DIRECTORS' DUTIES UNDER CHINESE LAW: A COMPARATIVE REVIEW

DR YUWA WEI*

INTRODUCTION

The terms "one-tier-board system" and "two-tier-board system" are customarily used to classify corporate governance systems of different jurisdictions. There are also other species of systems that do not strictly fit in any of the two major descriptions.[1] Nevertheless, it has been the trend in the development of all systems that the centre of corporate governance shifts from the members' meeting to the board of directors. Nowadays, the powers of corporate management are basically conferred on the board of directors in most systems.[2] Directors thus become crucial to the commercial performance of corporations and are held accountable for the conduct and activities of corporations. Consequently, directors have been subject to increasing legal responsibilities.

China is a latecomer to corporatisation. In China, corporatisation has been a means of facilitating the country's enterprise reform — reforming state owned enterprises into modern corporations.[3] The enactment of the 1993 *Company Law of the People's Republic of China* (the 1993 *Company Law*) was one of the products of China's enterprise reform efforts. The 1993

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* LLB, LLM, Ph.D, Senior Lecturer in Law, Faculty of Business and Law, Griffith University, Australia; Honorary Professor, Harbin University of Science and Technology, China; Member, Socio-Legal Research Centre, Griffith University.

1 For instance, the Japanese system has designed individual supervisors to exercise monitoring functions that are basically performed by the supervisory board in a two-tier-board system.

2 See Yuwa Wei, 'The Historical Development of the Corporation and Corporate Law in China' (2002) 14 *Australian Journal of Corporate Law* 240, 257.

3 See Yuwa Wei, *Comparative Corporate Governance: A Chinese Perspective* (2003) 1–4.

Company Law was amended twice since its coming into effect.[4] An advantage of being a latecomer is that China has the opportunity of assimilating relevant and useful heritage and incorporating advanced experience into its own practice. Indeed, China has endeavoured to fully take such advantage in the process of reforming its economic structure and modernizing its legal system. Corporate legislation and practice in China particularly illustrate this point. The 1993 *Company Law* is an outcome of both common law and continental law influences.[5] Corporate practice in China in the past ten years has further demonstrated that the Chinese have made great efforts to build up a corporate system which is close to the standard practice of other influential corporate systems, and, in the meantime, is applicable to its particular social and economic situations.[6] It is therefore interesting to have a close look at the Chinese treatment of directors' duties, which is a combination of the strengths of different systems. This article attempts to provide readers with an overview of directors' obligations in China from a comparative perspective in order to draw the readers' attention to the current development of Chinese corporate legislation and practice, and how it affects the duties of company directors.

The article proceeds as follows: Section I identifies the distinctive features of Chinese regulations and practice concerning directors' powers and duties and clarifies the policy and practical concerns behind the legal approaches relating to corporate governance. Section II supplies a general introduction to Chinese law and practice regarding directors' duties. Section III compares Chinese law on directors' obligations and the laws governing the subject in common law systems and in some other Civil Law jurisdictions, with attentions paid to the laws in the USA, the UK, Germany, Canada Australia and New Zealand. Section IV concludes the article by pointing out that current Chinese law on directors' duties is a combination of both Anglo-American and Continental European influences; most importantly, however, the law has been generally shaped by the corporate development and enterprise reforms in the China itself. How the Chinese will reform its company law and improve the

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4 The 1993 *Company Law of the People's Republic of China* was amended twice in 1999 and 2004 respectively.

5 See Wei, above n 3.

6 Ibid.

regulation over directors' duties in the foreseeable future remains open.

I. CHINESE CHARACTERISTICS

Speaking of Chinese characteristics relating to directors' role in Chinese corporate law and practice, there are four important features worthy of notice:

A. *A Board of Management?*

In common law systems, the powers of corporate control are divided between the board of directors and the members' meeting. Nowadays, the powers of managing the corporation are commonly vested in the board of directors. Once the powers are conferred on the board, the members' meeting cannot directly interfere with the management of the corporation but may influence it through some residual control powers, such as the power to alter the company constitution and the power to elect or remove directors.[7] Such an arrangement enables the board to play a dominant role in the management of the company, and in the meantime, highlights the issue of the possibility of abuse of powers by directors. This, in turn, underlines the needs to enhance the supervisory strength over the management of companies. Non-executive or independent directors become part of the monitoring mechanisms devised to prevent the abuse of powers by managements.

In some other systems, such as Germany, Holland and France, the laws place a supervisory board between the shareholders' meeting and the board of directors. The function of supervision over the board of directors is performed by the supervisory board. Such a system is described as a two-tier-board system. An archetypical aspect of the two-tier-board system is the co-determination regime which has been particularly practiced in Dutch and German systems. Co-determination expressly requires

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[7] The principle of division of powers was firmly established in the leading cases such as *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34, *Imperial Hydropathic Hotel Co Blackpool v Hampson* (1882) 23 Ch D 1 and *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

directors, when making business decisions, to take the interests of employees into consideration.[8]

Chinese company law has embraced the two-tier-board system and the ideology of co-determination.[9] The law provides for three types of companies: stock companies, limited companies and state-owned companies.[10] Stock companies are similar to public companies and limited companies are similar to private companies in the UK system. The state-owned company, however, is a distinct type of company. It is a one-person company in which the sole shareholder is the State. It has limited liability and is therefore a sub-species of limited company.[11] It is also distinct from the state-owned enterprise. The difference between a state-owned company and a state-owned enterprise is that a state owned enterprise has the power to own and dispose of the property invested in the company, while a state-owned enterprise does not have such power.[12]

China's 1993 *Company Law* stipulates that stock companies and limited companies should set up a supervisory board.[13] A limited company that is small in size and in the number of shareholders may appoint one supervisor instead of having a supervisory board.[14] Before the 1999 and 2004 amendments, the 1993 *Company Law* did not specify that a state-owned company needed to have a supervisory board. Such a company could have a supervisory board related regulations had provisions that the authorised department or organisation had the discretion to appoint a supervisory board to monitor the use of the assets of the state-owned company.[15] However, such a supervisory board

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8 See Wei, above n 3, 143.

