

THE MILK SCANDAL AND CORPORATE GOVERNANCE IN CHINA

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In this article, the authors examine the role of the state in corporate governance in China as manifested in the government's handling of the 2008 tainted milk scandal and subsequent bankruptcy of Sanlu, the corporate group at the epicentre of the scandal. The scandal involved 22 dairy companies in the industry and attracted worldwide attention. Although the immediate impact of the scandal has since subsided, its wider implications particularly for corporate governance in China have been subject to little analysis.^o In their involvement in the Sanlu case, the Chinese governments, at both central and local government levels, were clearly mindful of their overriding role in driving China's phenomenal economic growth. Perhaps for this reason, the government appears to have been swayed by the need to maintain business confidence and social stability in adjusting the rights and liabilities of those involved in the scandal. On most measures the government appears to have made these adjustments successfully. The authors argue that while macro-economic utility appears to have therefore provided a valid justification for the government in adjusting the liabilities of corporate managers and the claims of those suffering loss as a result of their actions, such an approach risks obscuring the distinct roles in corporate governance now required of the government, the corporate regulator, the market and the courts as China seeks to build its domestic markets and attract international investors through a strong regime of corporate governance.

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^o The relatively few scholarly publications on the 2008 China Milk Scandal have mainly focused on food safety and social and political issues. See for example, Zhao Litao and Lim Tin Seng, 'The Tainted Milk Formula Incident: Another Hard Lesson for China' in Litao Zhao and Lim Tin Seng (eds) *China's New Social Policy: Initiatives for a Harmonious Society* (World Scientific Publishing Company, 2009) 195; Xiaofang Pei et al, 'The China Melamine Milk Scandal and Its Implications for Food Safety Regulation' (2011)36 *Food Policy* 412; Yungsuk Karen Yoo, 'Reconceptualising Human Rights: Tainted Milk: What Kind of Justice for Victims' Families in China?' (2010)33 *Hastings International and Comparative Law Review* 555.

I INTRODUCTION

Since the late 1990s, China has attached great importance to improving corporate governance. This has been driven partly by the need to develop a strong domestic stock market and partly by the need for corporations to access international markets and the global expectations of good corporate governance. In 2002, a *Code of Corporate Governance for Listed Companies* was issued by the China Securities and Regulatory Commission (the 'CSRC'), the watchdog for the Chinese stock market and publicly listed companies.

Since this time, China has continued to strengthen its underlying legal and regulatory framework for corporate governance. The overhaul of both the PRC Company Law and the Securities Law in 2005, and the subsequent enactment of the Enterprise Bankruptcy Law in 2006 have been praised by western commentators.¹ This is especially so in the case of the Company Law revision. The 1993 Company Law, preoccupied with setting up a management structure for the corporatised state-owned enterprises (SOEs), largely ignored other issues especially protection for minority shareholders. With the adoption of many Anglo-American style directors' duties and shareholders' rights and new remedies, the revamped Company Law has been commended as bringing some 'new hope' in aligning the Chinese corporate governance with the OECD corporate governance principles.²

Nonetheless, an understanding of the role of the state in Chinese corporate law and governance must be set against its role in economic development in China. In its 30 years transition from a planned economy to a 'socialist market economy', the Chinese government has often assumed the role of business promoter.³ In addition to retaining a controlling stake in most of the country's large corporatised state-owned enterprises (SOEs), the government has maintained economic growth, measured by GDP growth,

¹ James V Feinerman, 'New Hope for Corporate Governance in China?' in Donald Clark (ed) *China's Legal System: New Developments, New Challenges* (Cambridge University Press, 2008) 36, 36; Roman Tomasic, 'Looking at Corporate Governance in China's Large Companies: Is the Glass Half Full or Half Empty?' in Guanghua Yu (ed) *The Development of the Chinese Legal System Change and Challenges* (Routledge, 2010) 182, 195; Baoshu Wang and Hui Huang, 'China's New Company Law and Securities Law: An overview and assessment' (2006) 19(2) *Australian Journal of Corporate Law* 229-236, 236; Tomasic, Roman, 'The Conceptual Structure of China's New Corporate Bankruptcy Law' in Rebecca Parry, Yongqian Xu and Haizheng Zhang (eds) *China's new Enterprise Bankruptcy Law: Context, Interpretation, and Application* (Ashgate Publishing, 2010) 21.

² Feinerman, above n 1, 36; Tomasic, above n 1, 195.

³ The close links between central and local governments and businesses in China are well documented in literature. For example, Stefan Halper, *The Beijing consensus: How China's Authoritarian Model Will Dominate the Twenty-first Century* (Basic Books, 2010); Tony Saich, *Governance and Politics of China* (Palgrave Macmillan, 2nd ed, 2004) 230; Scott Kennedy, *The business of lobbying in China* (Harvard University Press, 2008); Andrew Walder, 'Local governments as industrial firms: An organizational analysis of China's transitional economy' (1995) 101 *American Journal of Sociology* 263; Jean Oi, 'The role of the local state in China's transitional economy' (1995) 144 *The China Quarterly* 1132; Jane Duckett, *The entrepreneurial state in China: Real estate and commerce departments in reform era Tianjin* (Routledge, 1998).

as a key policy priority.⁴ This type of state-led economic development and growth has achieved phenomenal economic results and has often been seen as one foundation for hope and optimism in the midst of a global economic downturn. At the same time, the leading role played by the government in the Chinese economy inevitably conditions the governance practices of the Chinese companies, especially the large ones close to the government.

In this regard, a small number of case studies on corporate governance in China have focused on the “coincidence of the state power and state ownership” within individual companies.⁵ The blurred boundary here between government and business has often been manifested in government intrusion in corporate management, leading to doubts as to the very independence of Chinese companies as distinct legal entities.

The 2008 melamine tainted milk scandal provides a rare opportunity for understanding state involvement in Chinese companies at the broad industry level. Given the magnitude and extensive social impact of the scandal, it provides a remarkable insight into the interaction of state power, the forces of globalisation and the rise of interest group politics in China. At the end of the day, the handling of the scandal and its aftermath by the central and relevant local governments shows that corporate governance in China remains a state-led model, most akin to the ‘administrative model’ described by Milhaupt and Pistor.⁶ In this model, the state plays the prominent role in monitoring managers and mediating competing interests among key corporate stakeholders through formal and informal mechanisms.

In this article, the authors provide a brief overview of the 2008 Chinese milk scandal. More specifically, they consider the roles assumed by the central and local governments in dealing with the corporations involved while seeking always to maintain business confidence and social stability. They suggest that the close government-business relationship, apparent in the handling of the Sanlu bankruptcy case, obscures the distinct roles of the government in safeguarding public health on the one hand while reinforcing the responsibility of corporate officers and the rights of minority shareholders on the other. In these respects, the supervening paternalism of the government may ultimately hinder the development of the proper roles of the regulator, the market and the courts in maintaining good corporate governance. The article concludes that the unique Chinese government-business association, guided by a government emphasis upon economic growth, is continuing to shape corporate governance practice in China.

⁴ See the PRC State Council’s Annual Work Reports to the National People’s Congress in recent years.

⁵ For example, Alice De Jonge, *Corporate Governance and China’s H-Share Market* (Edward Elgar, 2008); Neil Andrews, ‘When the CEO Vanished in Spin: Information Disclosure, Corporate Governance and the Bank of China (Hong Kong) Holdings Ltd.’ (2004) 17 *Aust Journal of Corporate Law* 71-96; Curtis Milhaupt and Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World* (University of Chicago Press, 2008) Chapter Seven: The China Aviation Oil Episode: Law and Development in China and Singapore.

⁶ Milhaupt and Pistor, above n7, 139.

