

DIRECTORS' LIABILITY FOR FALSE STATEMENTS IN THE INFORMATION DISCLOSURE OF LISTED COMPANIES IN CHINA

*BIN HU** *CHENXIA SHI***

I. INTRODUCTION

Economic globalisation has increased the value of reliable information in internationalised capital markets. Hence, reliable information disclosure has become essential for the efficient functioning of capital markets.¹ The importance of information disclosure cannot be understated. Rampant occurrence of false statements in the information disclosure of Chinese listed companies² is not only materially adverse to the interests of investors but also detrimental to the market. Without investors' confidence in the integrity of the market, the market cannot operate well and grow. Accuracy and transparency of information disclosure are therefore the key areas of market regulation.

Achieving transparency in the information disclosure of listed companies in China has been a challenge. Although mandatory and continuous disclosure of information has been improved legislatively,³ and listed companies are prohibited from using false or misleading information or omitting material information from disclosure documents,⁴ in practice, misleading or deceptive information disclosure by listed companies has been widespread. However, companies and directors are not sufficiently punished for such corporate fault, affecting public confidence in the market.

This paper sets out to investigate directors' liability for false statements in the information disclosure of listed companies in China. The paper first looks at the current regulatory framework for directors' liability for false statements made by their companies. It closely examines recent rules of the Supreme People's Court on cases concerning false statements. It then discusses and evaluates current directors' liability for their companies' false statements and puts forward recommendations for reform.

II. REGULATORY FRAMEWORK FOR DIRECTORS' LIABILITY FOR FALSE STATEMENTS MADE BY THEIR COMPANIES

A. Regulatory and Legislative Developments

Since the early years of the development of listed companies and the securities market in China, false statements, misleading disclosure and market manipulation have been significant problems.⁵ Making false statements in the information disclosure of listed companies refers to conduct in contravention of securities law where persons involved in the information disclosure of companies make false statements which contain untrue, misleading information or material omission in relation to the facts, nature and prospect of

* Associate Professor and Director, Research Centre for Finance Law and Regulation, Institute of Finance, Chinese Academy of Social Sciences, Beijing; Research Fellow, Department of Business Law and Taxation, Monash University, Australia.

** Lecturer in Law, Department of Business Law and Taxation, Monash University, Australia.

1 See Paul M Healy & Krishna G Palepu, 'Information Asymmetry, Corporate Disclosure and the Capital Markets: A Review of the Empirical Disclosure Literature' (2001) 31 *Journal of Accounting and Economics* 405, 406-07.

2 See Zhiwu Chen, 'Capital Markets and Legal Development: The China Case' (2003) 14 *China Economic Review* 451.

3 Continuous disclosure means that listed companies are required to not only provide annual and periodical financial and operational information to their shareholders and to the regulators but also report information arising when certain material events occur in relation to the company's operations or financial position. See generally chapter 3 of the Securities Law of People's Republic of China (promulgated by the National People's Congress on 29 December 1998 and amended in 2005).

4 *Ibid.*

5 Zhiwu Chen, 'Capital Markets and Legal Development: The China Case' (2003) 14 *China Economic Review* 451.

offering and trading of securities.⁶ The Securities Law, Company Law and Criminal Law impose civil, administrative and criminal penalties on any person who contravenes provisions of these laws dealing with false statements.⁷ Authenticity, accuracy and completeness are adopted as three benchmarks of proper information disclosure.⁸ Before the promulgation or amendment of this primary legislation, the securities market regulator — the China Securities Regulatory Committee (CSRC) — had been active in tackling securities fraud through conducting regular reviews and random investigations and imposing administrative penalties on wrongdoers.⁹

B. Early Stage Administrative Regulations

In 1993, the Securities Committee of the State Council (SCSC, the former body of CSRC) introduced Provisional Measures on Prohibition of Securities Fraud¹⁰ to specifically deal with insider trading, market manipulation, false information disclosure and other forms of securities fraud.¹¹ It imposes primarily administrative penalties on issuers,¹² with no reference to penalties on directors. The SCSC also issued Interim Regulations on Share Issuing and Trading¹³ which contain similar provisions but subject any organisation and individual making false and materially misleading statements or major omissions to administrative penalties and potential criminal liability.¹⁴ These regulations did not provide civil liability and specific remedies for false statements made by listed companies and directors.

In June 1993, before the Company Law was promulgated, the SCSC released preliminary rules on the content and form required for information disclosure by listed companies, requiring directors of listed companies to ensure there is no false or misleading statement or material omission in the disclosure documents of their companies.¹⁵ Directors may be jointly liable if they fail to do so. However, no specific liabilities of directors were provided.

C. Major Legislations

The first Company Law was promulgated in 1993.¹⁶ It states that a company in contravention of the law shall bear civil liability for compensation.¹⁷ Where companies present false financial reports to shareholders and the public or make material omissions, the person in charge of the company, or other persons directly responsible, shall be fined between 10,000 and 100,000 RMB Yuan, and criminal liability may be imposed.¹⁸ The

6 See Wang Baoshu (ed), *Chinese Commercial Law* (new edition, 2001) 325-326.

7 See article 69 of 2005 Securities Law, articles 150 and 153 of 2005 Company Law and article 5 of the Criminal Law (6th Amendment).

8 Article 63 of 2005 Securities Law.

9 The CSRC regularly inspects activities of listed companies and publishes the inspection results if misconduct is detected. It gives warning to a company if the infringements are only minor. The CSRC usually issues public criticism, public condemnation, official warnings and monetary fines. See Liebman, Benjamin L. and Milhaupt, Curtis J., "Reputational Sanctions in China's Securities Market" (June 8, 2007). Columbia Law and Economics Working Paper No. 318 Available at SSRN: <http://ssrn.com/abstract=999698> at 27 November 2008.

