AMERICAN ENTREPRENEUR IN CHINA: POTHOLES AND ROADBLOCKS ON THE SILK ROAD TO PROSPERITY

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I. OVERVIEW

In many ways China is the new frontier for entrepreneurship as it is perceived to be a logical primary source of economical manufacturing, raw materials, and component parts, in addition to being considered a major end market.¹ China may also represent the most likely future competition for many American industries, as well as our major trading partner.² Increased commerce between the United States and The People’s Republic of China (‘‘PRC’’) demands that U.S. entrepreneurs understand the basic foundation for doing business in the PRC. An increasing demand for United States citizens to engage in commerce, or to sit on boards dealing with significant exposure to Chinese developments has also become a reality. A comprehensive and exhaustive treatment of this subject is beyond the scope of this article. However, an identification of some major issues, with suggestions for further research, is attempted. Hopefully, constructive thinking will result from an overview of how conducting business is fundamentally different in the PRC along with an examination of relevant corporate governance issues.

This paper is an outgrowth of an earlier article written to discuss the fundamentals of Chinese corporate governance.³ However, it soon became apparent that any such attempt required an understanding of some of the basic ways the Chinese environment differs from that familiar to those experienced in the ways of American or European governance. For example, common shares in China do not represent the same ownership interest or have the same designated rights as in the United States, there is no law protecting private property as we know it, and the functions of true “free economic markets” (securities or goods and services) have neither been understood nor embraced by officials having a natural cultural instinct for governmental control of economic enterprises.⁴ Accordingly, with a view toward the perspective of the entrepreneur, an attempt is made to bring to the reader’s attention some of the more significant differences found in conducting business in the PRC. Recent headlines depicting closer

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⁴ Id.
economic relations between the U.S. and China make the co-dependence between the two countries inevitable. China now ranks as the largest trading partner of the United States in terms of trade balance, ranks first in terms of imports into the U.S., and ranks third (behind Canada and Mexico) in terms of receiving U.S. exports.\(^5\) According to the World Bank, when measured by the “purchasing power parity” method, China has the world’s second largest economy.\(^6\) It ranks fourth (roughly equal to the economies of France and Great Britain) behind the U.S., Japan, and Germany, when viewed under the traditional market exchange method.\(^7\) When results for 2010 became available, China surpassed Japan as the world’s second largest economy.\(^8\) \(China\ Daily\) reports that “China’s economy grew at an annual rate of 9.5 percent in the second quarter of [2011], slower from a 9.7 percent rise for the first quarter.”\(^9\)

It has been said that the construction crane is the national bird of China. While China enjoys perhaps the oldest of the world’s great cultures, traveling through the PRC today and witnessing its dramatic economic growth, makes it difficult to understand that the beginning of relevant, modern Chinese legal development dates back only to 1979, with the \textit{Law of the People’s Republic of China} (“Chinese Company Law”) adopted in 1993.\(^10\) Even more astounding, the modern roller-coaster development of Chinese securities markets is essentially an experiment materially just twenty-something-years-old.\(^11\) Donald C. Clarke has recently highlighted the pressing need for


\(^10\) \textit{GU MINKANG, UNDERSTANDING CHINESE COMPANY LAW} 5-8 (Hong Kong Univ. Press, 2006).

\(^11\) \textit{CARL E. WALTER & FRASER J.T. HOWIE, PRIVATIZING CHINA: INSIDE CHINA’S continued . . .
scholarly research about comparative corporate governance, stating that:

[T]he last thirty years have seen a startling rise in the economic importance of other countries, particularly China and the rest of non-Japan Asia. From 1980 to 2006, for example, China’s share of world GDP (estimated on the basis of purchasing-power parity) rose from about three percent to about sixteen percent.¹²

Indeed, we should all be grateful to Professor Clarke for “bring[ing] comparative law—an interest in what people in other countries do—into the mainstream of a branch of American legal scholarship.”¹³