II MAIN PLAYERS IN THE 2008 CHINA MILK SCANDAL

At the outset, it is important to consider the main players in the scandal. The Chinese dairy industry has experienced explosive growth since 2000. With an average annual growth rate of 23%, the total sales of the industry amounted to 23.5% of the entire food sector in 2006.⁷

Prior to the milk scandal, the industry was dominated by four corporate groups, namely Yili, Mengniu, Sanlu and Guangming groups of companies. All four groups were implicated in the scandal to various extents. Yili is an Inner Mongolia-based corporate group listed in Shanghai. The largest shareholder, the Inner Mongolia Autonomous Region government, owned about 10% of the shares in Yili in 2007. Mengniu, another Inner Mongolia-based dairy manufacturer, is listed in Hong Kong. The ultimate controllers of Mengniu were its founders primarily the Chairman and CEO. Guangming Dairy is a listed company controlled by the Shanghai Municipal government through two local state-owned enterprises.⁸

Sanlu, the corporate group at the epicentre of the tainted-milk scandal, was China's then largest infant formula producer. The group was headquartered in the northern city of Shijiazhuang, Hebei Province. Strictly speaking, Sanlu did not fall under the definition of a state-controlled company. The predecessor of Sanlu was a cooperative formed among local dairy farmers, which under the Chinese Constitution, constitutes a special form of state ownership.⁹ Shareholding reform in Sanlu was carried out by the Shijiazhuang city government in 2002, when the net assets of Sanlu were converted into shares, of which 92% were sold to the then Sanlu management and employees. The ownership reform in Sanlu as well as many other formerly state-owned companies was, in part, directed to improving corporate governance. The idea was that with the introduction of multiple shareholders, the companies would be far removed from government intervention and thus more likely to operate along the same lines with their western counterparts.¹⁰

Following a joint venture agreement with the New Zealand dairy giant Fonterra, 56% of Sanlu came to be held by Sanlu Limited which had been set up to represent the interests of Sanlu management and employees. Fonterra held 43% of shares in Sanlu and appointed three of the seven directors to the Sanlu board.¹¹ The remaining 1%

⁷ China Economy Net news story, *China Dairy Industry Policy released* [Ru ZhiPin Gongye Chanye Zhengce Fabu] (in Chinese); China Economic Daily (17 June 2008) <http://finance.ce.cn/macro/gdxw/200806/17/t20080617_13226765.shtml>. The news story indicates that the total sales of the Chinese dairy products reached RMB106 billion yuan in 2006.

⁸ The 2007 Annual Reports of Yili, Mengniu and Guangming.

⁹ *Constitution of the People's Republic of China*, Article 6.

¹⁰ Zhang Xu, 'An Overview of SanLu's History' [Huanyuan Sanlu Qianshi Jinsheng] (in Chinese) *Huaxia Times* (20 September 2008) <<http://finance.rj.com.cn/2008/09/2000072101769.shtml>>.

¹¹ Richard Spencer and Peter Foster, 'China Milk Scandal Threatens Giant Dairy Firm', *Telegraph* (online) 24 September 2008

shares in Sanlu were held by several small shareholders.¹² Public listing had been sought by Sanlu even before the establishment of the Sanlu-Fonterra joint venture and news reports suggested that if not for the exposure of the tainted milk scandal, Sanlu could have been listed on the Shanghai Stock Exchange in 2008.¹³

In December 2008, Sanlu was placed into liquidation. A number of former Sanlu senior executives and other persons involved have been convicted of criminal offences. Work on the compensation for tort victims has also been finalised, with most of the victims' families accepting a compensation scheme put forward by the dairy companies and backed by the central and local governments. The bankruptcy assets of Sanlu were purchased by Sanyuan Foods, a Beijing municipal government-controlled company listed on the Shanghai Stock Exchange.

III BACKDROP TO THE SCANDAL

Although corporate scandals have not been rare in China, none has attracted so much attention as the 2008 milk scandal. The various causes of the scandal have become relatively well known with their extensive media exposure. In September 2008, Sanlu was one of 22 infant formula producers which were found by China's food safety watchdog, AQSIQ (Chinese State Administration of Quality Supervision, Inspection and Quarantine), to be using melamine at various levels in their products.¹⁴ This group comprised about one fifth of China's infant formula producers and included almost all of the large and medium sized producers.

Melamine is an industrial chemical. Sustained consumption by human beings particularly infants may cause kidney stones and kidney failure.¹⁵ Previously found in

< <http://www.telegraph.co.uk/news/worldnews/asia/china/3073998/China-milk-scandal-threatens-giant-dairy-firm.html>>.

¹² The issue of the ownership of Sanlu become quite controversial in the aftermath of the scandal, as many people believed Sanlu was a state-owned enterprise. At a press conference held on 13 September, Mr. Yang Chongyong, the Vice-governor of Hebei province in response to questions on the relationship between Shijiazhuang government and the Sanlu group, stated, "Sanlu is a company limited by shares. 43% of Sanlu is held by Fonterra of New Zealand, and 56% by Sanlu Limited. There are also some small shareholders in Sanlu. The government does not own any shares in Sanlu." See China Central Television News (online) *Hebei Vice-Governor: Government Own No Shares in Sanlu* [Hebei Sheng Fu Shengzhang; Zhengfu Zai Sanlu Jituan Youxian Gongsì zhong Meiyou Gufen] (in Chinese) (13 September 2008) <<http://news.cctv.com/china/20080913/103040.shtml>>.

¹³ Long Li, 'Application Submitted, Sanlu Hopeful of Getting Listed in A Share Market in 2008' [Sanlu Jituan Xiangguan Cailiao Yi Baopi Youwang 2008 nian Shixian A gu Shangshi] (in Chinese) 21 *Century Economic Report*, (17 September 2008) <<http://news.hexun.com/2008-09-17/108945053.html>>.

¹⁴ Muxue Quan, 'China Seizes 22 Companies with Contaminated Baby Milk Powder' *Xinhua Net News* (17 September 2008) <http://news.xinhuanet.com/english/2008-09/17/content_10046949.htm>.

¹⁵ World Health Organisation, 'Melamine-contaminated Powdered Infant Formula in China - Update 2' (29 September 2008) <http://www.who.int/csr/don/2008_09_29a/en/>.

China-produced animal feed sold in the US in 2007,¹⁶ melamine contamination resurfaced in 2008 and unfortunately led to as many as six deaths and nearly 300,000 infants suffering from “urinary problems” including kidney stones, according to the Chinese Ministry of Health.¹⁷ Most of those victims were fed Sanlu’s lower-end infant formula by their middle to low income families.¹⁸

From the trial of four former Sanlu executives and dozens of melamine-related convictions, it has become evident that some unscrupulous milk station operators supplying raw milk to the dairy companies were the main culprits in the scandal. They added melamine, known as “protein powder”, to diluted milk to artificially raise its protein levels.¹⁹

However, the 2008 milk scandal was complicated by other factors. The poor internal controls of the dairy companies appeared to have fuelled the greed of the milk station operators supplying milk. The effectiveness of their internal control systems, impressively described in their annual reports, was questioned in the aftermath of the scandal. This is despite the string of awards and titles for strong corporate governance these dairy giants had received over many years.²⁰ As a report provided by Xinhua News Agency stated:

The testing and quality check personnel can't have been completely ignorant or innocent. An explanation is that the milk company's rapidly expanding business scales led to a shortage of milk sources, which forces them to collect milk loosely, turning a blind eye to poor quality raw milk.²¹

This is especially so given that spiking source milk with melamine had become a “public secret” in the industry at least in Hebei Province.²² Dairy companies in China

¹⁶ U.S. Food and Drug Administration, ‘Pet Food Recall (Melamine)/Tainted Animal Feed’ (6 February 6, 2008) <<http://www.fda.gov/oc/opacom/hottopics/petfood.html>>.

¹⁷ PRC Ministry of Health Media Office, ‘Update on Treatment of Sanlu Tainted Infant Formula Victims’ [Weisheng Bu tongbao Sanlu Pai Yingyou Er Naifen Shijian Yiliao Jiuzhi Gongzuo Qingkuang] (in Chinese) 1 December 2008 <http://www.moh.gov.cn/sofpro/cms/previewjspfile/mohbgt/cms_000000000000000144_tpl.jsp?requestCode=38386&CategoryID=4814>.

¹⁸ PRC Ministry of Health Media Office, above n19.