9 See 1993 *Company Law* (PRC) arts 52, 71 and 118.

10 Ibid arts. 2 and 65. After the 2004 amendment, it is possible to set up a single shareholder company. Such a company is a limited company in nature.

11 Ibid, art. .

12 See generally the discussions on state-owned enterprises in Yuwa Wei, 'A Chinese Perspective on Corporate Governance' (1998) 11 *Bond Law Review* 363 and in Wei, above n 3, 93–6.

13 See above n 9, arts 52 and 118.

14 Ibid art 52.

15 For instance, such statements can be found in *Regulations of Administrating and Controlling the Assets of State-Owned Enterprises* 1994 (PRC) promoted by the State Council.

was substantially different from a supervisory board in a stock company or a limited company as provided in the Company Law. The supervisory board of a state-owned company was an external supervisory mechanism, not an internal supervisory organ.[16] Under the 1999 amended Article 67, a supervisory board was introduced into a state-owned company to exercise the following powers: (1) to examine the financial affairs of the company; (2) to exercise control with respect to violations of laws, regulations or company constitutions by company directors and managers; and (3) to exercise other powers specified by the State Council. Further amendments were made to the *Company Law* in 2004. The number of supervisors in a state-owned company has been increased from no less than three to at least five.[17] A state-owned company does not have shareholders meeting but has a board of directors to exercise managerial powers. Thus, all three types of companies have the board of directors as their internal corporate governance organs.

It is noteworthy that in Chinese corporations, the decision-making centre of the corporation is arguably the shareholders' meeting, which is the all-powerful organ of corporate governance, rather than the board of directors. The shareholders' meeting makes decisions on all the important matters concerning the corporation. Besides appointing and dismissing directors and supervisors, shareholders' meetings decide policies of business operation and investment plans.[18] They review and approve reports of the board of directors and the supervisory board, annual financial budgets, final accounts, and plans for distributing profits.[19] They also decide whether companies should increase or reduce the registered capital or issue debentures. They adopt resolutions on company mergers, division, dissolution, and liquidation.[20] Compared with the situation in some other jurisdictions, the range of the power of the shareholders' meeting in a Chinese company is much wider. Chinese legislators believe that this is necessary and suitable for the actual circumstances of China as Chinese corporate practice

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16 See relevant discussions in Yan Xiu, *The Principles of Company Law* (1997) 416.

17 See above n 9, art 71.

18 Ibid arts 38 and 100.

19 Ibid.

20 Ibid.

has only just begun. Accordingly, Chinese legislators believe that the law should give more protection to shareholders, so that they can exercise their rights effectively.[21]

Necessarily, Chinese Company Law gives the board of directors a lesser range of power. The board of directors only has the power to formulate business plans and investment plans as the power to approve the plans is in the hands of the shareholders' meeting. The main task of the board of directors is to implement resolutions passed at shareholders' meetings.[22]

From the above discussions, one can see that China has adopted a two-tier-board system and directors have liabilities that are similar to those in some continental systems such as Germany and France. However, it would be a mistake to presume that the situation is as straight forward as this. The Chinese corporate governance system has some unique features resulting from its historical legacy and trial and error in reforming its enterprise system. The development of the Chinese corporate governance system has followed a unique path. It is necessary to closely study directors' duties against such a background.

B. *Independent Directors Plus a Supervisory Board: An Innovation or Confusion?*

The second important factor distinguishing Chinese corporate law and practice from those in other jurisdictions is that Chinese corporations embrace the mechanisms of both a supervisory board and independent directors. Independent directors that sometimes are described as non-executive directors or outside directors are common to the one-tier-board system. They are thought to increase the accountability of the board of directors by separating its supervisory function from its managerial function.[23] Independent directors are expected to act as independent monitors of the activities of the executive board members and to offer objectivity, prestige, expertise, 'outside' experience and independent judgment of the company's management".[24] This independent director emphasis contrasts

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21 See Baoshu Wang, & Qinzhi Cui, *The Principles of Company Law* (1998) 25–6.

22 See above n 9, arts 47 and 100.

23 See Wei, above n 3, 121.

24 See James Corkery, *Directors' Powers and Duties* (1987) 4.

with a two-tier-board system, in which such purpose is achieved by the separate supervisory board. Accordingly, it seems odd for a one-tier-board system to embrace the idea of a supervisory board, or for a two-tier-board system to introduce independent directors, as independent directors and the supervisory board perform the same function. In addition, having both independent directors and a supervisor board increases governance costs. Nevertheless, the Chinese have had little difficulty accepting and implementing the "odd" idea.

The China Securities Regulatory Commission (CSRC), the regulatory body over securities transactions and securities markets has been promoting the practice of appointing independent directors to listed companies' boards. The CSRC produced the *Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies* in 2001. In the following year, it promoted the *Code of Corporate Governance for Listed Companies*. Since 2003, according to the Guidelines and the Code, all listed companies should have at least three independent directors. The CSRC has also organised training classes for independent directors. In addition, both the Guidelines and the Code have recommended an audit committee. The newly amended *Company Law* has firmly endorsed the idea of introducing both independent directors into listed companies.[25]

As in other jurisdictions, independent directors are defined as directors who hold no posts in the company other than the position of director, and who maintain no relations with the listed company or its major shareholders that might prevent them from making objective judgments.[26] The Chinese law states that one can hold concurrently the post of independent director in a maximum of five listed companies and thus have enough time and energy to perform an independent director's duties effectively. It is clear that independent directors in Chinese companies play the same role as non-executive or outside directors in common law systems.