10 Issued by the State Council Securities Committee on 2 September 1993.

11 See articles 12, 21 and 22 of the Provisional Measures on Prohibition of Securities Fraud (Issued by the State Council Securities Committee on 2 September 1993).

12 See articles 21 and 22 of the Provisional Measures on Prohibition of Securities Fraud (Issued by the State Council Securities Committee on 2 September 1993).

13 Issued by the State Council Securities Committee on 22 April 1993.

14 See articles 74, 77 and 78 of Interim Regulations on Share Issuing and Trading (Issued by the State Council Securities Committee on 22 April 1993).

15 See CSRC, *Implementation Rules on Information Disclosure of Listed Companies* (year) <<http://www.oecd.org/dataoecd/6/60/1931117.pdf>> at 27 November 2008.

16 Promulgated by the National People's Congress on December 29, 1993, effective from July 1, 1994, and amended in 1999 and 2005.

17 Article 228 of the 1993 Company Law.

18 Article 212 of the 1993 Company Law.

1997 Criminal Law amendments incorporated new criminal offences relating to false statements.¹⁹

The first Securities Law, promulgated in 1998, prohibits conduct involving securities fraud, insider trading and market manipulation.²⁰ It states that a company is subject to civil liability if it engages in falsifying records, makes misleading statements or material omissions which result in trading losses.²¹ Despite this provision, the first such action, brought against Chengdu Hongguang Co. Ltd for its accounting and disclosure irregularities, was dismissed by the court on the basis of lack of specific procedure for such civil actions in China at that time.²² Hence, cases of making directors personally liable for companies' false statements and providing civil remedies for investors harmed by market misconduct were non-existent. Serious market scandals involving false statements and market manipulation frequently surface, shaking investors' confidence in the market.²³ Legal academics and practitioners adamantly called for civil compensation cases arising from securities frauds to be accepted and heard by the courts.²⁴

This situation compelled the commencement of the Securities Law amendment. However, as legislative amendment is a lengthy process and could not address problems in the immediate term, the SPC stepped in and provided interim rules to deal with problems to alleviate investor anxiety about market environment with certain provisions on civil remedies for false statements in 2003.

D. Rules of the Supreme People's Court and Its Enforcement Role

The Supreme People's Court (SPC) issued three circulars instructing local courts on how to deal with civil compensation claims arising from securities fraud between September 2001 and January 2003.²⁵ In the First Circular, the SPC explained that the reason for not accepting such cases was that 'the people's courts do not have adequate resources to accept and hear such cases due to current legislative and judicial limitations.'²⁶

In the Second Circular, the Supreme Court gave designated courts permission to accept civil actions relating to the contravention of securities laws on the condition that the company had been administratively sanctioned for false disclosure by the CSRC.²⁷ The Second Intermediate Court of Shanghai tried the first such case on 11 November 2002 and the case was eventually settled.²⁸

The Third Circular (hereafter SPC Rules) maintains the condition for accepting false-statement compensation cases by the courts set out in the Second Circular and also permits

19 The Criminal Law was first promulgated in 1979 by the National People's Congress, which was then amended in 1997, 1999, 2001, 2002, 2005 and 2007 respectively. See articles 160 and 161.

20 See Article 5 of 1998 Securities Law.

21 Article 63 of the 1998 Securities Law.

22 L Wang, 'Supreme Court Instructs Lower Courts Not to Accept Civil Actions Concerning Securities Fraud' *Shanghai Security Daily* (Shanghai), September 2001.

23 Such as Qiongminyuan company in 1996; Hongguang company in 1998; Yinguangxia company in 2001 and Qionghua Hi-tech company in 2004.

24 See for example Junhai Liu, *Protection of Rights of Shareholder of Limited Liability Company by Shares* (2nd ed, 2004).

25 The first is the 'Circular of the Supreme People's Court on Temporary Refusal to Lodgement of Civil Compensation Cases Concerning Securities' ['*Zuigao renmin fayuan guanyu she zhengquan minshi peichang anjian zan buyu shouli de tongzhi*'] issued on 21 September 2001); the second is the 'Circular of the Supreme People's Court on Issues Concerning Filing of Tort Cases Resulting From False Statement on the Securities Market' ['*Zuigao renmin fayuan guanyu shouli zhengquan shichang yin xujiachengshu yinfa de minshi qinquan jiu fen anjian youguan wenti de tongzhi*'] issued on 15 January 2002); the third is the 'Certain Provisions of the Supreme People's Court on Hearing Civil Compensation Cases Arising From False Statement on the Securities Market' ['*Zuigao renmin fayuan guanyu shenli zhengquan shichang yin xujiachengshu yinfa de minshi peichang anjian de ruogan guiding*'] issued by Judicial Committee of Supreme People's Court on 9 January 2003, available at PRC Laws & Regs <<http://www.lawinfochina.com>> at 27 November 2008.

26 See the 'Circular of the Supreme People's Court on Temporary Refusal to Lodgement of Civil Compensation Cases Concerning Securities' ['*Zuigao renmin fayuan guanyu she zhengquan minshi peichang anjian zan buyu shouli de tongzhi*'] issued on 21 September 2001.

27 See the 'Circular of the Supreme People's Court on Issues Concerning Filing of Tort Cases Resulting From False Statement on the Securities Market'.