II. WHAT BASIC NEEDS ARE DRIVING CHINESE POLICY?

Susan Shirk, a former Deputy Assistant Secretary of State for East Asia and Pacific Affairs, and now Professor at UC-San Diego, notes that “[e]very good diplomat knows that you can never get anywhere until you put yourself in the shoes of the person sitting across the table from you.”¹⁴ Accordingly, all those seeking to do business in China are well served to constantly ask themselves “what we would want” if we were in charge of the PRC “controlled” economy. Law professors Norwood Beveridge, Tahirih V. Lee, Dean John Cooper and other commentators have observed that the motives of the PRC government appear to consist of the following four major objectives: (1) Increasing industrial productivity; (2) Seeking foreign exchange; (3) Import substitution; and (4) Job creation (perhaps the primary goal).¹⁵

Jamie F. Metzl of the Asia Society says “Driven by the need to deliver economic growth as a major justification for its existence, the

¹³ Id. at 109.
¹⁵ Norwood Beveridge, Professor, Oklahoma City University School of Law, Lecture for the 2007 International Conference at Nankai University in Tianjin, China (July 9-Aug. 4, 2007); Tahirih V. Lee, Professor, Florida State University College of Law, Lecture for the 2007 International Conference at Nankai University in Tianjin, China (July 9-Aug. 4, 2007); John F. Cooper, Associate Dean of International and Cooperative Programs and Professor of Law, Stetson University College of Law, Lecture for the 2007 International Conference at Nankai University in Tianjin, China (July 9-Aug. 4, 2007); see also Michael Petrusic, Oil and the National Security: CNOOC’s Failed Bid to Purchase Unocal, 84 N.C. L. REV. 1373 (2006).
Chinese government has done a tremendous job of creating wealth and bringing hundreds of millions of Chinese people out of poverty.”

Development of capital markets and an efficient framework for capital formation should allow China to tap its internal assets and the resources needed from the rest of the world to finance and fuel the PRC’s impressive economic growth. Yuwa Wei contends that the decision to open and nurture the growth of the Shanghai and Shenzhen exchanges rested upon two primary purposes: “(1) to utilize domestic savings to facilitate social funds and private companies; and (2) to discipline the listed companies and accelerate the pace of building a modern corporate governance system.”

The PRC leadership’s enlightened motivation to raise funds for the National Social Security Fund may be seen through its activities of June 12, 2001, when all companies were directed by the State Council to include 10 percent of state-owned shares in all initial or follow-on stock offerings. The 2008-2009 global financial crisis, however, “made clear that China’s dependence for growth on the purchasing power of consumers in America, Europe and Japan creates a dangerous vulnerability.” China’s need to expand and reinforce a “formal social safety net” is expanding as more Chinese reach retirement age. This will add unprecedented costs that may shock an already over-taxed environment that is heavily dependent on infrastructure projects and other state-directed investments for growth. In light of this,

Even if China’s leadership makes major progress on domestic reform, it will find that the international environment is becoming less conducive to easy economic expansion. Higher prices for the oil, gas,


18 Sandra P. Kister, China’s Share-Structure Reform: An Opportunity to Move Beyond Practical Solutions to Practical Problems, 45 COLUM. J. TRANSNAT’L L. REV. 312, 327 (2006) (explaining how deteriorating market conditions and political pressure resulted in abandonment of this requirement within just a few months).

19 Ian Bremmer, China’s Bumpy Road Ahead: Unrest, inflation and an aging populace stand in the way of the Middle Kingdom’s Touted Domination, WALL ST. J. (July 9, 2011), http://online.wsj.com/article/SB10001424052702303544604576430103921843770.html.

20 Id.

21 Id.
metals and minerals that China needs to power its economy will weigh on growth. The exertions of all those other emerging market players will add to the upward pressure on food and other commodity prices, suppressing growth rates and undermining consumer confidence, which have been the most important sources of social and political stability in China. . .

