee of the security of the State’s economy. Enterprises are the main force for technical innovation and industrial upgrading. Theoretically, enterprises operate according to market guidance. However, the current global competition in high and new technological industries has shown that as long as major technological innovation projects and development of high and new technological industries are involved, market guidance is not enough. The government's supporting policy plays an imperative role. Therefore, the competitive strength of a country depends on the joint guidance of both the government and the market.

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1097 Ibid.

1098 Ibid.
The article, once more, confirms the long-standing position of the government and the reality since the economic reforms. After all, the strategies of converting state-owned enterprises into corporations and reducing the proportion of public ownership in the national economy are only part of the government’s initiatives of the economic reforms. Thus, the future development of the corporation has to continually rely on the government’s guidance and support. The government will use legal, financial, and policy instruments to influence the development of the corporate system in China.

THE ROLE OF THE PUBLIC SECTOR

An important emphasis made by the Decision of the Fourth Plenum of the Fifteenth Central Committee of the Communist Party of China is to maintain public ownership as the dominant form of ownership in China. State-owned enterprises not only need to be reformed but also need to be developed. The reform and development of state-owned enterprises are decisive to the improvement of the overall quality of the national economy and the stability of society.

However, the domination of the public sector will not take the traditional form, ie, wholly owning most of the enterprises. In future, state-owned enterprises will only

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1099 See the Decision of the Communist Party of China Central Committee on Major Issues Concerning the Reform and Development of State-owned Enterprises.

1100 See “Programmatic Document Guiding Cross-Century Reform and Development of SOEs”, People’s Daily Online (October 9, 1999). <http://english.peopledaily.com.cn/home.html>. The article reports the main points made by Wu Bangguo, member of the Political Bureau of the Communist Party of China Central Committee and vice-premier of the State Council, when interviewed by the correspondent of the Study Time.
dominate important sectors and will take the lead in improving the quality of products, enhancing technological innovations, and realizing sustainable development.

**THE ROLE OF BANKS**

One of the deep-seated problems in state-owned enterprises developed during the economic reform era is the excessively heavy debt burden of these enterprises. Although measures were taken in order to check and write off bad debts and enlarge the enterprises’ equity proportion, their current asset-liability ratio remains high. This has frustrated the enterprises’ potential of development and resulted in extensive non-performing bank loans. Recently, the government has launched a full attack on the problem, by using the method of debt-equity swap. By converting debts into stocks, creditors’ rights of banks are changed into shareholders’ rights. The strategy tackles multiple problems at the same time. It can reduce the financing costs of the enterprises and enable them to make further development.1101 It can also improve banks’ assets and liabilities and their credit standing.1102 Moreover, it enhances banks’ participation in corporate governance. From the Chinese official viewpoint, this is a step toward “accelerating the establishment of a new-type bank-enterprise relationship”.1103

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1102 Ibid.

1103 Ibid.
This is a significant move to strengthen banks' position in the corporate system. China's intention of making banks to play an important role in facilitating a modern enterprise system is clear. In practice, the development toward this direction is speeded up. By January 24, 2000, China had converted the debts of 78 state-owned enterprises totaling 112.2 billion RMB yuan (13.5 billion US dollars) into equities. Meanwhile, another 601 state-owned enterprises had been approved to adopt the debt-equity swap method with an estimated 459.6 billion yuan (55 billion US dollars).1105

THE ROLE OF THE STOCK MARKET

While improving the efficiency of the financial sector, China has never given up the ambition of developing a strong stock market to assist the reform and development of the enterprise system. The Chinese government has recently issued a number of policies to encourage the further expansion of the stock market. State-owned listed companies are, now, allowed to buy shares. Insurance companies are permitted to invest in securities investment funds. Securities brokers are encouraged to expand their capital bases. It is believed that the securities market provides a feasible and cheap way for state-owned enterprises to withdraw from competitive sectors of the economy.1106 By this way, huge

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1105 Ibid.

funds can be concentrated in the sectors where the public sector can play bigger role.\textsuperscript{107} Chinese economists further predict that the securities market can play an important role in financing firms in China.\textsuperscript{108} It will help some state-controlled companies to reduce their debt to asset ratio and expand their profit bases.

Meanwhile, the potential of expansion of the securities market is still to be exploited, in terms of capital supply and raising funds for the companies. The saving deposits of Chinese citizens reached six trillion yuan in 1999, and the figure is likely to increase by 800 billion yuan a year.\textsuperscript{109} While listed companies in developed countries account for 50\% of all businesses, they only account for 10\% in China.\textsuperscript{110} Furthermore, while the capitalisation of the stock market is about 40\% of the GDP (gross domestic product) in developed countries, the capitalisation of the securities market is only 30\% in China.\textsuperscript{111}

Although the Chinese put more emphasis on the fund raising function of the securities market at the moment, the significant effect of the development of such a stocks market in relation to corporate governance should not be under estimated. Upon the expansion of the stock market and listed companies, takeovers will have a consequential influence on the corporate governance system in China, by developing a market for corporate control.