28 Z X Wang, 'First Civil Action Concerning Securities Market Fraud Settled', *Chinese Industrial and Commercial Times* (Beijing), November 2002.

actions where the company had been sanctioned for false or misleading disclosure by other administrative agencies or convicted of a crime.²⁹ Directors can be jointly liable to compensate investors with their companies for making false statements.³⁰ However, before investors initiate compensation action for their losses resulting from false statements, there must be an administrative penalty decision or a criminal court judgment made against alleged persons for their roles in false statements.³¹

As a result, investors can sue only if the alleged false statement has been investigated by relevant authorities³² and the alleged persons are subject to an administrative or criminal sanction. In other words, if alleged persons such as directors involved in a false statement have not been sanctioned by either a regulator or the criminal court, investors cannot sue them and get compensation for losses suffered from the alleged false statement. This not only deprives investors of their constitutional right to take civil action as citizens but also strips them of their right to take civil action in conjunction with a criminal proceeding.³³ On the other hand, such provisions may create opportunities for alleged wrongdoers to escape civil action by influencing administrative investigation outcomes or criminal proceedings through *guanxi* (personal connections) or bribery.³⁴

Even for investors who manage to take the action to the court, the onus is on them to persuade the courts to accept the case and prove their case is taxing.³⁵ The court accepts a case if investors' losses result from a false statement concerning securities and if requirements for a civil action set out in article 108 of the 1991 Civil Procedure Law are satisfied.³⁶ The key factor to determine is whether the investors' loss is causative to the alleged false statement.³⁷

The courts may combine individual actions into one trial after reaching consensus with both parties.³⁸ The SPC Rules favour joint action over individual action and provide more detailed rules on joint action.³⁹ However, the joint action the SPC favours falls within the second category of a joint action defined by the Civil Procedures Law with the effect that the onus is on investor claimants to make sure they 'join the party' before the hearing of the case, otherwise they may lose out on the case. Such a procedural hurdle is really unfair to individual minority investors and may cause substantial injustice.⁴⁰

29 See the 'Certain Provisions of the Supreme People's Court on Hearing Civil Compensation Cases Arising from False Statement on the Securities Market' and article 2 of the 'Circular of the Supreme People's Court on Issues Concerning Filing of Tort Cases Resulting from False Statement on the Securities Market'.

30 See Articles 26, 27 and 28 of the SPC Rules.

31 Article 6 of the SPC Rules.

32 Authorities that can impose administrative sanctions include CSRC, the Ministry of Finance and other organisations that have power to impose administrative penalties. In accordance with Articles 16, 17, and 18 of the Administrative Penalty Law, whether an organisation has power to impose an administrative penalty is primarily a matter decided by the State Council, provincial or autonomous region governments. The relevant organisation must have a function to administer public affairs. See the Administrative Penalty Law (promulgated by the National People's Congress on 17 March 1996). Also see article 5 of the Circular of the Supreme People's Court on Issues Concerning Filing of Tort Cases Resulting from False Statement on the Securities Market.

33 See the 1996 Criminal Procedure Law.

34 For example, the CSRC encountered great difficulties in pursuing five directors involved in the false statement case of Hainan Minyuan Modern Agricultural Company. For details see Daniel M. Anderson, 'Taking Stock in China: Company Disclosure and Information in China's Stock Markets' (2002) 88 *Georgetown Law Journal* 1919, 1934-35; also see Guiping Lu, 'Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme People's Court 2003 Provisions Concerning Private Securities Litigation' (2003) 12 *Pacific Rim Law and Policy Journal* 781, 795-98.

35 See Guiping Lu, 'Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme People's Court 2003 Provisions Concerning Private Securities Litigation' (2003) 12 *Pacific Rim Law and Policy Journal* 781, 798-801.

36 There are four elements of the requirement: (1) plaintiffs are natural persons, legal persons or other organisations whose interests are directly affected by the action; (2) defendants are identifiable; (3) there are specific claims, facts, and reasons; (4) cases are within the civil litigation scope of the courts and within the jurisdiction of the accepting courts.

37 Article 6 of the SPC rules.

38 Article 53 the 1991 Civil Procedures Law.

39 See articles 13, 14, 15, and 16 of SPC Rules.

40 Guiping Lu, 'Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme People's Court 2003 Provisions Concerning Private Securities Litigation' (2003) 12 *Pacific Rim Law and Policy Journal* 781, 798-801.

E. 2005 Securities Law Amendments

The 2005 Securities Law reinforces the SPC Rules and subjects directors to joint and several liabilities of compensation for making false records, misleading statements or major omissions which result in losses to investors unless they can prove absence of any fault on their part.⁴¹ However, its enforcement may be problematic as proof of fault is difficult where there are no detailed rules on the elements of fault.

III ROLE AND FUNCTIONS OF REGULATORS

Given legislative development has lagged behind rapid economic development in China, the scope and level of regulation provided by major legislation quickly become inadequate for real regulatory imperatives of the market. Such dynamic circumstances have propelled the creation of a powerful and active market regulator — the CSRC. The CSRC has the mandate of 'carrying out supervision and administration of the securities market' and investigating and punishing any violations of the securities laws.⁴² It has the power to supervise and inspect information disclosure of listed companies in relation to offering and trading of securities.⁴³ With its rule-making power, the CSRC has played a vital role in bridging gaps between legislation and filling in loopholes in the regulatory system of the securities market.⁴⁴

The CSRC issued numerous rules governing information disclosure in response to widespread misconduct of listed companies in the 1990s involving fraudulent accounting and false statements.⁴⁵ The CSRC also made efforts to transplant the Anglo-American system of continuous information disclosure as China's increased participation in the world economy has necessitated its conformation to international rules and practices. However, the borrowed system, detached from its source country's historical framework, is hardly compatible with the receiving country's existing legal infrastructure at micro level and with its existing political and economic institutions at macro level.⁴⁶ Enforcement is difficult despite CSRC's attempts to crack down and punish companies engaged in misconduct.⁴⁷ Many companies and directors engaged in false or misleading information disclosure were disciplined by the CSRC through administrative sanctions.⁴⁸

41 Article 69 of 2005 Securities Law states that a listed company shall be subject to compensation liabilities if it makes any false record, misleading statement or major omission, and causes losses to investors in the ordinary course of securities trading. Directors and other officers held directly responsible shall be subject to the joint and several liabilities of compensation unless they can prove absence of any fault on their part.