¹⁹ Yang Jianxiang, ‘Survivor Leads China's Milk Industry’ *Xinhua News Agency (online)* <http://news.xinhuanet.com/english/2008-11/15/content_10361534_3.htm>.

²⁰ For example, the awards received by Mengniu include: Best Corporate Public Image Award 2007 presented by the Enterprise Research Institute of Development Research Centre of the State Council and China Credit Research Centre of Beijing University, People’s Social Responsibility Award 2007 by the People’s Daily Online. See Mengniu 2008 Annual Report.

²¹ Yang, above n 21.

²² The practice of spiking source milk with melamine was traced back to April 2005 by the Deputy Governor of Hebei Province. See 21 Century Economy Reports news story, *Deputy-Governor of Hebei: Law Offenders Began to Add Melamine to Raw Milk From Two Years Ago*[Hebei Sheng Fusheng Zhang Toulou: Bufa Fenzi 2005 Nian Yi Kaishi Xiang Niunai Chan Sanju Qingan] (in Chinese), <<http://news.cnfol.com/080918/101,1280,4781164,00.shtml>>. Caijing Magazine, an influential Chinese non-state medium, Citing Hebei local dairy farmers, suggested that “the practice of spiking fresh milk with additives such as melamine had been a public secret for the past two years” See

used to rely on self-sufficient dairy farms, in which quality control over source milk was not a major problem. However, with the explosive growth since 2000, there has been fierce industry-wide competition for milk sources. In a quest to expand milk sources in the most 'cost-effective' ways, large dairy companies, including Sanlu, Mengnui and Yili, increasingly relied upon privately-run milk collection stations to purchase raw milk from small scale dairy farmers, instead of developing their own dairy farms. The combination of market competition, commercial greed and the lax quality control of the dairy companies led milk dealers to "spike raw milk with all sorts of additives, such as melamine".²³

As widely exposed in the media, the scandal has also been aggravated by a lack of clarity in the roles assumed by central and local government agencies in regulating a fundamental area of food safety. The focus of public criticism of AQSIQ was a system of exemption from quality inspections the agency had introduced in 2000 to "ease the burden for companies that otherwise would undergo repeated inspections".²⁴ The system allowed many companies including dairy giants like Sanlu to enjoy the quality inspection-free status. This was so despite alarms repeatedly raised by a series of major food scandals on food safety in China.²⁵

IV THE CLOSE RELATIONSHIP BETWEEN GOVERNMENT AND BUSINESS

The close ties between Sanlu and the local Shijiazhuang municipal government, where Sanlu was headquartered, raise important questions as to the ways in which blurred lines between the government and the corporations might undermine the regulation of officers' legal duties and broader responsibilities, and detract from the maintenance of good corporate governance practice.

As well as lax internal controls, Sanlu's case presents a special example of outright disregard for corporate social responsibility in the name of business survival needs. As revealed by the trial of the four Sanlu executives, the company had received complaints about babies rendered ill after drinking Sanlu-produced infant formula since December 2007. Some cases, including complaints about kidney stones, had emerged as early as March 2008. However, during the eight months from December 2007 to early August 2008, when melamine contamination was confirmed by tests

Chao Xu, 'Tracing Source of Melamine'[Sanju Qingan Suyuan] (in Chinese), (2008) 20*Caijing Magazine* <<http://magazine.caijing.com.cn/20080928/77700.shtml>>; Also see Jing Guo and Jingling Liu, 'Spilling the Blame for China's Milk Crisis' *Caijing Magazine online news*, 10 October 2008 <<http://english.caijing.com.cn/2008-10-10/110019183.html>> .

²³ Xu, above n 24.

²⁴ Yang Binbin 'Food Product Inspection Waivers Revoked' *Caijing Magazine online news*, 18 September 2008 <<http://english.caijing.com.cn/2008-09-18/110013644.html>>.

²⁵ These include a separate incident in 2004 where about ten babies were reportedly killed by fake or defective infant formula sold in Anhui Province. See Di Fang 'Milk Powders Kills Babies in Anhui Province, *China Daily* (online) 20 April 2004 <http://www.chinadaily.com.cn/english/doc/2004-04/20/content_324727.htm>.

reluctantly carried out by Sanlu with an outside organisation, the Sanlu management took extensive measures to cover up the scandal, in the name of internal inquiries being undertaken by the company.²⁶

The extremely cosy relationship between Sanlu and the Shijiazhuang municipal government is highlighted by the latter's extensive delay in reporting Sanlu's milk contamination to its higher authority, the Hebei Provincial government. When the municipal government finally received a report of melamine contamination from Sanlu, it took the government thirty-eight days (instead of two hours stipulated by a State Council regulation²⁷) to forward Sanlu's report to the provincial government. This meant that the central government was not informed of the incident until 9 September, which was nine months after the first sign of melamine contamination emerged.²⁸ Other reports from non-official media suggested that the alarm was coincidentally raised to the central government by the former New Zealand Prime Minister.²⁹

When asked what had caused the Shijiazhuang government to sit on Sanlu's report for more than a month, allowing the impact of melamine contamination to escalate, a spokesperson of the Shijiazhuang government invoked "support for local businesses".³⁰ The spokesperson even referred to a letter from Sanlu that had pleaded with the government to "increase control and coordination of the media, to create a good environment for the recall of the company's problem products...to avoid whipping up the issue and creating a negative influence in society."³¹ The association between Sanlu and the Shijiazhuang government must have been close enough to "convince" Fonterra, Sanlu's New Zealand joint venture partner, to "work within the

²⁶ Spencer and Foster, above n13; Teiqiao Ye, 'Truth of Sanlu Incident revealed' [Sanlu Shijian Zhenxiang Dabao Guang] (in Chinese), *China Youth Daily*, 1 January 2009 <http://news.xinhuanet.com/politics/2009-01/01/content_10587575.htm>.

²⁷ The State Council of the People's Republic of China, *National Emergency Plan for Handling Major Food Safety Accidents* (Effective on February 2006) [Guojia Zhongda Shipin Anquan Shigu Yingji Yuan] (in Chinese), s3.2.2.

²⁸ The Chinese Central Government, 'The Central Party Committee and the State Council Handle Persons Involved in the Sanlu Milk Scandal Seriously' [Dang zhongyang Guowu Yuan Yansu Chuli Sanlu Naifen Shijian Xiangguan Zeren Renyuan] (in Chinese), the PRC Central People's Government website, 22 September 2008 <http://www.gov.cn/jrzg/2008-09/22/content_1102256.htm>.

²⁹ There have been different explanations regarding how the scandal was exposed. Sanlu's New Zealand partner Fonterra claimed that it was informed by its Chinese Partner of the milk contamination on 2 August, 2008, the same day on which the Shijiazhuang city government was informed. After three unsuccessful meetings with the Shijiazhuang health officials to raise the alarm, the company reported the incident to the New Zealand Foreign Affairs Department on 22 August, which led to the issue finally being brought to the attention of the Chinese central government by the former New Zealand Prime Minister on 9 September. See Spencer and Foster, above n 13.

³⁰ Nan Su, 'Why Report of Sanlu Incident was Delayed?' [Sanlu Shijian Weihe Chichi Bubao] (in Chinese) *China Daily* (online), 1 October 2008 <[Http://paper.people.com.cn/rmr/html/2008-10/01/content_112000.htm](http://paper.people.com.cn/rmr/html/2008-10/01/content_112000.htm)>; BBC news, 'China Dairy 'Asked for Cover-up'' 1 October 2008 <<http://news.bbc.co.uk/2/hi/asia-pacific/7646512.stm>>.

³¹ Ibid.

system” to effect an official product recall. When informed of the melamine contamination by its Chinese partner, Fonterra went public only after three failed meetings with the Shijiazhuang municipal authorities.³²

It can be argued that as an individual case, the role of the Shijiazhuang government in Sanlu’s scandal should not be generalised. However, given the substantial convergence of government and business interests, one might expect that in similar circumstances a similarly protective role could well be adopted by some other local governments. The share of tax revenue between central and local governments has been considered an important factor for widespread local protectionism. Under this scheme, large local enterprises, both state and privately-controlled ones, serve as a major source of revenue for local governments.³³ On a broader level, local economic growth, measured by GDP growth rate as well as tax revenue, forms an important part of the performance review for local officials by their higher authorities.³⁴ As such, the more milk sold by the dairy companies means not only increased local revenue but also superior performance of local officials.