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[25] In 2004, a new provision, Article 123, was inserted into the 1993 Company Law, which stipulated that listed companies would be required to have independent directors on the board of management.

[26] See *Code of Corporate Governance for Listed Companies in China 2001* (PRC) art. 49. The *Code* was promoted by China Securities Regulatory Commission.

The obvious question is: why have the Chinese chosen this dual model instead of endeavouring to improve the efficiency of the supervisory board, or strengthening independent directors on the board to enhance monitoring? The problem is that Chinese companies despite their need for a truly independent supervisory mechanism have inherent weakness. In state-owned or controlled companies in which the state is the sole or dominant shareholder, the members of the supervisory board are likely to be state officials. In this environment, their dedication to their supervisory duties is highly questionable. Consequently, it is believed that it is necessary to have outsiders to exercise supervisory powers over the management, since the supervisory board of State employees is insufficient. Based on this belief, the idea of appointing independent directors onto the board of directors is seen as a necessity.[27] In addition, independent directors are usually legal or financial experts, or experienced business people. They have the have skills and experience an their social influence and professional background place them in a better position to bring influence on the management. The newly amended company takes a stand of exerting simultaneous efforts at both ends — increasing the supervisory strength of the supervisory board and embracing the idea of independent directors at the same time.

C. *The Chief Manager*

The third important feature of a Chinese company is that the chief manager, rather than the board of directors, plays an essential role in the day-to-day management of the company. The board of directors of a Chinese company can make decisions relating to day-to-day business operations, but it cannot carry them out. The tasks of daily business management are carried out by the chief manager of the company.[28] The board of directors together with the chief manager constitutes the company's management. This characteristic distinguishes the board of directors of a Chinese company from the board of directors of a German company. In a German company, the board of directors alone comprises the managerial organ of the company.

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[27] See Zhunhai Liu, 'The Important Issues of Corporate Law Reforms', in Liming Wang (ed) *The Forefront Forum for Civil Law and Commercial Law* 32, 45–7. See also Wei, above n 3, 121.

[28] See above n 9, arts 50 and 114.

In a Chinese company, the chief manager of is not necessarily a board member. Sometimes, a director may take the position of the chief manager.[29] A non-board-member Chief manager can attend a board meeting but cannot vote at the meeting.[30] A chief manager owes the duties of a director, and is an internal organ of corporate governance. This differentiates a chief manager in a Chinese company from an executive officer in a US or a UK company.

D. *The Legal Representative*

The fourth feature of Chinese corporate law and practice is that Chinese companies have a legal representative who plays an important role in corporate governance. The legal representative represents the company in dealing with outsiders, represents the company in a court and signs contracts on behalf of the company. The chairperson of the board of directors is usually the legal representative of the company.[31] The common law traditionally holds that the chair of the board mainly performs some ceremonial functions such organising meetings.[32] In China, however, apart from being the legal representative, the chair of the board also has the powers to minor the implementation of the board resolutions. The chair may also delegate the above powers to a vice chair person.[33]

E. *The Corporate Law Reforms*

The above special features of Chinese corporate law are indicative that directors of Chinese companies play a less significant role in corporate governance compared with both

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29 Ibid arts 51 & 115.

30 Ibid.

31 Ibid art 13.

32 The view can be found in *Hughes v NM Superannuation Board Pty Ltd* (1993) 29 NSWLR 653; *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549; and *State Bank of Victoria v Parry* (1990) 2 ACSR 15 at 29. However, many hold an opposite view and believe that a chairperson has greater responsibility than an ordinary director. For instance, in *AWA Ltd v Daniels t/as Deloitte Haskins & Sells* (1992) 7 ACRS 759 at 876, it is said: "The chairman is responsible to a greater extent than any other director for the performance of the board as a whole and each member of it". Nevertheless, The Chair's usual functions do not involve business operations, such as making contracts on behalf of the company. See Ford, Austin and Ramsay, *Ford's Principle of Corporations Law* (2003) 663.

33 Ibid arts. 48 and 110.

common law and continental European jurisdictions. In contrast to the trend of development in some other jurisdictions, the 1993 *Company Law* gives the board of directors reduced power. As previously noted, the board of directors only has the power to formulate business plans and investment plans, since the power to approve of which is in the hands of the shareholders at a meeting.

Having a powerful shareholders' meeting above the board of directors and a powerful chief manager underneath it, leaves the board with a limited role. There is a danger that the board of directors may become a scarecrow in practice.[34] It seems problematic to impose all of the duties of loyalty on directors on one hand, but to give all of the executive powers to the chief manager on the other.[35] In the meantime, the *Company Law* does not clarify the relationship of delegation and reliance between the board and the chief manager. There is no provision concerning directors powers to delegate their duties nor what an acceptable standard of reliance is. Furthermore, it is impractical and unnecessary to separate clearly the process of making daily business decisions from the process of executing daily business decisions, since they interact.

The 1993 *Company Law* was subject to wide criticism since its enactment. The lack of specific provisions resulted in dissatisfaction generally in both legal and business communities. Many suggestions on reforming the current legislation to enhance and further clarify the regulation of directors' duties were made. Two corporate reform Bills were passed in 1999 and 2004 respectively. The 2004 reform Bill makes significantly improvements in corporate governance regulations. Firstly, it increases detailed provisions on shareholders meetings and meetings of the board of directors. Secondly, it enhances the supervisory function of the supervisory board by granting extensive monitoring and discipline powers it. Thirdly, the amended *Company Law* furthers the protection of employees' interests by improving the co-determination system in the company. Fourthly, it introduces more mechanisms of members' remedies.

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[34] See Wei, above n 3, 117.

[35] Ibid.