\textsuperscript{107} Ibid.
\textsuperscript{108} Ibid.
\textsuperscript{109} Ibid.
\textsuperscript{110} Ibid.
\textsuperscript{111} Ibid.

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THE MOVE TOWARD COMPREHENSIVELY STRENGTHENING MANAGEMENT

A notable development has happened in the Chinese enterprise reform, which is the emphasis on the role of managers of state-owned enterprises in determining the success of the enterprise reform. The Decision of the Fourth Plenary Session of the Communist Party of China Central Committee stated that comprehensive strengthening and improvement of enterprise management is a guideline for the enterprise reform.\(^{1112}\) Premier Zhu Rongji, the administrative head in charge of the enterprise reform, also made the comment that the key to China's enterprise reform lies with managers.\(^{1113}\) Since then, managers' skills and competence have become a focus of attention.

It is believed that any system, no matter how good, has to be carried out by individuals; and a mechanism, however good, has to be operated by them.\(^{1114}\) Therefore, to build up a team of high-quality managers is crucial to the establishment of a modern enterprise system.\(^{1115}\) In this process, state enterprises should take the lead. The Decision of the Fourth Plenary Session of the Communist Party of China Central Committee highlights the required quality of the managers of state-owned enterprises. They must have strong enterprising management knowledge, understand business operations and

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\(^{1112}\) See the *Decision of the Communist Party of China Central Committee on Major Issues Concerning the Reform and Development of State-owned Enterprises*.

\(^{1113}\) Zhu made the remarks at the National School of Administration in late 1999.


\(^{1115}\) *Ibid.*
management, and be good at making scientific decisions in the light of market changes.\textsuperscript{1116} It is reported that lax management and managers' lack of professional insight and ability are responsible for the non-market orientation of some enterprises.\textsuperscript{1117} Some managers cling to the idea of "waiting for, depending on and asking for" help from higher level authorities.\textsuperscript{1118} This is exacerbated by lack of disciplinary regulations. A survey shows that the losses in most loss-making enterprises are caused by managerial problems including mistaken decision-making and corruption.\textsuperscript{1119}

Methods of improving the management function proposed include: firstly, new methods of training, selecting, assessing and supervising managers should be established and improved.\textsuperscript{1120} This requires optimizing the allocation of professional resources and creating a competitive environment with openness and equity for selecting managers. It is necessary to learn from the good management experiences of some successful companies and to learn modern management methods form successful foreign enterprises.

Secondly, more incentive and control mechanisms should be introduced. To link managers' income with enterprises' business achievements may be an effective method

\textsuperscript{1116} See the \textit{Decision of the Communist Party of China Central Committee on Major Issues Concerning the Reform and Development of State-owned Enterprises}.  
\textsuperscript{1118} \textit{Ibid}.  
\textsuperscript{1120} \textit{Ibid}.  

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of stimulating managers’ wisdom and potential. In the meantime, rules and regulations concerning standardising and supervising managerial behavior should be completed.

It is noteworthy that the Decision of the Fourth Plenary Session of the Communist Party of China Central Committee regards further reform of the personnel system of the state owned enterprises and creation of a good policy-related environment as a “primary link in promoting outstanding managers”. This reflects the inclination of cultivating and seeking good stewards to manage the State’s property.

EVALUATING THE PRACTICABILITY OF THE PROPOSED MODEL OF CORPORATE GOVERNANCE ACCORDING TO THE TREND OF THE CORPORATE DEVELOPMENT IN CHINA

The analyses carried out by this chapter show that China will continually go forward along the path of developing an enterprise system where public ownership and the corporate form are dominant. In this system, both banks and the stock market are expected to act as important monitoring powers relative to corporate governance. These developing trends are perceived and followed in the proposed model in chapter 19.

However, the recent corporate development in China suggests that there is no sign that performance contracts between the government and state asset management companies will be adopted. Thus, whether the method of concluding the performance contracts

1121 See the Decision of the Communist Party of China Central Committee on Major Issues Concerning the Reform and Development of State-owned Enterprises.
designed in the model in chapter 19 will become an option, depends on the future corporate development in China.

The models of corporate governance in chapter 19 stress controlling management power and developing disciplinary mechanisms for managers. This results from the influence of the current mainstream thinking concerning corporate governance, which emphasizes monitoring management power. The model gives more attention to ensuring shareholders' monitoring power, and upholding the accountability of the board of directors, and seeking other possible monitoring forces over management. By contrast, while justifying legal and other supervisory mechanisms to restrain management power, Chinese policy makers currently put more emphasis on the need to improve the quality of managers and entrepreneurs.