Strong growth in China, coupled with America’s unsustainable fiscal policies, high unemployment and weakened consumer demand, will generate friction between the world’s two largest economies—in particular, by significantly increasing the likelihood of protectionism on both sides. That’s a problem for American companies looking for access to Chinese consumers, but it’s far more troublesome for the Chinese, who rely more on U.S. fiscal stability, investment, technology and consumption.22

III. DOING BUSINESS IN CHINA IS NOT JUST LIKE DOING BUSINESS IN ANOTHER FOREIGN COUNTRY

Business decisions may prove unusually complex to foreigners seeking to do business in the PRC. Evolving from Confucianism,23 the traditional Chinese culture places much more emphasis on the nurturing and maintenance of relationships than in most other areas of the world. Relationships and connections, or “Guanxi,” are the “vehicle in which Chinese business is conducted. Nothing gets done without them.”24 In this system,

[family and social context define the individual, unlike the Western view in which the individual defines his own context. In other words, self-individualization is possible only through an interaction with others within the context of one’s own social roles and relationships. The self is always in relation to others, a rational self; a

22 Id.
rational being.\textsuperscript{25} Under this powerful system of Guanxi, “[p]eople’s sense of themselves, and their self-worth, is often determined by their relationships with others. The Chinese are both individualist and group-oriented and the relationships between group and individual are complex and deep-rooted.”\textsuperscript{26} Thus, it has been observed that personal and business relationships in China must be developed on two levels: “with the person as an individual, and the person as a member of a reference group.”\textsuperscript{27}

It is true that Westerners also develop guanxi-type relationships and networks. What distinguishes the Chinese Guanxi system, however, is that in China this same pattern of relationships is also central to the business world, on a quite explicit and open basis. Business associates within a network are referred to as being zi jia ren (one’s own family). In a Confucian society, guanxi represents a natural blurring of the line between the professional and the personal . . . This complex system carries expectations that favors will be returned.\textsuperscript{28}

American businessmen in China should remain conscious of the Guanxi system. While “[s]ome Chinese businesspeople dismiss guanxi as old fashioned and . . . replaced by modern Western methods[,] . . . the Western business person should assume both approaches are relevant.”\textsuperscript{29}

Guanxi and Western models of approaching a transaction need to be viewed in tandem: a strong enough relationship gains entry to the Western model of negotiation and hopefully to an eventual contract and continued relationship. The bigger the risk, the stronger the guanxi will need to be. The process of securing a contract in China is rarely the free market auction paradigm Westerners expect. For example, the terms of a business may be determined by the parties; however, to be sure, all local implications of the business (like

\textsuperscript{25} Greenlee, \textit{supra} note 24.
\textsuperscript{26} Id.
\textsuperscript{27} Tim Ambler, Morgen Witzel & Chao Xi, \textit{Doing Business in China} 110 (2d ed. 2009).
\textsuperscript{28} Greenlee, \textit{supra} note 24.
\textsuperscript{29} Id.
suppliers) will be determined by guanxi. 30

A. The Modern Chinese Legal System

The development of modern law in the different Chinese jurisdictions often rests upon fundamentally different foundations. Hong Kong company law is based upon British tradition. 31 The Company Law of the People’s Republic of China 32 of 1993 was based largely on the company laws of Taiwan, France, Germany, and Japan. 33 Taiwanese law was heavily influenced by the German and Japanese Commercial Code. 34 However, Taiwanese law was heavily influential upon the Chinese drafters substantially for language reasons; “yet Taiwan’s company law is itself a hybrid, since it was originally based on both German and Japanese law and, after World War II, came under U.S. influence.” 35 The growth of the Chinese legal system has been described as

... one that our Chinese colleagues tell us is part of the civil law system (dalufa xi). Without debating the merits of that characterization here, or examining strong German, Japanese, and Soviet influences, there is a pronounced bias in Chinese law-making and the Chinese legal system towards positive, statutory law—rather than judicially articulated case law and jurisprudence. Whereas in the United States or

30 Id.
31 Gu, supra note 10, at 10-11.
34 Hou Xinyi, Professor & Vice Dean, Nankai University Law School in Tianjin China, Lecture for the 2007 International Conference at Nankai University in Tianjin, China (July 9-Aug. 4, 2007).
35 Siems, supra note 33, at 66.
England, for example, one might expect to see a key concept like fiduciary duty elaborated in a fact-specific case opinion, in the Chinese context we would expect to see the same concept described in a formal statute or regulation, and then invoked by a public legal authority (like a court) in arriving at a decision or implementing an enforcement action. (It is worth noting in this context that many scholars, in fact, believe that the specific concept of fiduciary duty is best developed, and may only be available, in common law systems.)