In Sanlu’s case, the company contributed 330 million yuan (approximately US\$48.5 million) in tax revenue to the municipal government in 2007 alone.³⁵ As one of China’s top 500, the company was also on the lists of “key enterprises” supported by the Shijiazhuang City and Hebei Province. Ms Tian Wenhua, Sanlu’s Chairwoman and CEO, was given “more than 100” national and local honorary titles including representative to the National People’s Political Consultative Conference and the Hebei Provincial People’s Congress.³⁶

Whilst more refined judgments might be made as to the roles played by the Shijiazhuang city government and AQSIG respectively in the 2008 milk scandal, (for

³² Spencer and Foster, above n 13; Also see Shanshan Wang, ‘Fonterra CEO reflecting on investing in China’, *Caijing Magazine News* (online) 5 December 2008 <<http://www.caijing.com.cn/2008-12-05/110035012.html>>.

³³ Maria Edin, ‘Local State Structure and Developmental Incentives in China’ in Richard Boyed and Tak-Wing Ngo (eds) *Asian States: Beyond the Developmental Perspective* (RoutledgeCurzon, 2005) 110, 117-122; Shenzhen Stock Exchange Research Institute, *An Empirical Study on the Development of China’s Private Sector Listed Companies*, January 2008 <<http://www.szse.cn/main/files/2008/02/25/091811911155.pdf>>. At the end of 2005, the private sector in China accounted for more than 57% of all enterprises in China and contributed to 65% of China’s GDP, absorbing more than 75% of the urban employment.

³⁴ Maria Edin, *Ibid*; Huayun Yang, ‘Member of the Standing Committee of the National People’s Congress Criticises Irrational Government Performance View: Local GDP Figures should be Disregarded’ *Xinhua News* online, 29 December 2008 [Renda Weiyuan Pengji Nuqu Zhengji Guan: Difang GDP Tongji Ying Quxiao] (in Chinese) <http://news.xinhuanet.com/fortune/2008-12/29/content_10572701.htm>.

³⁵ Willy Lam, ‘Milk scandal sours China’s ‘soft power’’, *Asia Times* (online), 10 October 2008 <<http://www.atimes.com/atimes/China/JJ10Ad02.html>>.

³⁶ Hongxiang Xiong, ‘Four Former Sanlu Senior Executives including Chairwoman Tian Wenhua Stood for Trial in Shijiazhuang Today’ [Sanlu Jituang Yuan Dongshi Zhang Tianwen Hua De Sining Gaouan Shijiazhuang Shoushen] (in Chinese), *Xinhua News* online 31 December 2008 <http://news.xinhuanet.com/legal/2008-12/31/content_10583852.htm>.

example, the involvement of the former appeared more deliberate and probably more culpable than the latter), the roles of both government and agency perhaps find their ultimate justification in the emphasis of the central government on maintaining strong economic growth and the need to make practical judgments directed to this end.

On the other hand, maintaining this policy priority, and the government's concern for minimising business compliance costs, have clearly produced some unintended consequences. In particular, the emphasis on economic growth tends to obscure the distinctly different roles required of the government, the corporate regulator, the market and the courts in maintaining the corporate governance framework. This loss of regulatory clarity, manifested in part by government protection of businesses, appears to have contributed to the companies' lax internal controls, and may have contributed further to excessive-risk taking and irrational competition among the dairy companies, and in some cases ignorance of law in pursuit of corporate profits.

V THE GOVERNMENT'S HANDLING OF THE SCANDAL AFTERMATH

Apart from leaving behind close to 300,000 baby victims, the exposure of the tainted milk scandal clearly threw the Chinese fast growing dairy industry into a deep crisis. Whilst the Sanlu group of 30 subsidiaries and entities became essentially insolvent, other dairy giants including Yili and Mengniu were also hit hard. Dairy sales slumped with lost consumer confidence and worldwide bans on Chinese dairy products.³⁷

As discussed above, a weak local government, substantially captured by business interests, appeared evident in the Shijiazhuang city government's involvement in Sanlu prior to the exposure of the scandal. The strong leadership of the central government in handling the aftermath of the scandal is however highly significant. The importance of the scandal to the central government is demonstrated by a broad range of measures the government promptly adopted in its aftermath. Massive dairy product recalls were issued, food safety standards tightened and free medical examination and treatment were also ordered for melamine affected children. Charges were laid against dozens of milk station operators, "protein powder" producers, and the disgraced Sanlu Chairwoman and executives. A number of government officials at both central and local levels have also "stepped down" or been sacked (though no charges have been reportedly laid against any of them).³⁸

³⁷ Jin Wang, 'China Dairy Crisis, Industry Reorganisation Inevitable' [Zhongguo Ruye Weiji- Hangye Xipai Buke Bimian] (in Chinese), *China Securities Daily*, 22 September 2008 <http://www.cs.com.cn/xwzx/05/200809/t20080922_1591661.htm>.

³⁸ The Chinese Central Government, 'The Central Party Committee and the State Council Handle Persons Involved in the Sanlu Milk Scandal Seriously' [Dang zhongyang Guowu Yuan Yansu Chuli Sanlu Naifen Shijian Xiangguan Zeren Renyuan] (in Chinese), the PRC Central People's Government website, 22 September 2008<http://www.gov.cn/jrzg/2008-09/22/content_1102256.htm>; Xin Hua

A Dealing With The Tort Victims

Needless to say, one of the most contentious issues arising from the milk scandal is compensation for the near 300,000 tort victims. Should the scandal occur in a western market economy such as Australia, one would expect a flood of lawsuits brought before the court by the families of tort victims, or these days more probably, class actions being pursued on behalf of those victims against the tortfeasor companies, as well as the Shijiazhuang municipal government should it become evident that the government had played a role in exacerbating the loss or injury suffered by the victims. If any dairy company, such as Sanlu, became insolvent or approached insolvency due to massive debts owed to their creditors, external administration such as voluntary administration or liquidation may be the fate of the company.

In the aftermath of the scandal, most of the dairy giants have survived the catastrophe with a great deal of self-help as well as some help from the government. The latter involved government subsidies provided to companies and dairy farmers, as well as government-sponsored media campaigns in an attempt to restore consumer confidence. However, Sanlu, the corporate group most seriously affected by the scandal, was clearly on the verge of bankruptcy. At the outbreak of the scandal, while Sanlu's 15 billion yuan brand name was rendered worthless, the company faced potential claims of 0.7 billion yuan from its trade creditors alone. This means with 1.224 billion yuan worth of net assets by the end of 2007, it was difficult for Sanlu to meet all potential claims in tort and contracts.³⁹

Strangely, during the four months from the first eruption of the scandal on 11 September to 23 December 2008, when Sanlu was declared bankrupt by the Shijiazhuang City Intermediate Court (on an application filed by a state-owned bank), no other claims, including tort claims, associated with the scandal, were reportedly heard by any Chinese court. It is not that no one sued. The few claims filed were simply refused to be accepted or heard.⁴⁰

The Chinese law does provide some redress for tort victims. The 1986 General Principles of Civil Law, which sets out a basic framework for Chinese civil and

News online, 'Update on Sanlu Infant Formula Incident'[Sanlu Pai Yingyou Er Naifen Shijian Gundong Baodao] (in Chinese) 20 September 2008 <http://news.xinhuanet.com/newscenter/2008-09/20/content_9935963.htm>.

³⁹ China News online, 'Compensation Claims against Sanlu Suspended: Who shall Compensate the Victims?'[Sanlu Suopei Zanlu Lian, Shuilai Peichang Shouhai Zhe?] (in Chinese) 11 November 2008<<http://www.chinanews.com.cn/cj/xfsh/news/2008/11-11/1445254.shtml>>.