CONCLUSIONS

It is the time to summarize this thesis and this chapter. The institutional framework plays an important role in the performance of an economy. This fact has been illustrated by the experience of the successful economies. At the initial stage of China's enterprise reform, the reform effort did not focus on institutional changes toward nurturing profit maximising behavior, but on increasing enterprises' autonomy so as to strength enterprises' vitality. Since the strategy gained limited success. Chinese reformers, eventually, devoted their attention to the institutional structure of the enterprise system.

1122 See Douglass C North, Institutions, Institutional Change and Economic Performance (1990), 69.
1123 Ibid.
Since the mid-1980s, corporatisation has been gradually carried out in China. Since then, corporate governance is seen as a key element relating to the performance and economic efficiency of the enterprise system.

Modern corporate governance theories begin to be studied and applied in China. Following corporate ownership and agency cost analyses, the Chinese government has taken steps to separate the role of administering the national economy from the role of the owner of state-owned enterprises by establishing the Administrative Bureau of State Assets and state asset management companies. A number of measures have been taken to release state-owned enterprises from the excessive burden of non-commercial objectives. The banking system is to be restructured to make banks to play a greater role in facilitating a modern enterprise system and in corporate governance. A securities market is being developed to finance corporations and establish some market control of corporate governance.

In 1994, the first Company Law of the People’s Republic China became effective. The law provides the internal structure of corporate governance for Chinese companies. A commercial company has the shareholders’ meeting, managerial organ and supervisory organ. These organs are conferred different governance functions.

Despite these institutional and legal efforts, the system of corporate governance in China is far from complete. For instance, although the Administrative Bureau of State Assets and state asset management companies are established to exercise state shareholder rights, there are no adequate regulatory and institutional measures to ensure the efficiency and competence of these institutions. The law does not clarify whether a wholly state-owned company is required to set up a supervisory organ. There are no
sufficient provisions about the special requirement of the qualifications and obligations of the directors and managers in state-owned and controlled companies either. All these indicate that the system of corporate governance in China is still in the process of developing. At this special historical moment, the issue how should China develop its corporate governance system attracts wide interest and attention. People benefit from the increasing discussions and debates on this topic in terms of gaining a clearer view of the path of corporate development in China, the problems existing in the Chinese enterprise system, and the special social and institutional situations of China. With a sophisticated understanding on the issue, we are able to draw a sketch about the direction of corporate development in China. This, then, encourages us to discuss how China should develop its corporate system, and what kind of corporate governance model is suitable for China.

A suitable model of corporate governance for China has to be economically rational and practically feasible. This model needs to take not only economic rationality but also China's special social, political and cultural situations into consideration. Different developing paths have shaped divergent corporate systems in the world. Among them, some systems have produced successful corporate economies. The experience of these systems provides sources for China to develop its own path of successful corporate governance. Learning from others' experience is particularly necessary at a time when economic globalisation and integration are increasing, and important systems are accelerating the process of harmonizing their corporate laws and practice.

Bearing this in mind, this thesis has proposed a model of corporate governance for China. This model avoids making radical and revolutionary recommendations. It concerns itself more with the feasibility and practicability of its proposed model. It gives
more consideration to mainstream corporate theories and practice. It recommends that performance contracts and professional assessment institutions should be adopted to ensure the competence and efficiency of the Bureau and state asset management companies. It suggests that the advantages of corporate group structure, institutional shareholders and banks' involvement in corporate governance should be fully exploited.

An overall picture is that the model in chapter 19 basically corresponds with the general theme of the development of corporate governance in China, but has some differences regarding implementation. The experience of future practice may bring better judgement on the rationality of the model. With China's further integration into the world economy, the enterprise reform and corporatisation will be carried into a new stage. It will be interesting to see to what extent that the proposed model may be consistent with the emerging practice in China.

Since the economic reforms, Chinese policy-makers have always had a clear vision about national development. In relation to the strategies of the reforms, the Chinese prefer gradualism and flexibility. The reforms have been carried out step by step, and phase after phase. Long-term, middle-term and short-term goals complement each other. The final outcome is the result of the accumulation of experience and consideration. In this process, any useful discussion is appreciated. In addition, China is resisting the trend towards greater privatisation of the public sector. It will be interesting to see whether it can successfully challenge conventional wisdom.
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Appendix

Future development of corporate governance

NPC (central or local)  →  CCP

State administration of state property

Ministries (central or local)

Monetary authorities, securities regulatory authorities, professional bodies

Holding companies for state shares

Financial intermediaries (including those specializing in investing state shares)

All other investors (individuals, organizations, and companies, government or privately owned)

Professional advisers

Shareholders' general meetings

Employee representatives

Supervisory board

Committee

Committee

Committee

CEO

Senior managers

Employees

Senior managers

Supervisory board

Committee

Committee

Committee

CEO

Senior managers

Supervisory board

Committee

Committee

Committee

Professional advisers

Professional advisers

Policy or personal influence

Provision of professional services on competitive market

Regulatory relationship

Fiduciary/accountability relationship

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