However, simply introducing more directors' duties may have limited impact on the improvement of corporate governance in Chinese companies. The time is ripe for considering the issue of enhancing the role of the board of directors in the Chinese corporate governance system. The powers of the board of directors, stipulated under the *Company Law*, are not clearly defined and they overlap with the powers conferred on the general meeting and the chief manager. In practice, the problem or danger is that the board of directors may only play a ceremonial role becoming a figurehead in corporate management.[36] Without a clear division of powers among the general meeting, the board of directors and the chief manager, goals of increasing the accountability and efficiency of board may not be achieved.

II. DIRECTORS' DUTIES IN CHINA

The 1993 *Company Law* imposes duties on directors as contained in Articles 148 to 151. Before the 2004 amendment, the law did not specify to whom the duties were owed. The Law only stated that directors had "the duty to comply with the constitution of the company, discharge duties honestly, in the interests of the company, and avoid using their position and powers in the company to make personal gains".[37] It was presumed that the duties were owed to the company not individual shareholders based on the fact that directors were selected by the shareholders' meeting not individual shareholders. It provided that directors must not misappropriate the company's property. Directors were also forbidden from being involved in transactions that result in conflicts of interests and engaging in businesses that compete with the company.[38] Nevertheless, the law did not absolutely prohibit directors from dealing with the company. It merely stipulated that directors should not enter into a contract or have transactions with the company unless such transactions were

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[36] See discussions in Yanhua Wang, 'A Comparative Analysis on the Tendency of Making the Board of Directors A Mere Figurehead in Chinese and Japanese Companies' in Liming Li (ed), *The Comparison of Chinese and Japanese Enterprise Systems* (1998) 282, 282–301.

[37] It was stated previously in art 59 of the *Company Law* before the 2004 amendment.

[38] It was stated previously in art 61 of the *Company Law*.

permitted by the constitution of the company or approved by the shareholders' meeting.[39] However, the law did not address the issue of disclosure of interests by directors nor the issue of whether directors could be present and vote on the matters at the shareholders' meeting if the director was also a shareholder. It appeared that the above duties basically fell into the category of duty of loyalty in common law.

The amended *Company Law* clarifies that directors owe their duties to their companies. Before the amendment in 2004, the Company Law did not expressly impose the duty of good faith and duty of care on directors. After the amendment, the *Company Law* unequivocally provides that directors owe a duty of good faith and a duty of care to their companies.[40] However, the law does not explain the meaning of good faith and care. Good faith originates from Latin words "bona fide". In the context of directors' duties, it has to be interpreted according to how the law recognises the relationship between directors and their companies. In Civil Law jurisdictions, it is generally understood that the relationship between a company and its directors resembles the relationship between a principle and an agent.[41] Agents have duties to exercise their powers in good faith and with a degree of care. Here, the duty of good faith is based on the doctrine of good faith in contract law, but goes beyond the scope of contract law by requiring directors to actively discharge their duties of good faith and to place their companies' interests in front of their personal interests.[42] In common law jurisdictions, the contents of fiduciary duties are largely defined by the law of trust. Directors are generally regarded as fiduciaries/trustees of their companies, and therefore owe fiduciary duties to their companies. Chinese law does not set the concept of fiduciary relationship. The law provides a list of specific duties of good faith which suggest the duties of good faith in Chinese law are close to the duties of good faith in some civil law systems, to be precise, in German corporate legislation. In China, directors have

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[39] Ibid.

[40] See above n 9, art 148

[41] For instance, the Italian Commercial Law, Japanese Commercial Law and Taiwanese Company Law all clarify that directors are agents of their companies.

[42] See Hao Zhou, 'Directors' Duty of Good Faith' in Ping Jiang and Zhenshan Yang (eds), *Civil Law and Commercial Law Forum* (2004) 434, 437.

a duty not to divulge the company's secret information, which is very similar to the relevant duty in the German law. Article 149 of the 1993 *Company Law* states: "unless the approval of the shareholders' meeting is obtained, the directors, supervisors and chief manager must not divulge the company's secrets". Directors who have breached the above duties are personally liable for the damages suffered by the company.[43]

Before 2004 amendment, the Chinese *Company Law* did not expressly address the duty of care. However, most comments and discussions assumed that directors owe a duty of care to their companies based on principles of agency law where agents owe a duty of care to the principle.[44] This view reflected the influence of continental Europe. The newly amended *Company Law* unmistakably imposes the duty of care on directors.[45] It is, however, unclear what the standard of care the law intends to follow. Some jurisdictions, such as Germany, uphold a standard of care exercised by a managerial expert or a business person, while some other jurisdictions, particularly those in common law systems, adopt a standard of a reasonable person.[46] It is noteworthy that the reasonable person standard in these common law systems is, in fact, a mixture of an object test and a subjective test.[47] The reasonable person is put in the corporation's circumstances and in the position of the particular director. The court will take the responsibilities held by the particular director in the particular company into consideration when deciding if the duty has been breached. As a result, the precise degree of care which a reasonable person would exercise in a particular case will vary.[48] The failure to address the standard of care in the current Chinese *Company Law* will inevitably cause confusion in practice.

Furthermore, there have been calls to impose common law fiduciary duties on directors in China. It was expected by many

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[43] See above n 9, art 150.

[44] See relevant discussions in Ping Jiang, *Company Law Textbook* (1987) 172; Wang and Cui, above n 21, 206, 208; and Xiu, above n 16, 270, 280–2.

[45] See above n 9, art 148.

[46] See Zhou, above n 42, 443.

[47] See Phillip Lipton and Abe Herzberg, *Understanding Company Law* (2004), 341–2. See also Ansheng Dong, *UK Commercial Law* (1991), 269.