⁴⁰ Yanxia Wu, 'Why Tort Claims Associated with the Milk Scandal refused to be Heard by Courts? Reasons Explained by Vice-president of the Hebei Lawyers Association' [Jieshi Huaner Minshi Peichang An wuyi Huo shouli Hebei Lvxie jieshi](in Chinese) Xinhua Net News 7 January 2009<http://news.xinhuanet.com/legal/2009-01/07/content_10615043.htm>; New York Times (online) 17 October 2008 <<http://www.nytimes.com/2008/10/17/world/asia/17milk.html?fta=y>>.

commercial legislation, imposes on manufacturers as well as sellers the liability for economic loss and physical injury caused by defective goods.⁴¹

This general provision has been reinforced by at least two pieces of legislation on consumer protection, namely the Law for the Protection of Consumer Rights and Interests (the “Consumer Protection Law”) and the Law on Product Quality Liability (the “Product Quality Law”). Article 35 of the Consumer Protection Law, echoed in Article 43 of the Product liability Law, allows a “consumer or other victim” who suffers economic loss or physical injury as a result of defective goods to claim compensation from both the seller and the manufacturer. The heads of damages include “medical expenses, nursing expenses during medical treatment, the reduced income for loss of working time and other expenses”.⁴² Should a consumer or victim be “disabled” by the defective product, the compensation should also include “the victims’ expenses on self-help devices, living allowances, compensations for disability and the necessary living cost of the persons supported by the disabled”. Further, should death be caused by defective goods, the defendant will also be liable for “funeral expenses, death compensation and the necessary living cost of the persons supported by the deceased during their lifetime.”⁴³ Although neither compensation for pain and suffering (“mental and spiritual loss” in Chinese terms) nor exemplary damages are provided in any Chinese legislation, it is not rare for the court to award such compensation in practice, under either the heads of “compensation for disability”, “compensation for death” or a judicial opinion issued by the Supreme People’s Court on “mental and spiritual loss” in civil cases.⁴⁴

In relation to the forms of litigation, the Civil Procedure Law of the PRC provides for individual actions as well as a “collective action” that resembles some key features of an Australian style class action. A Chinese “collective action” under the Civil Procedural Law, enables the persons comprising a class to “elect representatives from among themselves to act for them in the litigation”.⁴⁵ Where the number of persons comprising one of the parties is large but uncertain at the commencement of the action, the court may issue a public notice informing those entitled to participate in the action to register their rights with the court within a specific period of time fixed by the court.⁴⁶ In the latter circumstance, the court’s decision for the collective action is binding not only upon those who have registered with the court, but also “those

⁴¹ *The Civil Procedure Law of the People’s Republic of China*, Article 122.

⁴² The Consumer Protection Law of the People’s Republic of China, Articles 41 and 42; The Product Quality Liability Law of the People’s Republic of China, Article 44.

⁴³ *Ibid.*

⁴⁴ The PRC Supreme People’s Court, *An Explanation on Several Issues Relating to The Assessment of Mental and Spiritual Loss in Civil Litigation* [Zuigao Renmin Fayuan Guanyu Queding Minshi Qinquan Jingshen Sunhai Peichang Zeren Ruogan Wenti de Jieshi] (in Chinese), 2001.

⁴⁵ PRC Civil Procedure Law, Article 54.

⁴⁶ PRC Civil Procedure Law, Article 55 (1).

who have not registered their rights but have instituted legal proceedings within the period of limitation of the action”.⁴⁷

The fairly comprehensive law on consumer protection in China appeared to sit uncomfortably with the lack of court involvement in disputes associated with the tainted milk scandal. The highly sensitive nature of the scandal, particularly the potentially bad publicity and social unrest that could be generated by a flood of lawsuits, apparently led the courts to defer their primary role in settling disputes to the government. It is true that the legislation in China has often been drafted in too broad terms to provide the courts with much clear guidance. This is especially so with class action.⁴⁸ Such deficiency had nonetheless been often filled in China with some degree of judicial creativity, particularly in the form of judicial opinions issued by the Supreme People’s Court in guiding decision-making by lower courts. There was however little room for this sort of judicial creativity to apply in the handling of the aftermath of the milk scandal.

B Government Efforts To Rescue Sanlu

Apart from compensation for tort victims, government intervention in business was also manifested in the handling of the collapse of Sanlu. The placing of Sanlu into liquidation would be a good test case for the newly enacted Enterprise Bankruptcy Law (the “EBL”). The EBL, enacted in August 2006, was to replace a 20-year-old bankruptcy law that applied only to state-owned enterprises on a trial basis. Drawing upon international experience in insolvency law and practice, the new legislation provides for bankruptcy procedures including liquidation, compromise as well as an American style reorganisation.

Although Sanlu eventually did not avoid a court-ordered liquidation, this outcome was not intended by the Hebei and Shijiazhuang governments when the scandal first broke. This can be demonstrated by the refusal of the Shijiazhuang Intermediate Court (the court which, as discussed below eventually heard Sanlu’s bankruptcy case on another application) to hear an earlier bankruptcy application filed by one of its sales agents against Sanlu. The application was rejected with no clear reason given.⁴⁹

⁴⁷ PRC Civil Procedure Law, Article 55(4).

⁴⁸ Lay Hong Tan and Jiangyu Wang, ‘Modelling an Effective Corporate Governance System for China’s Listed State-Owned Enterprises: Issues and Challenges in a Transitional Economy’ (2007)7 *Journal of Corporate Law Studies*, 143, 162-163; Broadly-based legislation is considered by Pistor and Wellons as a legal drafting technique commonly employed by state-led economies to allow for sufficient bureaucratic flexibility in intervening in the economy. See Katharina Pistor and Philip Wellons, *The Role of Law and Legal Institutions in Asian Economic Development, 1960-1995* (Oxford University Press, 1999) 53.

⁴⁹ Ning Kang, ‘Sanlu Bankruptcy Case, Death or Rebirth?’ [Sanlu Pochan an, Shi Xiaoshi Haishi Niepan] (in Chinese) *Xinhua News* online 5 January 2009 < http://news.xinhuanet.com/fortune/2009-01/05/content_10604233.htm>.

The idea of having Sanlu taken over by another company, rather than placing it into liquidation was clearly preferred by the government on economic grounds. The value of the “intangible assets” accumulated by the leading dairy giant over the past twenty years, ranging from advanced production and marketing systems to extensive network for source milk, could be better realised through a takeover. Further, there would be a greater chance for Sanlu to repay its debts should it stay in business.⁵⁰

The plan emerged on 26 September, when the shares of Shanghai-listed Beijing Sanyuan Foods were suspended, and the company announced that it ‘had received a government notice to consider a Sanlu merger plan’.⁵¹ Commentators said that Sanyuan had been selected for two main reasons: first, the company is the major Chinese dairy company that was not implicated by the scandal (in part due to its reliance on self-sufficient dairy farms for source milk), and second, Sanyuan is a state-controlled company which makes it easier for the government to manipulate.⁵²

The proposed Sanyuan takeover of Sanlu has been widely regarded as “an impossible mission” from a pure market perspective.⁵³ Whilst Sanlu has been one of the leading Chinese dairy giants with businesses around the country, Sanyuan, with its annual sales amounting to only about 10% of Sanlu, was largely unknown to consumers outside Beijing. Sanyuan claimed that the acquisition would raise its market competitiveness by adding to its liquid milk business an extra line of business in powdered milk. Industry experts however suggested that problems such as business integration and cash flow, particularly with the indeterminable amount of potential claims faced by Sanlu, could drag Sanyuan into insolvency. Further, the fundamental problem that had caused the demise of Sanlu, i.e., its heavy reliance on milk dealers for source milk, could pose a significant threat to Sanyuan’s branding. With the backing of Beijing and Hebei governments, the takeover negotiations nonetheless continued for months, though not always smoothly.⁵⁴

⁵⁰Ibid.