42 See articles 178 and 179 of 2005 Securities Law.

43 Article 179 of the Securities Law.

44 For detailed account on CSRC's regulatory role in securities market, see Chenxia Shi, 'Protecting Investors in China Through Multiple Regulatory Mechanisms and Effective Enforcement' (2007) 24 *Arizona Journal of International & Comparative Law* 451.

45 See Gongmeng Chen et al, 'Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions' (2005) 24 *Journal of Accounting and Public Policy* 451, 480.

46 Hideki Kanda & Curtis Milhaupt, 'Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law' (Working Paper No. 219, Columbia Law School Centre for Law and Economic Studies, 2003) available at Social Science Research Network <<http://ssrn.com/abstract=391821>>27 November 2008.

47 For example, one of the biggest fraudulent disclosure cases in corporate China, the Yinguangxia case, was exposed in 2001. The Yinguangxia company inflated its export income to Germany for the year 2000 in its annual report to as high as Deutschmark 180 million, whereas the actual figure was less than U.S. \$30,000. The serious and widespread practice of false disclosure or major omissions in the disclosure documents of listed companies prompted the CSRC to conduct a vigorous campaign in 2001, naming that year as a year of Regulation Storm. Statistics indicate that about 50 listed companies received an inspection, warning, criticism or fine from the CSRC, SETC, or other regulatory bodies. See 'Corporate Governance Measures on Noncompliance Issues of Companies as the Discipline of Securities Market Enters the Final Stage', *China Business Post* (Beijing), 25 October 2002.

48 For example, Hongguang Company made its public offering in June 1997 by issuing 70 million A shares and raised 410.2 million RMB yuan. There was a huge gap between its projected profits in the prospectus and profits actually generated after its IPO, which raised suspicion. The CSRC investigated and found that the company, at the time of the listing, falsely reported its 1996 profits and covered up a major event relating to a key production line. In October 1998, the CSRC imposed sanctions on the company and 13 directors for defrauding investors by under-reporting company's losses in its 1997 interim and annual reports and misusing raised capital. The CSRC fined Hongguang Company 1 million RMB Yuan and confiscated 4.5 million RMB Yuan. It also banned the chairman of the board of directors, He Xingyi, from serving any listed company or securities company at senior management level. See the Penalty Decision [*Chufa jue ding*] of the CSRC [1998] 75, available at China Securities Regulatory Commission

Administrative sanctions of the CSRC that may be imposed on listed companies and directors include reprimand, warning, fine, suspension and banning from the market.⁴⁹ For minor misconduct, the CSRC may issue reprimands (including correction orders and notices of criticism)⁵⁰. For more serious violations, the CSRC use formal warnings or fines (for companies ranging from 300,000 to 600,000 RMB Yuan and for persons directly in charge and, for the other persons directly responsible, ranging from 30,000 to 300,000 RMB Yuan).⁵¹ Companies and directors subject to formal warnings and/or administrative fines as a result of making false statements may potentially bear compensation liability under 2003 SPC Rules.

Table 1 below indicates the number of directors sanctioned by the CSRC for making false statements from 1995 to 2006 and the types of penalties made against them. It is interesting that the number of administrative sanctions issued by the CSRC against directors from 1995 to 2006 is very small compared to voluminous penalty decisions against listed companies,⁵² and against the background that misleading and false statements have been widespread on China's securities market and investors have been calling for tough sanctions on directors who are seen as the chief architects of information disclosure of listed companies, as well as CSRC's own efforts to make directors of listed companies accountable.⁵³ This indicates that directors were, in practice, unlikely to be held liable for false statements of the company. Enforcement bottleneck has been a long standing issue in China. There has only been a modest increase of numbers of sanctions against directors since 2003 when the SPC allowed false-statement cases to be accepted on the condition that the alleged persons were subject to an administrative sanction by the CSRC or convicted of a crime.

<http://www.csrc.gov.cn> at 27 November 2008; also see Daniel M. Anderson, 'Taking Stock in China: Company Disclosure and Information in China's Stock Markets' (2002) 88 *Georgetown Law Journal* 1919, 1931-33.; also see Gongmeng Chen et al, above n 48,480.

49 See Zhou Xiaochuan, 'Improving Efficiency of Investigating and Sanctioning to Take to the New Stage' (Speech delivered at national conference on securities sanctioning, Guangdong, August 9, 2001) China Securities Regulatory Commission <<http://www.csrc.gov.cn/n575458/n575742/n2529771/2562783.htm>> at 27 November 2008.

50 Correction orders are issued to compel a company or individual to correct certain conduct. Notices of criticism are publicly circulated to deter a company or individual from further violations due to reputational damage such criticism may cause.