B. No Concept of Private Property

American businessmen in China must understand the development and extent of private property rights in China. The 1949 dismantling of the Shanghai Stock Exchange, the third largest in the world at that time, by the Chinese Communist Party was the direct result of the inability to reconcile Marxist principles with the concept of private-share ownership. It was observed that, “the creation of a national stock market raised deep ideological concerns about the meaning of private property rights, the appropriate extent of state ownership, and the role of the planned economy in a socialist market economy.”

Regarding private property,

[w]hen China’s national stock exchanges were established, private property rights held only a feeble status. The word “private” had only recently entered the Constitution of the People’s Republic of China (the “Constitution”), when the 1988 amendment replaced the phrase “individual economy of urban and working people” with the phrase “private sector of the economy.” Article Eleven of the Constitution described the private sector as a mere “complement” to

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37 Kister, supra note 18, at 316-17.

38 Id. at 316.

39 Id. at 317 n.24 (citing XIAN FA [Constitution] art. 11 (1988) (China)) (footnotes in original omitted).
the dominant public economy.\textsuperscript{40}

Language contained in the fourth amended version of the Constitution of the People's Republic of China, Article 13 states, “[c]itizens’ lawful private property is inviolable” and “[t]he State, in accordance with law, protects the rights of citizens to private property and to its inheritance.”\textsuperscript{41} However, “[t]he State may, in the public interest and in accordance with law, expropriate or requisition private property for its use and shall make compensation for the private property expropriated or requisitioned.”\textsuperscript{42}

C. Accounting Standards: Auditor Frustration and Adoption of International Financial Reporting Standards (“IFRS”)

I seem to remember from my introduction to accounting course that “accounting” could be defined as “the language of business.” How can anyone manage, oversee or control any enterprise toward growth without reliable numbers to measure performance (or lack of it)?

The Wall Street Journal reports during 2011, that “[s]ince February, the so-called Big Four accounting firms have resigned or been dismissed from at least seven Chinese companies listed in the U.S., according to SEC filings . . . in three instances, auditors quit the accounts before completing the auditing of any financial reports.”\textsuperscript{43} Auditor verification of even the most basic of accounting items, such as cash, is proving difficult or impossible in China. “Problems with ‘bank confirmation’—the process by which an auditor checks with a company’s bank to verify its balances—have risen in about 10 recent disputes between U.S.-traded Chinese firms and their auditors, according to Securities and Exchange Commission filings.”\textsuperscript{44} The U.S. Public Company Accounting Oversight Board (“PCAOB”) inspectors “conduct regular evaluations of the firms that audit the

\textsuperscript{40} Id. at 317 n.25 (citing XIAN FA [Constitution] art. 11 (1988) (China)) (footnotes in original omitted).
\textsuperscript{42} Id. at § 3.
books of U.S.-traded companies in order to assess the firms’ performance and ensure they’re complying with auditing standards.”\textsuperscript{45} But so far, “Chinese authorities haven’t allowed the PCAOB’s inspectors into their country to evaluate the work of the 53 Chinese audit firms registered with the PCAOB, including affiliates of the Big Four accounting firms.”\textsuperscript{46}

This came at a time when “U.S. investors [during 2011] [had] lost billions of dollars in the face of scandals involving U.S.-listed Chinese companies that auditors have alleged misrepresented their business and financial position.”\textsuperscript{47} Moreover,