⁵¹ Xiaomin Qiu, ‘Insiders Comment on Sanyuan Sanlu Merger; Sanyuan Left with No Choice’ [Zhiqing renshi tan Sanyuan Binggou Sanlu; Sanyuan Shenbu Youji] (in Chinese), *Xinhua News* (online) 4 January 2009 <http://news.xinhuanet.com/fortune//2009-01/04/content_10598930.htm>; China Economy Net news, *Sanyuan May Take over Tainted Milk Brand Sanlu*, 27 September 2007 <http://en.ce.cn/Business/Enterprise/200809/27/t20080927_16935772.shtml>.

⁵² Qiu, above n 53.

⁵³ Zhang Xu, ‘Wandashan on watch Sanlu Restructuring: Sanyuan Likely to Struggle Alone’ [Sanlu: Wanda Shan Pangguan Sanyuan Huo Gudu Poju] (in Chinese), *Shanghai Securities Daily* (online) 5 November 2008 <http://cs.xinhuanet.com/cqzk/05/200811/t20081120_1659972.htm>.

⁵⁴ Xinhua Net news, *Sanyuan Taking over Sanlu, A Sensitive Case* [Sanyuan Binggou Sanlu: Guanxi Mingan de Juzhong Ju] (in Chinese), 2 January 2009 <http://news.xinhuanet.com/fortune/2009-01/02/content_10590487.htm>

C Liquidating Sanlu: the role of the courts obscured by economic utility and paternalism

The Sanyuan takeover plan was not successful, and was followed by an order of the Shijiazhuang Intermediate Court placing Sanlu into bankruptcy liquidation as applied by a local branch of a state-owned bank, a Sanlu's creditor. On 12 January 2009, a public notice was issued by the court, inviting creditors to file their claims with the bankruptcy administrator appointed by the court.⁵⁵ With news reports indicating that some core enterprises in the Sanlu group had resumed production under a lease agreement with Sanyuan, commentators said that the "government-led bankruptcy" of Sanlu would probably work more favourably to Sanyuan, as it provided Sanyuan with an opportunity to acquire Sanlu's bankruptcy assets without taking over its debt.⁵⁶

Sanlu was declared bankrupt on 12 February 2009. On 4 March 2009, Sanyuan acquired Sanlu's bankruptcy assets at a public auction with the bidder criteria tailor-made to Sanyuan (The auction was only open to Chinese domestic dairy producers that had not been implicated in the milk scandal).⁵⁷ The Sanlu bankruptcy case was concluded on 22 November 2009. The court order stated that after priority creditors, including employees and secured creditors had been paid, there were no assets available for distribution among ordinary creditors, including the tainted milk victims.⁵⁸

The swift handling of the Sanlu bankruptcy case without causing major social unrest appeared to have been facilitated by some measures the central and local governments adopted outside the court proceedings. Firstly, with some "pre-arrangement" made by the government for the tort victims, the commencement of the Sanlu bankruptcy proceedings did not result in a flood of law suits filed by tort victims. On 10 December, after three months of contention surrounding the issue of the victims compensation, the Ministry of Health issued a media release stating that "relevant departments are now considering a compensation plan for the Sanlu infant milk powder incident," and "the Ministry was compiling information about the victims

⁵⁵ Shanshan Wang, 'Sanlu Bankruptcy Proceedings Commenced: Creditors to File Claims' [Sanlu Pochan An Qidong Zhaiquan Ren Dengji](in Chinese) *Caijing Magazine* online, 13 January 2009<<http://www.caijing.com.cn/2009-01-13/110047651.html>>. Article 14 of the EBL provides that the court hearing the bankruptcy proceedings shall "within 25 days from the date it has accepted a bankruptcy application, notify known creditors and issue a public notice to that effect". Under Article 45, once the court has accepted an application for bankruptcy, it must also set a time limit for creditors to file their claims, and that time limit should be within a range of no less than 30 days but not more than three months from the date the public notice of the court's acceptance of the bankruptcy application was issued.

⁵⁶ Xinhua Net news, *Sanlu to be Declared Bankruptcy: Rumoured in Favour of Sanlu* [Sanlu Jiang Xianggao Pochan Chuanyan lihao Sanlu Shougou] (in Chinese) 23 December 2008<http://news.xinhuanet.com/fortune/2008-12/23/content_10547631.htm>

⁵⁷ People's Daily online news, *Sanyuan Buys Scandal-hit Sanlu Dairy Company at Auction*, 4 March 2009< <http://english.peopledaily.com.cn/90001/90783/91300/6606135.html>>.

⁵⁸ Yan Wang, 'Compensation Lawsuit over Tainted Milk Postponed' *China Daily* (online) 9 December 2009<http://www.chinadaily.com.cn/business/2009-12/09/content_9144184.htm>.

who may receive compensation”.⁵⁹ No further details of the plan were subsequently released. However, on 30 December 2008, one week after Sanlu was declared bankrupt, the state media China Daily revealed that the 22 dairy companies involved in the milk scandal (including Sanlu) had committed 900 million yuan (US\$131 million) as “one-off compensation”⁶⁰ to all tort victims. Hence, each victim family would receive a sum of 2,000 yuan (US\$292) or 30,000 yuan (US\$4,400) depending on the degree of sickness of their babies caused by the tainted milk, or 200,000 yuan (US\$29,000) in case of death.

In addition, the 22 companies would establish a 200 million yuan fund to be managed by the China Dairy Industry Association to “cover medical bills for any lingering problems related to the tainted milk.”⁶¹ The fund would also allow the tort victims to have access to insurance coverage with a leading state-controlled insurance company, as arranged by the dairy companies, for the “full amount of medical bills related to the tainted milk incurred before they turn 18 years of age”.⁶² This arrangement appeared to be a pure business act of the dairy companies. However, it was also suggested that the 902 million yuan, contributed by Sanlu one week before it was declared bankrupt, was raised “with the assistance” of the Shijiazhuang government.⁶³

Further reports indicated that the implementation of the compensation scheme has been highly successful. The overwhelming majority (90.7%) of the near 300, 000 victim families had taken up the offer made by the dairy companies by early 2009.⁶⁴ This is so, despite various criticisms surrounding the adequacy of the compensation proposed.⁶⁵

The fact that most tort victim families gave up a judicial redress for their claims is not surprising. Lying at the bottom of the priority list for distribution of bankruptcy assets

⁵⁹Tingyu Zhou, ‘Relevant Chinese Departments Considering a Compensation Plan for Problem Powdered Milk Victims’ [Zhongguo Xiangguan Bumen Zhengzai Taolun Wenti Naifen Shijian Peichang Fangan] (in Chinese), *Xinhua Agency News* (online) 10 December 2008 <http://news.xinhuanet.com/newscenter/2008-12/10/content_10484532_1.htm>.

⁶⁰Zhe Zhu and Xiaohuo Cui, ‘22 Dairy Firms to Pay \$160m in Compensation’, *China Daily* (online) 30 December 2008 <http://www.chinadaily.com.cn/cndy/2008-12/30/content_7351554.htm>.

⁶¹Ibid.

⁶²Wu, above n42.

⁶³Lin Niu, ‘Shijiazhuang Official Dismissed Alleged Government Assistance in Fund Raising for Sanlu to Repay Its Debt through providing Government Office Buildings as Guarantee’ [Shijiazhuang Guanfang Cheng Diya Zhengfu Dayuan Chou Sanlu Peikuan Yiwu Xuyou] (in Chinese), *Xinhua Net News*, 8 January 2009 <http://news.xinhuanet.com/politics/2009-01/08/content_10625612.htm>.

⁶⁴Xinhua Net news story, *Over 90% Tort Victims of the Tainted Powdered Milk Incident Voluntarily Accepted the Compensation* [Chao 90% Yingyou Er Naifen Shijian Huaner Jiazhang Yi Jieshou Zhudong Peichang] (in Chinese) 24 January 2009 <http://www.he.xinhuanet.com/news/2009-01/24/content_15543516.htm>.