51 See article 191 and 193 of 2005 Securities Law.

52 Since 2002, the CSRC has made 155 administrative penalty decisions, 20 market banning orders, and 64 compulsory rectification notices. See 'Administrative Penalties of the CSRC Will Be Professionalised' (2006) Stockstar <http://news.stockstar.com/info/darticle.aspx?id=SS.20061026_30474415&columnid=94#> at 27 November 2008.

53 For details on CSRC's regulatory storm in 2001, see Chenxia Shi, 'Securities Regulation and Competition in China' (2006) 14 *Trade Practices Law Journal* 120.

Table 1⁵⁴

Year	Number of directors Penalised	Types of Penalties			
		Public Criticisms	Warning	Fine	Banning from Market
1995	1	1			
1996	4	2	2		
1997	0				
1998	5		5		1
1999	6	1	5	1	1
2000	11		11	8	1
2001	21	12	7	8	
2002	5		5	5	
2003	14		14	13	
2004	22		22	22	
2005	11		11	11	
2006	25		25	25	

Similarly, stock exchanges play their role in monitoring information disclosure of listed companies.⁵⁵ The stock exchanges may impose sanctions on listed companies and directors including oral warnings, notices of criticism and public criticisms.⁵⁶ The exchanges may issue these sanctions against companies and directors involved in false or misleading disclosure and inaccurate profit forecasts.⁵⁷

IV. DIRECTORS' LIABILITY FOR THE FALSE STATEMENTS MADE BY THEIR COMPANIES

Directors exercising decision-making powers of the company are accountable to those who are affected by their decisions, including the company, shareholder and other constituents.⁵⁸ Making directors accountable requires rigorous regulatory regimes and

54 1995-2001 data in the table are sourced from Xudong Zhao (ed), *Listed Company Directors' Liability and Penalties Imposed On Them [Shangshi Gongsi Dongshi Zeren Yu Chufa]* (2004) and 2002-2006 data in the table are collected from the penalty decisions of the CSRC on its website: <<http://www.csrc.gov.cn>>.

55 Article 115 of the Securities Law.

56 Public criticisms were used only from 1999. See Zhipan Wu, 'Studies on the Stock Exchanges' Power of Sanctioning' [*Zhengquan Jiaoyisuo Chuli Quan Wenti Yanjiu*] (2005) Research Papers on Shanghai Stock Exchange website <<http://www.sse.org.cn/UpFiles/Attach/1903/2005/04/28/1405348750.doc>> at 27 November 2008.

57 Ibid.

58 See, for example, Brian R Cheffins, Bernard S Black, and Michael D Klausner, 'Outside Directors, Liability Risk and Corporate Governance: A Comparative Analysis', (Working Paper No 48, European Corporate Governance Institute, 2005); Theodor Baums, and Kenneth E Scott, 'Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany' (2005) 53 *American Journal of Comparative Law* 31; Justice Joseph T Walsh, 'The Fiduciary Foundation of Corporate Law' (2002) 27 *The Journal of Corporation Law* 333. Also see Laurence Pritchard, 'England and Wales' in Paul J Omar (ed), *Directors' Duties and Liabilities* (2000) 24.

imposition on directors of duties to their companies.⁵⁹ Historically directors' duties in both Chinese legislation and academic literature have been limited.⁶⁰

As China has traditionally been a civil law country, directors' liabilities arise from breaching their statutory duties and contravening laws and the company constitution.⁶¹ The 1993 Company Law imposed certain duties on directors in very general terms⁶² without concrete provisions on their liabilities. The 2005 Company Law amendment dedicated a new chapter to qualifications and duties of directors.⁶³ It provides that directors owe a duty to act in good faith and a duty of care to companies.⁶⁴ However, the meaning of 'good faith' and 'standard of care' are not clearly elaborated, which may again affect enforcement outcomes. The law prohibits directors from engaging in seven types of conduct deemed in breach of director's duties,⁶⁵ and imposes compensation liability on directors in general terms without providing procedural details.

The 2005 Securities Law amendment reinforces the SPC Rules and it also provides that directors of a listed company shall give their opinions in writing on the periodic report of the company and guarantee the authenticity, accuracy and integrity of the information disclosed by the company.⁶⁶ Directors shall be given a warning or fine if they are directly in charge of, or otherwise directly responsible for, information disclosed by the company containing false and misleading statements.⁶⁷ Directors in contravention of the law are subject to both civil compensation liability and a fine, and if their assets are sufficient to pay both, then civil compensation must be paid first.⁶⁸ The CSRC may ban persons in serious contravention of laws and rules from serving as a director of a listed company and participating in the securities markets.⁶⁹ In terms of criminal liability, the 1997 Criminal Law and its recent 6th amendment imposed criminal liability on directors involved in false statements but penalties are quite light.⁷⁰

In fact, directors have been more frequently punished administratively by the CSRC and the stock exchanges for their own wrongdoing or for the fault of a company of which they are in charge.⁷¹ However, these sanctions are top-down disciplinary sanctions and do not concern direct remedies to investors. Directors sanctioned by the CSRC or other regulatory bodies for false statements of their companies may potentially lead them to pay civil compensation to investors under 2003 SPC Rules.

The SPC Rules elaborate more specifically in terms of directors' civil liability. According to the SPC Rules, parties involved in making false statements concerning securities face civil liability for the loss suffered by investors resulting from those

59 While external regulation is important, directors' duties play a larger role in preventing corporate misconduct in the long run. This is because, although the power of a director can be demonstrated by exercising decision-making power collectively with other directors of the company, his or her duties and responsibilities can only be borne individually. If duties and responsibilities were to be borne collectively by the directors, this would lead to a situation in which nobody will be held accountable for anything. For a recent discussion, see John Armour, and Joseph A McCahery, 'After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US' (Working Paper No 2006-2007, Amsterdam Centre for Law and Economics, 2006).