[48] Ibid.

that the amendment Bills were likely to import common law fiduciary duty into the Chinese system.[49] To their disappointment, the most recent reform Bill continues to be silent on the topic. Some point out that it is time for the *Company Law* to address the issue since concepts of the duty loyalty and the duty of care in the common law have already been introduced into some special laws and decrees. For instance, the *Opinions on Further Promoting Standard Operation and Deepening Reforms in Companies Listed Abroad* states that "directors have the duty of loyalty, and should be diligent".[50] The *Essential Rules for Companies Listed Abroad* also provides that the end of employment does not automatically discharge directors, supervisors and senior officers from their fiduciary duty.[51] As a result, the matter of whether the director is agent or fiduciary is unsettled.

China is in the process of drafting a trust law. It will be interesting to see what effect, once enacted, the trust law may have on corporate practice, and whether a fiduciary relationship will be identified and fiduciary duties introduced by the law, and ultimately if directors will be held liable for breaches of fiduciary duties. Such an outcome would not be a complete surprise as there are calls to impose common fiduciary duties on directors.

III. COMPARING THE CHINESE EXPERIENCE WITH COMMON LAW AND CIVIL LAW EXPERIENCES

A. *Fiduciary Duty in Common Law Systems*

In common law systems, the powers of corporate control are divided between the board of directors and the members' meeting. Nowadays, the powers of managing the corporation are commonly vested in the board of directors. Once the powers are conferred on the board, the members' meeting cannot directly interfere with the management of the corporation although they may influence it through some residual control power, such as

[49] See Yan Xu, *Principles of Company Law* (1997) 271.

[50] The *Opinions on Further Promoting Standard Operation and Deepening Reforms in Companies Listed Abroad* was promulgated by the Ministry of Trade and Commerce and the China Securities Regulatory Commission on March 29, 1999.

[51] See Essential Rules for Companies Listed Abroad 1994, art 118.

the power to alter the constitution and the power to elect or remove directors.[52] Once a person has entrusted his or her property or affairs to another person, that person is at risk of suffering loss by the other's wrongdoing whether through fraud or mismanagement.[53] This risk is evident in the members/directors relationship. Directors with vested powers have the opportunity of abusing the property they have been entrusted with. Members become vulnerable when they do not have control over day-to-day management and have to rely on directors for information.[54] As a result, the common law has seen the necessity to impose strict fiduciary and legislators have created statutory duties for directors. Consequently, directors in common law systems are subject to both general law duties and statutory duties. However, the statutory and general duties are different in different jurisdictions. For instance, in Australia, the introduction of directors' statutory duties is for the purpose of introducing a separate regime of civil remedies and criminal penalties. However, in Canada and New Zealand the purpose of introducing directors' statutory duties is not completely clear,[55] although presumably, their purpose is to codify and restate the law.[56] A most distinctive development of Australian corporate law in relation to directors' duties is that the civil remedial regime makes directors' duties enforceable by the Australian Securities and Investments Commission (ASIC), a regulatory body charged with the sole administration of corporations.

The general law duties imposed on directors in common law systems can basically be subdivided into two types: the fiduciary duties of loyalty and good faith and the non fiduciary duty of care, skill and diligence.[57] In Australia, the duty of loyalty and

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[52] The principle of division of powers was firmly established in the leading cases such as *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34, *Imperial Hydropathic Hotel Co Blackpool v Hampson* (1882) 23 Ch D 1 and *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

[53] See H A J Ford, R P Austin & I M Ramsay, above n 32, 306.

[54] Ibid.

[55] See John Farrar, Corporate Governance in Australia and New Zealand (2001) 102.

[56] Ibid.

[57] Ibid 100. Also see Ford, Austin and Ramsay, above n 53, 358. Whether or not a director's duty to exercise reasonable care is a fiduciary duty is still an open question e.g. *Permanent Building Society v Wheeler* (1994) 11 WAR 187.

good faith comprises the duty to act in good faith in the best interests of the company, the duty to act for a proper purpose, the duty to retain discretions, and the duty to avoid conflicts of interests. The fiduciary duties require directors to make business decisions that will be in the interests of the company, for a proper purpose and to avoid placing themselves in a position where their personal interests conflict with the interests of the companies in which they serve as directors. The interests of the corporation usually refer to the interests of the members of the corporation as a whole but not individual members.[58] The members certainly include existing members and may also include future members of the company.[59]

Recent years have seen the expansion of interests to be taken into account with potential for fiduciary obligations.[60] In some very special situations the interests of the company include the interests of minority members and creditors.[61] Directors therefore owe a fiduciary duty to the minority members and the creditors of the corporation under such special circumstances. For instance, in *Coleman v Myers* and *Peskin v Anderson*,[62] the court held that under special circumstances directors owe their fiduciary duties to individual shareholders. The special circumstances include the situation where there is commercial dealing between a director and a member and the director causes the member to act in a certain way which is detrimental to them. In addition, sometimes the interests of other stakeholders other than those of members are also regarded as relevant by courts.[63] The duty to act for a proper purpose is closely linked to the duty

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58 See *Percival v Wright* [1902] 2 Ch 421.

59 See Provident International Corp v International Leasing Corp Ltd [1969] 1 NSWR 424 and Darvall v North Sydney Brick & Tile Co (1987) 12 ACLR 537.

60 See Robert Baxt, Keith Fletcher and Saul Fridman, *Corporations and Associations: Cases and Materials* (2003) 344.

61 See *Coleman v Myers* [1977] 2 NZLR 225; *Brunninghausen v Glavanics* (1999) 17 ACLC 1247; *Kinsela v Russell Kinsela Pty Ltd* (1986) 10 ACLR 395 and *Walker v Wimborne* (1976) 137 CLR 1.

62 [1977] 2 NZLR 225 and (2001) 19 ACLC 1301.