[a] court challenge against the China unit of accounting giant Deloitte Touche Tohmatsu by the U.S. Securities and Exchange Commission escalates a clash between U.S. and Chinese regulators on how much oversight the U.S. should have over the hundreds of Chinese firms listed on U.S. exchanges . . . In opening a new front in its battle to tighten oversight of U.S.-listed Chinese companies, the SEC argues that it isn’t clear what Chinese laws would be violated, if any, by turning over audit records . . . The dispute also highlights the shortcomings of regulation in China, which is complicated by vague laws, competing regulatory agencies and a tight rein on information.\textsuperscript{48}

In November 2005, the PRC announced a commitment to converge Chinese Accounting Standards (“CAS”) with International Financial Reporting Standards (“IFRS”), culminating efforts by the Ministry of Finance (“MOF”) since the early 1990s to establish standard accounting practices across diverse types of enterprises.\textsuperscript{49} The


\textsuperscript{46} Id.


\textsuperscript{48} Id.

business and financial news site Moneyweb reports,

the process of convergence will involve integrating the IFRS principles into CAS and will result in the amendment of all existing standards and the issuance of an additional 22 Specific Standards. While the revised CAS will not reflect a literal translation of IFRS, their scope will include all IFRS principles. In addition, they will contain interpretive guidance to address the accounting for specific types of transactions (e.g., combinations of companies under common control) and industry accounting issues (e.g., extraction of petroleum and natural gas) . . . There will, however, continue to be a small number of differences between the revised CAS and IFRS to reflect unique circumstances in China. These differences, among other things, relate to (i) a prohibition of the reversal of asset impairment once it has been made; (ii) the accounting for certain government grants; and (iii) related party disclosures.50

While listed companies in China adopted the new accounting standards during 2007, Liu Yuting, director of accounting for the MOF, announced during July 2007 that “central-level state-owned enterprises would comply with the new regulations by 2008 and the scope would be expanded to include all large- and mid-scale enterprises a year later.”51

Perhaps as a move by the SEC to allow or require U.S. issuers to use IFRS (as a step towards a single set of globally accepted accounting standards), Chinese convergence takes place as the SEC announces that foreign private issuers will be allowed to file financial statements using IFRS, as published by the International Accounting Standards Board (IASB) without a reconciliation to U.S. GAAP (Generally Accepted Accounting Principles).52 This is effective with financial statements for the period ending after November 15, 2007.53

The SEC has recently solicited public comment regarding

50 Id.
53 Id.

Systems for financial audit and control appear to suffer from cultural considerations different from Western concepts of good business practice. Yuwa Wei observes that Chinese law \lq\lq does not clarify the status of internal auditors.q\rq\footnote{Wei, \textit{supra} note 17, at 218.} Total subjection to a general manager substantially weakens an auditor’s monitoring power.\footnote{\textit{Id.} at 219.}

**D. Experience with Markets and \lq\lq Corporate Form\rq\rq\lq is Disarmingly Recent**

The experimental and pragmatic approach to economic development resulting from Deng Xiaoping’s vision created heightened tension among regulators.\footnote{See, e.g., Kister, \textit{supra} note 18, at 312.} A curious paradox characterizes China’s framework for economic development. The government embraces an experimental approach in adopting new market systems, while it also insists on retaining crucial levers of control. The most important reform currently underway in China derives from this paradox.\footnote{\textit{See id.}.}

Shortly after China introduced a stock market:

\[T]\h e Chinese securities market regulator made a move to insure government control over the state-owned sector of the economy. It prohibited more than two-thirds of shares technically listed on the market from actually trading. This internal dysfunction – a phenomenon that is unique in the world – has produced a stock market that appears puzzling from the outside. The market has grown admirably from a market capitalization of only 105 billion renminbi (RMB) [13 billion U.S. dollars] in 1992, to 3572 billion RMB (443 billion U.S. dollars), representing approximately 34% of China’s gross domestic product, in 2005. But despite this growth, the market has faltered for years at about 46% below its mid-2001 level. One commentator has likened the performance of the market...
since July 2001 to ‘passing through the valley of the shadow of death.’\textsuperscript{59}