60 For a historical account on the development of company law in China, see Chenxia Shi, 'Commercial Development and Regulation in Late Imperial China: An Historical Review' (2005) 35 *Hong Kong Law Journal* 481.

61 See chapter 6 of 2005 Company Law.

62 See Articles 148, 149, 150 and 151 of 1993 Company Law.

63 See articles 147, 148 and 149 and generally Chapter 6 of 2005 Company Law.

64 Article 148 of 2005 Company Law.

65 See article 149 of 2005 Company Law.

66 Article 68 of 2005 Securities Law.

67 Article 193 of 2005 Securities Law.

68 Article 232 of 2005 Securities Law.

69 Article 233 of 2005 Securities Law states: 'If laws, administrative regulations or relevant provisions of the State Council's securities regulatory authority are violated and the circumstances are serious, the State Council's securities regulatory authority may take the measure of banning the relevant persons responsible from the securities market. ... "[B]an from the securities market" means the system wherein the affected person may not engage in the securities business or is prohibited from serving as a director, supervisor or senior officer in a listed company for a certain period of time or for life.'

70 Directors can face up to three years imprisonment or between 20 000 to 200 000 RMB Yuan fine, or both. See article 161 of the Criminal Law.

71 See article 191 and 193 of 2005 Securities Law.

statements.⁷² They include companies, promoters, controlling shareholders and actual controllers of the company; directors, supervisors and senior managerial personnel of the issuers, securities underwriters, or securities listing sponsors.⁷³ Investors can bring action against any one of them or all of them.⁷⁴

The circumstances under which the directors are jointly liable with companies for making false statements include circumstances where directors: participate in making false statements; know or ought to know about the false statement and do not oppose to it; and other situations where directors should assume responsibility for the false statement and its effects,⁷⁵ which is in fact a 'catch-all' clause giving courts discretion over directors' liability for false statements made by companies. Directors' liabilities are limited to actual losses suffered by investors.⁷⁶

Therefore only those investors who purchase affected securities after a false statement is made, and before the false statement is exposed or rectified, and who then sell the affected securities or continue to hold securities after the exposure or rectification of the false statement, are entitled to seek compensation for their loss.⁷⁷ So the compensation coverage is quite narrow, excluding indirect loss or other expenses incurred by investors.⁷⁸

The SPC Rules also instruct courts to use mediation as a method of resolving cases concerning false statements⁷⁹ in accordance with principles and procedures of mediation set out in the Civil Procedure Law.⁸⁰ The courts may conduct mediation before trial or any time prior to delivering decisions.⁸¹ Mediation is a traditional method of resolving conflicts in China but its usage for compensation cases against directors may diminish the importance of tough legal liability as deterrence for directors. As successful mediation results in settlement of the case under the guidance of the courts, the settlement is paid by the company as the party to the mediation. Directors therefore do not bear personal liability for their involvement in making false statements.

An encouraging development in the 2005 Company Law amendment is that the concept of lifting the corporate veil has been introduced. However, the circumstances under which the corporate veil can be lifted are extremely limited. It provides that if the sole shareholder of a one-member company is unable to prove that the company assets are separate from their own assets, he or she shall be jointly liable for the debts of the company.⁸² If shareholders use the company form to defraud or avoid an existing legal obligation, particularly to creditors, then the corporate veil may be lifted⁸³ to make them personally liable for company's debts. This was mainly targeted at controlling shareholders of listed companies who evaded debt repayment by transferring assets between entities, mixing company assets with personal assets or otherwise siphoning off company assets to the detriment of the company, minority shareholders and creditors.⁸⁴ Clearly, lifting the

72 See articles 7, 21, 22, 23, 24, 25, 26, 27 and 28 of the SPC Rules.

73 Article 7 of SPC Rules.

74 Article 12 of SPC Rules.

75 See Article 28 of the SPC Rules and article 63 of the 1998 Securities Law; also see Zhennan Cui and Mingsheng Ma, 'Directors' Liability to Shareholders in Cases Concerning False Statements' [*'xu jia chen shu zhong dongshi dui gudong zeren yanjiu'*] (2003) 2 *China Legal Studies [Zhongguo Fauxe]* 96.

76 See articles 30 of the SPC Rules.

77 According to article 18 of the SPC Rules, the causation between the false statement and investors' loss can be found by referring to the following elements: the investments were securities directly affected by the false statement; the affected securities are purchased between the date on which the false statement is made and the date on which the false statement is exposed or rectified; and investors suffered loss from selling securities on or after the date on which the false statement was exposed rectified, or from ongoing ownership of the securities after the false statement was exposed or rectified.

78 Such as the litigation costs, travel expenses and the lost wages for days in court.

79 See article 4 of the SPC Rules.

80 See articles 85, 86, 87, 88, 89, 90 and 91 of 1991 Civil Procedures Law.

81 See article 128 of 1991 Civil Procedure Law.

82 See article 64 of 2005 Company Law.

83 Article 20 of 2005 Company Law states that where any of the shareholders of a company evades the payment of its debts by abusing the corporate separate legal personality and the protection of limited liability, it shall bear several and joint liabilities for the debts of the company if it seriously injures the interests of creditors.

84 'A Comparison Between the Old and New Company Law: 30,000 Yuan is now the threshold of Incorporating A Company', *China Legal Daily* (Beijing), 1 November 2005.

corporate veil should be extended to directors in certain circumstances, for example, where directors participate in the wrongdoing of the company, causing damages or loss to third parties.