63 For instance, the interests of employees may become relevant following the changes in the corporations law in some jurisdictions such as the UK (the introduction of s 309 of the *Companies Act* 1985) and Australia (the introduction of ss 596AA, 596AB and 596AC of *Corporations Act* 2001). See also the discussions in Baxt, Fletcher and Fridman, above n 60, 344.

to act in the best interests of the company.[64] When a director acts in his or her own interests rather than the interests of the company and when a director knowingly misuses his or her powers, the duty to act for a proper purpose is certainly breached.[65]

Duty of care, skill and diligence requires directors to exercise a degree of care, skill and diligence when discharging their duties as directors. The key issue relating to duty of care, skill and diligence is how to measure the degree of care, skill and diligence. In other words, the key is what the standards of care, skill and diligence are. The general proposition is that a director should exercise a degree of care and diligence that an ordinarily prudent person in a like position would exercise under similar circumstances. This appears to be an objective reasonable person standard. However, it has not been applied as an entirely objective test by courts.

In the USA, when determining directors' duty of care, skill and diligence, the courts will first decide whether the directors in question are insiders or outsiders and if they are found be insiders, the court may impose a higher standard.[66] Furthermore, if directors are elected to the board for their special skills, they may be tested according to a standard measured by their expertise.[67] In Australia, by way of contrast, it was established in *Daniels t/as Deloitte Haskins & Sells v AWA Ltd*[68] that the same standard (a reasonable person standard) of care and diligence applies to both executive directors and non-executive directors. Some recent cases, however, suggest that the chairperson of the board who is given additional duties may need to take additional reasonable steps to make sure that all additional duties are discharged properly.[69] These recent cases once again illustrate

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[64] See Ngurli Ltd v McCann (1953) 90 CLR 425 and Australian Metropolitan Life Assurance Co Ltd v Ure (1923) 33 CLR 199.

[65] See Mills v Mills (1938) 60 CLR 150 and Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821.

[66] See *Bates v Dressler*, 251 US 524, 40 S Ct 247, 64 L Ed. 388 (1920). Also see James Cox, Thomas Lee Hazen and F Hodge O'Neal, *Corporations* (1995) 188.

[67] Ibid.

[68] (1995) 37 NSWLR 438.

[69] See *ASIC v Rich & Ors* (2003) 21 ACLC 450 and *Whitlam v ASIC* (2003) 21 ACLC 1259.

that the reasonable person standard is not applied as an entirely objective test by Australian courts. When deciding breaches of duty of care, skill and diligence the courts will take account of the particular circumstances of the particular company and the particular situation of the particular director into consideration. In the meantime, the decisions of these cases have re-opened the debates on the issue of whether different standards should be applied when deciding directors' duty of care, skill and diligence.

Without examining the business judgment rule, any discussion on directors' duty of care, skill and diligence would be incomplete. The function of business judgment rule is to provide a safe harbour for directors, by saying that as long as they make business judgments in good faith, for a proper purpose and are not self interested in the transaction, they are taken to meet the requirements of duty of care and diligence.[70] The existence of the business judgment rule acknowledges that not all business decisions made by directors have good economic outcomes and directors should not be penalised for making decisions that prove to be losses or honest mistakes.[71] Judges recognise that they are not in a position to second-guess business decisions.[72] The business judgment rule encourages directors to take risks and both the corporation and shareholders benefit from the risk taking conduct of the directors.[73] Before the introduction of the statutory business judgment rule, the common law did have a concept similar to the business judgment rule.[74] It was found, however, that the case law was somewhat unclear.[75] The statutory business judgment rule has superseded the case law rule.

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[70] See Ford, Austin and Ramsay, above n 53, 355. See also Roman Tomasic, Stephen Bottomley and Rob McQueen, *Corporations Law in Australia* (2002) 359.

[71] See generally discussions in Douglas M Branson, *Corporate Governance* (1993) 338–41. See also the discussions in Farrar, above n 55, 136.

[72] Ibid.

[73] See Melvin A Eisenberg, *Whether the Business-Judgment Rule Should Be Codified* (Background Study for the California Law Revision Commission, May 1998) 43–5.

[74] See Bernard S Black, 'The Core Fiduciary Duties of outside directors' (2001) *Asia Business Law Review* 3, 3.

[75] See relevant discussions in Eisenberg, above n 73.

In the USA, a statutory business judgment is contained in the *Model Business Corporation Act* and the *Principles of Corporate Governance* of the American Law Institute.[76] Australian corporate legislation has provided the statutory business judgment rule since 1999.[77] However, the business judgment rule is not universal. New Zealand corporate law does not include a business judgment rule.

The Chinese *Company Law* stipulates that directors have the following duties: a duty of good faith, a duty to disclose, a duty to maintain secrecy, a duty to compensate the company for breach of duty, a duty not to carry on a competing business, and a duty not to deal with the assets of the company fraudulently.[78] Essentially, these duties are about the duty of good faith. No provision enunciating fiduciary duty can be found in the Chinese company law. Some argue that the duty of good faith includes the duties that are equivalent to the fiduciary duty.[79]

The question is how the Chinese define the duty of good faith. At common law, good faith means honesty, a person honestly believes that he or she is honestly discharging his or her duties. It is the opposite of bad faith or dishonesty.[80] Under the duty of good faith, directors are required to exercise their powers and perform their duties honestly. In civil law systems, the duty of good faith requires directors to fulfil their duties faithfully, uphold the interests of the company, and exercise a reasonable degree of care. The duty of good faith also requires directors to actively act in the interest of the company, and forbids directors to use their positions to seek personal gains.[81] It appears that the intention of the law makers is to interpret the duty of good faith based on the civil law doctrine.

With regard to the duty of care, the Chinese *Company Law* only introduces the concept of the duty of care without defining the

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76 It can be found in section 8.30 of the *Revised Model Business Corporation Act 1999* (US) and section 4.01(a) of the American Law Institute's *Principles of Corporate Governance 1992*.