⁶⁵Zhu Zhu and Xiaoho Cui, ‘22 Dairy Firms to Pay \$160m in Compensation’ *China Daily* (online) <http://www.chinadaily.com.cn/cndy/2008-12/30/content_7351554.htm>. For example, one report indicates that “many parents find the 2000 yuan for ‘the minor kidney problems’ too inadequate to accept. Other criticisms on the inadequacy of compensation plan related to the scope and the period of the insurance coverage and the lack of involvement of the families of the tort victims in the formulation of the scheme.

together with other unsecured creditors,⁶⁶ there was no guarantee that they could receive more than what the companies had offered, not to mention the formidable legal and financial difficulties these families could face in filing their proof of debt with the bankruptcy administrator. Under Article 47 of the EBL, the admissible forms of proof of debt include judgement and arbitration and pending judgment and arbitration debts.⁶⁷ Without a court having heard their claims, the tort victims did not have any judgements, or pending judgements to submit to the bankruptcy administrator as proof of debt. Although they had thirty days (the time limit given by the bankruptcy administrator for filing claims and proof of debt) to lodge their claims with the Shijiazhuang Intermediate Court,⁶⁸ the tight deadline for them to prepare and lodge their cases could be an insurmountable hurdle to overcome, even if the court was prepared to hear their claims. All these factors, and a traditional Chinese mentality of resorting to the government for resolution for disputes, contributed to the high acceptance rate of the government-sponsored compensation plan.

Secondly, in relation to Sanlu's trade creditors, a separate debt repayment agreement, also backed by government, was reached outside Sanlu's bankruptcy proceedings. The agreement was signed on behalf of Sanlu by Sanlu Trading Company, a wholly-owned subsidiary of Sanlu.⁶⁹ The agreement was finalised on 23 December, when Sanlu was delivered the bankruptcy order. On the same day, the Hebei Provincial and Shijiazhuang municipal governments, after a meeting between "the Hebei Provincial Communist Party Committee, the Provincial government, and the Shijiazhuang city Party Committee and the government", agreed to "guarantee the co-ordination of the full repayment should Sanlu have difficulties in repaying the debts".⁷⁰ The guarantee was provided following a petition by 300 Sanlu sales agents who gathered at the Sanlu headquarter and in front of Hebei Provincial government.

⁶⁶ The order of distribution of bankruptcy assets as provided in Article 113 of the EBL is as follows: (1) bankruptcy expenses and common benefits debts (certain debts incurred by the debtor company after the commencement of the bankruptcy proceedings such as those arising from agency by necessity or personal loss or injury caused by the company property; (2) unpaid wages and other welfare payments; (3) unpaid social insurance premiums and taxes; (4) unsecured claims; Where the insolvent assets are not enough to satisfy the debts in the same ranking, the *pari passu* rule will apply. Note that there is currently a debate among the Chinese legal scholars on whether the debt owed to tort victims by Sanlu should be classified as common benefits debt.

⁶⁷ Note in relation to the forms of proof of debt, the EBL has adopted a much narrower approach as compared to s553 (1) of the Australian Corporations Act which includes "all debts payable by and all claims against the company (present or future, certain or contingent, ascertained or sounding only in damages)" arising before the commencement of the winding up.

⁶⁸ The Enterprise Bankruptcy Law of the People's Republic of China, Article 21. The Article provides that once a bankruptcy application against a debtor company has been accepted by the court, any civil claims against the debtor can only be lodged with the court hearing the bankruptcy case.

⁶⁹ Jing Li, 'Sanlu to be Sold through Bankruptcy Auction: Total Debts Estimated Near 2 Billion Yuan' [Sanlu Pochan Paimai Huanzha, Guji Sanlu Zong Fuzhai Jin 20 Yiyuan] (in Chinese), *Xinjing Daily News Story*, 25 December 2008, found on Xinhua Net <http://news.xinhuanet.com/fortune/2008-12/25/content_10555709.htm>.

⁷⁰ *Shijiazhuang City Government Report on Sanlu Bankruptcy Case* (full text), Xinhua Net News <http://news.xinhuanet.com/fortune/2008-12/25/content_10557898.htm>.

The validity of the separate debt repayment agreement is highly doubtful. Under Article 16 of the EBL, once the court has accepted an application for bankruptcy, any repayment of debts by the debtor company to individual creditors should be void. However, in the Sanlu bankruptcy case, it is unlikely that the Court or the bankruptcy administrator (headed by an official of the Shijiazhuang State-owned Assets Supervision Commission)⁷¹ exercised their power to treat the agreement as invalid. This is especially so given the fact that Sanlu Trading Company, the wholly-owned subsidiary of Sanlu, was excluded from the Sanlu bankruptcy procedures.⁷²

Upon the commencement of Sanlu's bankruptcy proceedings, Fonterra issued a media release stating that "Sanlu will now be managed by a court-appointed receiver who will assume responsibility for an orderly sale of the company's assets and payment of creditors"⁷³ A closer examination of the Sanlu bankruptcy liquidation case in this article however suggests that the case is more of an administratively rather than judicially manipulated outcome.

VI THE CHINESE STATE-LED MODEL OF CORPORATE GOVERNANCE

In their 2008 seminal work *Law and Capitalism*,⁷⁴ Milhaupt and Pistor use a case study on the collapse of China Aviation Oil (a subsidiary of the mainland Chinese state holding company listed on the Singapore Stock Exchange) to illustrate the coordinative function of law in centralised legal systems such as the Chinese system (as distinct from a function protective of individual rights). In doing so, Milhaupt and Pistor see the Chinese model of corporate governance as an "administrative model" that performs "mainly coordinating functions".⁷⁵ In other words, corporate governance in China is primarily a tool of the state and state holding companies to coordinate competing interests among favoured groups (such as state bureaucracies, enterprises and foreign institutional investors) while holding outside shareholder and stakeholder rights in check.⁷⁶

⁷¹ Shuhui Hang, '14-Member Sanlu Bankruptcy Liquidation Team Formed' [Sanlu Pochan Qingsuan Xiaozu Shisi Ren Zucheng] (in Chinese) *Dongfang Daily* (online) 31 December 2008 <<http://www.dfdaily.com/html/113/2008/12/31/351068.shtml>>.

⁷² Xijing Daily News Story, *Sanlu to be Sold through Bankruptcy Auction: Total Debts estimated Near 2 Billion Yuan* [Sanlu pochan paimai huanzha, guji sanlu zong fuzhai jin 20 yiyuan] (in Chinese), 25 December 2008, found on Xinhua Net <http://news.xinhuanet.com/fortune/2008-12/25/content_10555709.htm>.

⁷³ Fonterra Media Release, *Sanlu Bankruptcy Order*, 24 December 2008 <<http://www.fonterra.com/wps/wcm/connect/fonterra.com/fonterra.com/our+business/news/media+releases/sanlu+bankruptcy+order>>

⁷⁴ Milhaupt and Pistor, above n 8.

⁷⁵ *Ibid* 139.

⁷⁶ *Ibid*.

The case study on the Chinese central and local governments' handling of the 2008 milk scandal aftermath clearly supports this characterisation of Chinese corporate governance by Milhaupt and Pistor. The formal structure of corporate governance in China has undergone substantial changes in the past few years. To accommodate the increasing demands made on the state for the improved monitoring of managers, the attraction of new investors to the market and the protection of other emerging interest groups, the Chinese government is attaching much greater importance to the protection of outside investors and stakeholders. This is in part reflected in the increased protection afforded to minority shareholders and outside stakeholders, such as consumers, in the Chinese law and regulations. The same approach to corporate governance will be essential to fulfilling China's longer-term objective of attracting foreign institutional investors – in order to provide greater depth and maturity to the domestic market.

As the case study in this article suggests, the important legislative and regulatory changes that have been made however, have not amounted to a systemic change of the Chinese corporate governance from a state-led to a market-led model. In practice, few of these legislative and regulatory reforms have led to a transfer of the ultimate control over the companies from the state to private sector institutions. While the state retains control over major corporate decision-making either through controlling shareholdings (in Sanyuan's case) or other informal ties (in the case of Sanlu), the state retains the power to veto private law suits by shareholder and outside stakeholders through a supportive court system. In short, the state remains playing a large role in monitoring managers and mediating competing interests among key corporate stakeholders through both legal and extra-legal means.