V. COMMENTS AND CRITIQUE ON DIRECTORS' LIABILITY FOR COMPANIES' FALSE STATEMENTS AND RECOMMENDATIONS FOR REFORM

A. Comments on the SPC Rules

The SPC Rules marked the beginning of civil compensation actions for investors who have suffered loss as a result of false statements in the information disclosure of listed companies. This was a significant step forward in investor protection in China. However, conditions attached to investors' rights to take such action make the protection rather limited.

Firstly, the prerequisite rule discussed above⁸⁵ effectively limits the scope of cases to be accepted and heard by the courts. The SPC Rules directing designated courts to only accept cases concerning false statements ruled out investors' chances for suing directors for other securities-related misconduct of listed companies. Keeping many other actionable cases out of the gates of the court fails fair and just principles of the law.

Secondly, the requirement of causation between the false statement and investors' actual loss limits the number of eligible investors to sue. Investors who purchase or sell affected securities at times other than those specified by the SPC Rules are effectively excluded from compensation even if they suffered loss as a result of the false statement. This is again contrary to the fairness principle upheld by the law and championed by the regulator.

Thirdly, the SPC Rules fail to provide investors with a helpful and effective procedure by which they may get access to the courts and judicial remedies. There are also limited numbers and locations of courts to which investors can bring the cases. Intermediate people's courts designated by the SPC as courts of first instance to accept such actions are those located in provincial capital cities, metropolitan cities, cities under separate zoning and cities of special economic zones.⁸⁶ Investors residing in places other than these locations of the courts face practical difficulty in taking the action.

Hence limitations of the SPC Rules make it difficult for investors to actually obtain compensation for losses suffered as a result of false statements. These limitations are also due to inadequacy, gaps and loopholes of existing primary legislation. As China has no common law tradition, only statutes have the effect of law⁸⁷ and the SPC Rules are either supplementary to the law or constitute further interpretations of the law. Without detailed provisions in primary legislation on civil penalties against directors for the courts to refer to in handling cases, the legal standing of compensation orders imposed by the courts on directors in accordance with the SPC Rules lacks a solid base, thereby affecting the vigour of the enforcement. Hence, the improvement of the situation will depend on the further reform and improvement of the Securities Law, the Company Law, Civil Procedures Law and Criminal law, as well as on the meaningful consultation, coordination and cooperation between the legislature, courts and regulators.

B. Comments on Statutory Liabilities of Directors

The 2005 Company Law amendment and Securities Law amendment improved provisions in many areas requiring regulation or demanding regulatory changes. However, they failed to make headway in building up a strong civil penalty regime in China. Like previous laws, the amendments only provide directors' civil liability in general terms without providing

⁸⁵ See above n31.

⁸⁶ Article 8 of the SPC rules.

⁸⁷ *Zhonghua Renming Gongheguo Lifafa* [Legislation Law of the People's Republic of China] (promulgated on 15 March 2000 and effective from 1 July 2000) (PRC), art. 2.

details on substantive and procedural requirements, leaving effective exercise of investors' statutory rights in question.⁸⁸

The 2005 Company Law amendment provides a right for shareholders to commence a derivative action,⁸⁹ which has been seen in other jurisdictions as an important mechanism for holding directors accountable and reducing agency costs.⁹⁰ This is the first time in China that shareholders' derivative action is allowed in circumstances where directors violate the laws, administrative regulations or company constitution during the course of discharging their duties, and cause losses to the company.⁹¹ However, the law does not stipulate detailed procedures for taking such an action, nor does it elaborate on the types of remedies available to shareholders, apart from compensation. There are also limitations on the eligibility of shareholders to take such action.⁹²

The criminal liability imposed on directors for false statements is not adequate and tough enough to deter wrongdoings. The 2006 Criminal Law (Sixth Amendment) states that where companies and enterprises, which are subject to obligations of information disclosure in accordance with law, provide shareholders and public investors with false accounting reports or reports in which material information has been concealed, or fail to disclose other important information, thereby seriously harming the interests of shareholders and others, the person in charge of the company or other persons directly responsible shall be subject to up to three years imprisonment and/or a 20 000 to 200 000 RMB Yuan fine.⁹³ A managing director is certainly the person in charge of the company, and other persons directly responsible for information disclosure are mostly directors, so this criminal sanction applies to directors, but the penalty is too light to exert real punishment and deterrence power, particularly in the context of the widespread occurrence of false statements in China's fledgling securities market. Even developed markets with relatively enhanced information disclosure and mature regulatory systems impose tougher criminal sanctions on false statements.⁹⁴ Furthermore, this sole provision dealing with criminal liability for false statements does not clearly define circumstances under which imprisonment and/or fines shall be imposed, which gives rise to enforcement difficulties.

Administrative sanctions of the CSRC against directors are therefore the dominant sanctions. Apart from warnings and fines, public criticism makes the criticised party feel humiliated and shameful, a complete 'loss of face' in Chinese society.⁹⁵ As good name and reputation are traditionally held high by Chinese people throughout history, reputational damage may deter some companies and directors from engaging (or continue to engage) in activities which may attract public criticism from either stock exchanges or the CSRC. However, it may mean little to unscrupulous ones. Hence, the overall deterrent effect may not be significant enough to curb or constrain misconduct and violations of law.