China experienced corporate scandals and deceptive securities market manipulation during the late 1990s, culminating in a market sell-off during the first years of the new millennium.\textsuperscript{60} Much as the U.S. securities markets suffered from the likes of Enron, WorldCom, and Adelphia Communications,\textsuperscript{61} the PRC had its own long list of scandals including the Qiong Min Yuan case, the Zheng Bai Wen case, and the Chengdu Hingguang case.\textsuperscript{62} While it is tempting to consume many pages to describe the various methods employed to defraud innocent investors, suffice it to say that the Chinese experience rivaled that of the West, resulting in the destruction of investor confidence that would impact capital formation for several years. However, much like the U.S. experience, in just a few short years the investing markets seem to have suffered from an amnestic ability to ignore the painful lessons of the recent past, with Chinese markets soaring 98\% for the Shenzhen Composite and 130\% for the Shanghai Composite during 2006, producing 163\% (Shenzhen) and 97\% (Shanghai) returns during 2007; losses of 62\% in Shenzhen and 65\% for the Shanghai Stock Exchange Composite Indexes during 2008, but gains of 64\% (Shenzhen) and 47\% (Shanghai) during the first eight months of 2009.\textsuperscript{63} By September 26, 2011, the five-year non-inflation adjusted return for the Shenzhen index was 144\% and

\textsuperscript{59} Id. at 312-13.

\textsuperscript{60} Wei, supra note 17, at 225.

\textsuperscript{61} See generally Victor Futter, \textit{An Answer to the Public Perception of Corporations: A Corporate Ombudsperson?}, 46 BUS. LAW 29 (Nov. 1990) (including an account of pre-Sarbanes-Oxley corporate wrongdoing).

\textsuperscript{62} Wei, supra note 17, at 214.

\textsuperscript{63} Id.; see also Shanghai Stock Exchange Composite Index, BLOOMBERG, http://www.bloomberg.com/quote/SHCOMP:IND (last modified June 6, 2012) (“The Shanghai Stock Exchange Composite Index is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. The index was developed on December 19, 1990 with a base value of 100. Index trade volume on Q is scaled down by a factor of 1000.”); Shenzhen Stock Exchange Composite Index, BLOOMBERG, http://www.bloomberg.com/quote/SZCOMP:IND (last modified June 6, 2012) (“Shenzhen Stock Exchange Composite Index is an actual market cap weighted index (no free float factor) that tracks the stock performance of all the A-shares and B-share lists on the Shenzhen Stock Exchange. The index was developed on April 3, 1991 with a base value of 100. Index trade volume on Q is scaled down by a factor of 1000.”); James T. Areddy, \textit{China’s Slower Profit Train Could Derail a Stock Boom}, WALL ST. J., Jan. 3, 2008, at C1.
44% for Shanghai. For perspective, these results contrast with a loss of approximately 5% on the Dow Jones for the comparable period.

E. Banking in the PRC

Volumes have been written about banking opportunities and the Chinese banking system. While coverage of this topic in any substantial way far exceeds the scope of this article, a focus on the business risk associated with structural banking weakness needs to be mentioned. “China’s administrative and regulatory framework for banking as well as its judicial system, now only in their infancy, is faced with the challenge of attempting to deal with an aspiring 21st century banking system.” It seems likely such a new focus within China toward growing Western-style banks will introduce new systematic business environment risk for investors and those conducting commerce in the PRC.

China’s first regulatory agencies were formed in 1995 following its admission into the WTO. As part of its accession into the WTO, China agreed to “apply and administer all WTO-related laws, regulations and other measures in a ‘uniform, impartial and reasonable manner.’” Some commentators believe that this shift in the Chinese banking system may simply be “out of the reach [for the] fledgling [Chinese] administrative and judicial system[s].” The commentators note that the Chinese do “not have much experience drafting clear and detained regulations and [that they] lack a track record or tradition of administering law in an impartial and unbiased manner.”