77 It is contained in section 180 (2) of the *Corporations Act* 2001 (Cth).

78 See above n 9, arts 148–50.

79 See Zhou, above n 42, 447.

80 See *Black's Law Dictionary* (5th ed, 1979) 623–4. See also Peter E Nygh (ed), *Business and Law Dictionary* (2nd ed, 2002) 232.

81 See Zhou, above n 42, 437.

scope of the duty or providing specific duties. Consequently, introduction of a business judgment rule has not been considered. Indeed, before the connotation of the duty of care is explicated by the law and courts, it would be premature for the Chinese to put the issue of introducing a business judgment rule on the agenda.

In sum, the Chinese *Company Law* does impose the duties of avoidance of conflicts of interests, and care, skill and diligence on company directors. However, these duties are imposed on directors, not based on a fiduciary relationship, but derived from a relationship between an agent and a principal. Under the current *Company Law*, it is more appropriate to define the directors as the agents of their companies, not fiduciaries.[82] In practice, because of a lack of legislative explanation, the finding of a breach is much dependant on an individual judge's discretion.

B. *Directors' Duties in Civil Law System*

The laws regarding directors' duties in some civil law systems are, to some extent, quite different from the common law systems. The most distinctive difference is that directors' duties are fully codified. Another important factor is that some influential jurisdictions such as France and Germany endorse a two-tier-board system which, under certain circumstances, results in some managerial powers being shared by the supervisory board and the board of directors. In most continental jurisdictions, incorporated business structures are basically classified into two forms: joint stock companies, which are companies with share capital, and companies with limited liability. Hybrids do exist. The co-determination regime that has been popularly practiced in Dutch and German systems has an archetypical aspect that is very foreign to common law systems. Co-determination expressly requires directors to take the interests of employees into consideration when making business decisions.[83]

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[82] Ibid.

[83] See Friedrich K Kubler, 'Dual Loyalty of Labor Representatives' in Klaus J Hopt and Gunther Teubner (eds), *Corporate Governance and Directors' Liability: Legal, Economic and Sociological Analyses on Corporate Social Responsibility* (1985) 429, 431

French corporate law also imposes a duty of care and a duty of loyalty on directors. The directors' duties are largely based on agency law. Directors are agents of their companies. Thus the duty of loyalty is generally owed to the company not the shareholders. The consequence of breach the duty is severe. Directors are personally liable for the creditors' claims in the case the company becomes insolvent and the directors' negligence has contributed to the insolvency.[84] Directors who are engaged in self-dealings or transactions causing conflicts of interests may be subject to criminal penalties.

In Germany, Aktiengelleschaft (AG, share companies) and Gesellschaft mit beschränkte Haftung (GmbH, companies with limited liability) are regulated by separate laws. According to German law, directors of an AG are independent, whereas directors of a GmbH have a duty to follow shareholders' directives.[85] Generally speaking, directors of AGs and GmbHs have three types of duties: duties of diligent management; duties of loyalty towards the company and duties of secrecy.[86] The duty of diligent management is similar to the duty of care, skill and diligence in the common law systems. The duty is owed to the company not its shareholders or creditors.[87] The standard of care is objective and requires consideration of particular circumstances such the size, objectives, trade and financial structure of a company.[88] The courts also adopt an approach that is similar to the American business judgment rule in determining duty of care.[89]

The duty of loyalty is a recent development in German corporate law. The directors' duty of loyalty is owed to both the company and the shareholders. The duty requires directors to exercise their power with good faith and to avoid placing themselves at a

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84 See James A Fanto, 'France' in AR Pinto and G Visentini (eds), The Legal Basis of Corporate Governance in Publicly Held Corporations: A Comparative Approach (1998) 1, 22.

85 See Erich Schanze, 'Directors Duties in Germany' (1999) 3 *Company, Financial and Insolvency Law Review* 286, 287.

86 Ibid 289.

87 Ibid.

88 See Rolf Birk, 'Germany' in Arthur R Pinto and Gustavo Visentini (eds), The Legal Basis of Corporate Governance in Publicly Held Corporations, A Comparative Approach (1998) 53, 66.

89 Ibid. See generally the discussions in Schanze, above n 85, 291–2.

position where there is a conflict between their personal interests and the interests of the company. Self-dealings and competition with the company are prohibited. The standard of discharging the duty is described as higher than the general standard of good faith in common law.[90] The duty of secrecy requires directors not to divulge confidential information concerning company affairs. The duty continues even when the person ceases to be a director.

The issue of directors' duties is further complicated by the notion of "co-determination" or "worker participation". Supervisors, apart from the duties specifically signed for supervisors by laws, also owe to their companies the duties that ordinarily owed by directors. Those labour representatives on the supervisory board face the challenge of dual loyalty. It should be borne in mind that worker participation is by no means restricted to a two-tier board system. In common law systems, it is not uncommon for employees to nominate their representatives onto the board of directors. Such directors are described as nominee directors. Nominee directors may find themselves in a position where their loyalty owed to their nominators conflict with their duties owed to the companies. The common law has basically settled the issue of to whom nominee directors should direct their loyalty since the delivery of a series of decisions including *Scottish Co-operative Wholesale Society Ltd v Meyer*,[91] *Levin v Clark*,[92] *Boulting v Association of Cinematograph, Television and Allied Technicians*,[93] *Bennetts v Board of Fire Commissioners of NSW,*[94] and *Berlei Hestia Ltd v Fernyhough.*[95] The general rule is that nominee directors owe their duties primarily to the companies in which they serve as directors.[96] A director does not breach his or her duties by being a nominee director unless the director actually breaches the duties by placing him or herself in a position where his or her duties owed to the company and the nominator conflict. In addition, a nominee director can avoid a

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[90] See Schanze, above n 85, 294.

[91] [1959] AC 324.

[92] [1962] NSWR 686.

[93] [1963] 2 QB 606.

[94] (1967) 87 WN (Pt 1) (NSW) 307.

[95] [1980] 2 NZLR 150.