In short, while administrative and civil penalties are imposed to deter, compensate or remedy certain unlawful activities, criminal penalties are mainly for punishment purposes. The social stigma carried by the criminal convictions can be a strong deterrent. Currently,

88 See Guiping Lu, 'Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme People's Court 2003 Provisions Concerning Private Securities Litigation' (2003) 12 *Pacific Rim Law and Policy Journal* 781, 795-98.

89 See Company Law, ch. 3, art. 111.

90 For a detailed account on the role of shareholders' derivative action in enhancing directors accountability, see Ian Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales Law Journal* 149, 151-153.

91 See article 153 of 2005 Company Law.

92 See articles 152 and 153 of 2005 Company Law. The shareholders holding one per cent or more of the total shares, either separately or collectively, may request in writing the supervisory board to institute an action on behalf of the company. If the supervisory board refuses to bring such requested action or fails to take action within 30 days of receiving the request, or in urgent circumstances if the failure to immediately initiate the action may result in irreversible damages to the company, the shareholders may institute derivative action.

93 See article 5 of 2006 Criminal Law (sixth amendment).

94 Up to \$5 000 000 fine and up to 20 years imprisonment under the Sarbanes-Oxley Act in the United States; and up to 7 years imprisonment under the Prevention of Fraudulent Investment Act in the United Kingdom.

95 For importance of reputation in Chinese society today, see Benjamin Liebman, 'Innovation Through Intimidation: An Empirical Account of Defamation Litigation in China' (2006) 47 *Harvard International Law Journal* 33.

in the regulation of the securities market, administrative penalties are overused, whereas civil penalties and criminal penalties are underdeveloped.

VI. RECOMMENDATIONS FOR STRENGTHENING DIRECTORS' LIABILITY

- A. Future amendment of the Securities Law should expand application scope of civil liability against directors. The law should provide detailed rules on civil penalties imposed on directors and civil remedies available to investors. For investors to effectively exercise their rights, both well-considered substantive and procedural requirements for directors' civil liability should be provided. The Civil Procedures Law should also be amended to reflect consistency in terms of procedures for civil actions on the securities market. The current limitations of the SPC Rules on investors' civil action for companies' false statements should be removed. Tougher criminal liability should be imposed on directors. A lengthy imprisonment is mostly likely to deter serious offences.
- B. Class action should be introduced to provide investor protection. Class actions and contingency fees play an important role in the enforcement of securities law in the United States. Class actions allow numerous individual investors 'who have been harmed by the same securities violation to pool their claims together into a single action.'⁹⁶ The combined recovery of losses is sufficient to make the action financially viable. Also, contingency fees allow lawyers to be paid only if the action is successful, which enables investors to attract lawyers to represent them without the investors incurring a financial burden if they lose their case.⁹⁷ Thus, class actions and contingency fee arrangements deter violations of securities law by companies. Of course, the direct transplantation of the U.S. class action to China will not be entirely feasible due to embedded differences in legal culture, law enforcement and corporate governance regimes.⁹⁸ However, class action as an effective tool for investor protection should be designed according to current market conditions and capacity of the courts, and gradually expanded and developed or reformed in tandem with the development of the market, the courts and laws. In addition, provisions on shareholders' derivative action need to be improved, both in terms of substantive requirements and procedures. The current simplistic provision in the law creates a situation where investors have a right, but they can hardly exercise that right.
- C. The corporate veil should be lifted to make directors personally liable for corporate fault in circumstances where directors are controllers of the company and acting in their own interests at the expense of company's interest or in serious breach of their duties. For example, failure to discharge their duty to guarantee the authenticity, accuracy and completeness of information disclosed by the company should give rise to their personal liability for compensation to investors who suffered loss as a result of false or misleading information provided by the company. Moreover, direct and independent liability should also be imposed on directors for corporate fault areas of environmental law, taxation law and labour law. For example, failure to discharge their duty to remit company taxes should result in them being personally liable for such taxes owed. Uniform standardisation of directors' liability across legislations will provide a solid

⁹⁶ See James D Cox, 'Protecting Investors In The United States Through Multiple Enforcement Mechanisms' (2002) Organisation For Economic Co-operation and Development <<http://www.oecd.org/dataoecd/21/61/2756029.pdf>> at 27 November 2008.

⁹⁷ Ibid 7-8.

⁹⁸ It was feared, given the vast number of Chinese investors, that class actions may expose listed companies, the majority of which are state-owned, to massive compensation actions that would potentially increase conflict between investors and the state, destabilising economic and political order. See Benjamin Liebman, 'Class Action Litigation in China' (1998) 111 *Harvard Law Review* 1523.

framework for building a strong system of accountability for directors and enhance enforcement.

VII. CONCLUSION

The rapid development of the securities market in China has not been matched by an appropriate level and scope of regulation. Uncertainty and grey areas in laws and regulations have always been a problem. In particular, directors' liability for corporate fault is under-regulated generally. Only a few general and succinct provisions have been provided by amended Securities Law, Company Law and Criminal law in relation to directors' liability for false statements made by their companies. And directors are only liable to pay compensation to investors who are harmed by the company's false statements if they are directly in charge or otherwise directly responsible for the company's information disclosure. The SPC Rules allowing investors' civil action against directors for false statements set a high threshold for most investors to actually get access to justice they are seeking. In practice, there are not many cases where directors have been held liable.

Further reform is required to strengthen directors' liability, both civil and criminal liabilities. While administrative sanctions have been extensively used by the CSRC to rein in market misconduct, such a direct interventionist approach should be moderated with the progress of rule of law in China. The emphasis should now be shifted to building a strong civil liability regime. A robust directors' civil liability system will improve investor protection and corporate governance in China.