The model seems to have produced some highly efficient outcomes in the Sanlu bankruptcy case in economic terms. Although the scandal has seen the demise of the Sanlu empire, the business growth of this corporate group has quickly resumed under Sanyuan's branding. With government support, the dairy business might also be expected to return to its growth rate prior to the scandal. The tens of thousands of tort victims received some level of compensation and there is no guarantee that they would be better off by going through the court procedures. Nor did the over 10,000 Sanlu employees have much to lose. As the Party Secretary of Sanlu declared, "whoever wants to buy Sanlu must also take Sanlu's employees".⁷⁷ As such, with social stability successfully maintained, damage to economic growth has also been kept to the minimum.

However, from a corporate governance perspective, one may ask how the state-led model, exhibited throughout the scandal, might contribute to the governance of the Chinese companies. This, according to the CSRC (China Securities Regulatory

⁷⁷ Xinhua Net news story, *Sanlu Communist Party Secretary: Whoever Wants to Buy Sanlu Must Also Take Sanlu's Employees* [Sanlu Dangwei Shuji: Xiangmai Sanlu bixu Jieshou Quanbu Zhigong] (in Chinese) 11 January 2009 <http://news.xinhuanet.com/local/2009-01/11/content_10638134.htm>.

Commission, will underlie the healthy and sustained development of the Chinese stock market in the long term.

In the first place, rigorous monitoring of managers may be diminished with strong state involvement in business. So far, only the Chairperson and three other executives of Sanlu have been prosecuted. They were convicted for “producing and selling fake or defective products” (rather than the more serious charge of “producing and selling poisonous food products” for which the maximum penalty is death) under the PRC Criminal Law.⁷⁸ In the absence of a special investigation similar to an Australian style royal commission inquiry, questions regarding the adequacy of internal control of those companies and the attribution of fault to those involved will remain unanswered. Even if fault were attributed to those within the corporate group, there have been few reported cases in which directors of a Chinese company are brought before the court purely for breach of directors’ duties under PRC Company Law.

Secondly, with strong government intervention in Chinese companies, including not only state-owned corporations but also the large private corporations (believed to conform more closely to the concept of the modern market-driven corporation), there may be very little room left for market forces to play a role in maintaining good corporate governance. It has been suggested that as well as internal monitoring mechanisms, the external market forces, such as the market for corporate control and the product markets are important monitoring mechanisms in disciplining corporate governance by helping to align the interests of the company managers with those of the shareholders. The handling of the tainted milk scandal by the Chinese central and local governments however suggests that the function of the market forces in relation to corporate governance may be limited under the current state-led corporate governance in China. Government intervention may not allow the advantages of the modern corporate form to be fully exploited by the Chinese corporations.⁷⁹

Finally, and probably the more fundamental problem with the state-led model, has been the compromise of the rule of law. The importance of legal regulation and enforcement in keeping good corporate governance has been postulated by numerous authors.⁸⁰ Particularly, the function of insolvency law, according to the Cork Committee Report, is not limited to facilitation of distribution of insolvency assets among creditors. It is also to “uphold business standards” and “commercial morality”

78 Feng Zhu, ‘Former Sanlu Chairwoman TianWenhua Sentenced to Life Imprisonment’ [Yuan Sanlu Jituan Dongshi Zhang Tianwen Hua Yishen Bei Panchu Wuqi Tuxing] (in Chinese) *Xinhua Net News* <http://news.xinhuanet.com/legal/2009-01/22/content_10701439.htm>. The offence for ‘producing and selling fake or defective products’ for which the maximum penalty is life sentence is provided in Article 140 of the PRC Criminal Law. The offence for “producing and selling poisonous food products” is provided in the PRC Criminal Law, Article 144.

⁷⁹ Roman Tomasic and Jenny Fu, ‘Government-owned Companies and Corporate Governance in Australia’, (2006) 3 *Corporate Ownership & Control*, 123, 126.

⁸⁰ For example, Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer and Robert Vishny, ‘Investor Protection and Corporate Governance’ (2000) 58 *Journal of Financial Economics* 3; La Porta R, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, Legal Determinants of External Finance 1997(52) *Journal of Finance* 1131.

through investigative and disciplinary measures.⁸¹ The importance of a robust tort system in keeping good corporate governance has also been highlighted by corporate law scholars.⁸²

China has been proud of itself for having established a “basic legal framework for socialist market economy” within a short thirty years of reform.⁸³ Both the exposure, and the handling of the 2008 milk scandal however seem to confirm commentators’ view that the Chinese system still looks “more like a system of rule by law rather than a system of rule of law”.⁸⁴ The Chinese system of rule by law itself is far from being perfect as far as corporate governance is concerned.⁸⁵ The frequent use of political rather than judicial settlement of corporate disputes, as exhibited in the tainted milk scandal, means that the capacity of law to enforce compliance and deter corporate malfeasance may be very limited.

VII CONCLUSION

In short, the intervention in business by the Chinese government may find its justification in the common goal of promoting economic growth. Although this is one important policy objective particularly with the global economic downturn, the examination of the state’s involvement in the 2008 tainted milk scandal and its aftermath in this article suggests that this policy has had some unintended effects upon governance of Chinese companies. Importantly, it has blurred the line between the role of the government and the roles of the market, the regulator and the courts in maintaining the corporate governance framework. As Chinese companies are fast

⁸¹ Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558., 1982) para 191. The Cork Report has in part prompted the Hammer inquiry into Australian insolvency law which was completed in 1988.

⁸² See for example, Peta Spender, ‘Weapons of Mass Dispassion: James Hardie and Corporate Law’ (2005) Griffith Law Review 280; Nicholas Howson, ‘Regulation of Companies with Publicly Listed Share Capital in the People’s Republic of China’ (2005)38 Cornell International Law Journal 237, 246.

⁸³ Director of the State Council Legal Office: *30 Years in China’s Legal Development* [Guowu Yuan Fazhi Bangong Shi Zhuren: Woguo Zhengfu Fazhi Jianshe Sanshi Nian] (In Chinese), <http://www.china.com.cn/policy/txt/2009-01/07/content_17069154.htm>; For a review of the development of the Chinese legal system over the past few years, see Donald Clarke, ‘Introduction: The Chinese Legal System Since 1995: Steady Development and Striking Continuities’ in Donald Clarke (ed) *China’s Legal System: New Developments, New Challenges* (Cambridge University Press, 2008) 1.

⁸⁴ Roman Tomasic and Jane Fu, ‘Regulation and Corporate Governance of China’s Top 100 listed companies?’ (2006)27 *The Company Lawyer*, 278, 280; Randall Peerenboom, *China’s Long March toward Rule of Law*, (Cambridge University Press, 2002)8; Jianfu Chen, ‘Policy as Law and Law as Policy – The Role of Law in China’s Development Strategy’, in Christoph Antons (ed) *Law and Development in East and Southeast Asia* (RoutledgeCurzon, 2003) 251, 260; Pitman Potter, *The Chinese Legal System: Globalisation and Local Legal Culture* (Routledge, 2001) 10.

⁸⁵ For a critique of the new Company Law, see for example, Zhong Zhang, ‘Legal Deterrence: the foundation of corporate governance-evidence from China’ (2007)15 *Corporate Governance: An International Review*, 741; Hong Lay Tan and Jianguy Wang, above n50.

expanding overseas,⁸⁶ the role of the state in Chinese corporate governance might also give intending foreign institutional investors cause to reflect upon the central importance of the state and the role of law in corporate governance in China. In practice, a great deal may continue to rest upon the capacity of the government to balance its different roles and adjust the competing interests of corporate officers, shareholders and outsider stakeholders.

⁸⁶ This point has been well-documented in a sizeable literature on the rise of sovereign investment funds in China. For example, Ian Bremmer, *The End of the Free Market: Who Wins the War Between States and Corporations?* (Portfolio, 2010); Ronald Gilson and Curtis Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism', (2008)60 *Stanford Law Review* 1345, 1346; Larry Cata Backer, 'Sovereign investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State Owned Enterprises and the Chinese Experience' 2010 (19) *Transnational Law & Contemporary Problems*, 3.