[96] See Bennetts v Board of Fire Commissioners of NSW (1967) 87 WN (Pt 1) (NSW) 307.

breach by seeking protection from the constitution of the company. The constitution may allow the director to act in the interests of the nominator in the case where there is a conflict.[97]

In Germany, however, the problem is solved by means of fusing the employees' interests and the company's interests into enterprise interests.[98] The employees' interests of the company are part of the enterprise interest. Employees' representatives on the supervisory board may not breach the duty of loyalty if they advance the interests of the company's own employees at the expenses of the benefits of the company itself. However, a supervisor is liable if he or she influences the supervisory board to promote the interests of an outsider.[99] Consequently, a supervisory probably breaches the duty if the supervisor promotes the benefits of other union members who are not the employees of the company, since it is likely that these union members will fall into the scope of outsiders.

After the reform in 2004, the Chinese *Company Law* has substantially enhanced the supervisory strength of the supervisory board.[100] The co-determination arrangement is further developed. The purpose of increasing the power of the supervisory board and improving worker participation is to curtail the insider contract problem and the rampant abuse of powers by management. Nowadays, the board of supervisors has the powers to propose a resolution for a shareholders meeting to remove a director who has breached laws or the constitution, or the decisions of the shareholders meeting.[101] Furthermore, the board can even bring a legal action against the director. The law stipulates that at least one-third of the members on the supervisory board should be employee representatives.[102] Moreover, the law states that a state-owed company does not hold shareholders meetings and the board of directors exercises the powers usually exercised by the shareholders meeting. The law goes ahead to stipulate that a certain number of directors

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[97] See *Levin v Clark* [1962] NSWR 686.

[98] See Kubler, above n 83, 433.

[99] Ibid.

[100] See Jingkang Gao and Zhenzhong Liao, 'An Overview of Commercial Law Research' in Baoshu Wang (ed), *Business Law Annual of China* (2004) 1, 9.

[101] See above n 9, art 54.

[102] Ibid 52.

should be appointed by employees of the state-owned company. In the meantime, the state-owned company also needs to establish a supervisory board with at least one-third employee representatives. As a result, in a state-owned company, labour representatives sit on both boards.[103]

With the increasing weight of co-determination in corporate governance, the Chinese law needs to address the issue of dual loyalty. The *Company Law* does elucidate that directors and other officers owe their duties to the company. If labour representatives have an agenda to represent employees' interests, they inevitably face the question of to whom their duty of loyalty should be directed when the employees' interests conflict with the shareholders' interests. The lack of clarification regarding the issue in the current Chinese law and court rulings will inexorably add further uncertainty in future cooperate practice.

IV. CONCLUSION

It appears that directors are generally operating under two types of duties: duty of care and duty of loyalty in most systems, although, to a certain degree, the contents, the interested groups included, the remedies, and manners of enforcement may vary in different jurisdictions. Since the end of 1970s, China has deserted the dogmatic theory of planning economy and begun economic reform. The essential goal of its economic reform is to establish a market economy like the one operating in the Western world. This means importing and modifying a range of Western economic and legal ideology and practice. China is calling its scholars to study Western commercial law theories and legislation by Chinese. The 1993 *Company Law* is a result of such a movement. In the meantime, the Chinese authorities have warned people not to blindly absorb western experience and but to incorporate experience that is useful and practical within China. This usually has meant establishing a modern legal system with Chinese characteristics. It will thus be interesting to see how Chinese corporate law addresses the issue of directors' duties.

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[103] The *Company Law* also provides that limited companies may also appoint labour representatives on the board of directors. When this happens, labour representatives also sit on both boards of such a company. See ibid 45.

With the increasingly important role played by the board of directors in corporate management, directors' duties become an essential issue in corporate governance. In China, the board of directors is given a comparatively small range of powers compared with some other systems. This is because Chinese law promotes shareholder centralism, upholds a two-tier-board structure, and emphasises the role of chief manager in its corporate management.[104] In addition, many issues relating to directors' duties are not addressed by its corporate law. For instance, the standard of care is not elucidated in the *Company Law*. The possibility of the introduction of fiduciary duties and the business judgment rule is currently debated intensively.

The Chinese *Company Law* is rich in principles but lacks details. It states that the internal governance structure of a company follows the principles of clear division of power and liability, scientific management, reasonable incentives, and punishment for wrongdoing. It embraces the important principles and practice of a modern corporate system. It selects corporate rules from different systems and adjusts them to suit the Chinese situation. The Chinese law governing directors' duties is one of the areas that have been deliberated on mostly by reformists. In the future, it is expected that more amendments are to be made to the 1993 *Company Law*. The new company code should provide detailed and improved rules on directors' duties.

The Chinese *Company Law* is a hybrid code that combines characteristics of both common law and civil law. The designation of the board system and directors' duties in the *Company Law* is substantially influenced by the German or civil law system. With the progress of the enterprise reform, China has constantly turned to common law for further inspiration. The world has witnessed the dazzling practice of the Chinese piecing all possible mechanisms together in the field of company law. After adopting the two-tier-board structure of the German system, the Anglo-American one-tier-board practice of appointing independent (non-executive) directors onto the board has been introduced into China's corporate system. Nowadays, independent directors are compulsory to listed Chinese

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104 See above n 9, arts 38, 50, 52, 100, 114, and 118.

companies.[105] The introduction of independent directors was an extraordinary effort to tackle the insider control problem that has plagued the incorporated state-owned enterprises for a long time, given the cost of having both the supervisory board and independent directors. Now, after introducing the civil law concept of good faith as the essential duty imposed on company directors, the Chinese are attempting to make their directors subject to common law fiduciary duty at the same time.

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[105] See above n 9, art 123. See also China Securities Regulatory Commission & State Economic and Trade Commission, *Code of Corporate Governance for Listed Companies in China* (2001), art 40.