Furthermore, the difficulties facing the Chinese government in regulating the banking industry are “not only organizational and technical but cultural as well.” One commentator points out that “China is a single party socialist state saddled with a transition

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64 Trautman, supra note 3, at 13 n. 37.
65 Id.
66 Id. at 13 n. 38.
69 Jirak, supra note 67, at 334.
70 Id. at 335.
71 Id.
72 Id.
economy, an immature legal system, and a historical legacy of more than two millennia in which the subordinate role of law as a means of achieving social order stunted the growth of a culture of legality.”

Cultural barriers, while difficult to quantify, undoubtedly play a factor in Chinese banking law risk.

While the current state of banking regulation in the People’s Republic may appear bleak, that “is not to say that no progress has been made.” China has made an effort in three of its five-year plans to “increase legal education and awareness.” Some examples of the Chinese government’s attempts to educate its people on the law include broadcasting of live trials on television and sponsoring “radio shows in order to educate citizens about their legal rights.” However, “continuing uncertainty in the judicial and administrative framework presents serious questions about China’s ability to handle a banking system vaulting into the 21st century.”

The non-performing loan (“NPL”) issue

Does the level of non-performing loans on the books of PRC banks remain a significant risk to all engaged in Chinese commerce, as well as to global political stability? One commentator believes that “[d]ecades of policy lending have saddled the four state-owned banks with an unhealthy level of non-performing loans from state-owned enterprises. Asset management companies have been created to manage these NPLs, but the situation is far from stable.” Further, “[a] lack of corporate governance has also created an environment where management of banks is opaque and corruption widespread.” Undoubtedly, the risks associated with

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73 Id. (quoting Randall Peerenboom, Globalization, Path Dependency and the Limits of Law: Administrative Reform and Rule of Law in the People's Republic of China, 19 BERKELEY J. INT'L L. 161, 261 (2001)).
74 Id. at 335.
75 Id.
76 Id.
77 Id.
78 Id.
79 Trautman, supra note 3, at 15 n. 50.
the Chinese banking system are great.81

One commentator noted, “The existence of NPLs is a legacy of the role that China’s banking system played prior to the current reforms. At that time, banks served primarily as a funding source for programs dictated by state-owned enterprises.”82

In fact, “[s]cholars have speculated [that] NPLs comprised anywhere from ten percent to forty percent of all banking assets. Dai Xianglong, the governor of the PBC ‘officially recognized that the ratio of NPLs to total outstanding loans at the Big Four was 25% in 1999.’”83 Standard and Poor’s (“S&P”) further corroborated this idea in 2001 and “predicted that the Big Four would require $540 billion, half of China’s annual GDP, to account for NPLs.”84

Notwithstanding the estimates quoted above, “some Western analysts disagree with such assessments and put the amount of NPLs in the banking system at around forty percent.”85 In May 2005, S&P put the figure at around thirty-one percent.86 “Others suggest ‘the staggering figure of NPLs has already made the Big Four technically insolvent.’”87 Great pressure still exists to make loans to state-owned enterprises or recently privatized state-owned enterprises that are still controlled by party leaders.”88

81 Id.
82 Jirak, supra note 67, at 336.
83 Id. at 337
84 Id. (citing Robyn Meredith, China Fever: Mainland Stocks are Hot, but Many Are Just Sick, FORBES, July 4, 2005, at 83 (“Some of the Biggest China IPOs due this year are in the shaky sector of banking. Academics and economists outside China say 25% of all Chinese bank loans are bad. A bailout would cost China a punishing 17% of its gross domestic product, or $280 billion, UBS says.”)).
85 Id.; see also Billion-dollar gamble: Another of China’s big banks finds illustrious foreign partners, ECONOMIST (Sept. 3, 2005), http://www.economist.com/node/4352061 (“To spruce themselves up for listing, the banks have been selling off their old non-performing loans: they even put their bad-loan ratios in single digits, although the true figures are probably still much higher.”).
86 Jirak, supra note 67, at 337.
87 Id.; see also Craig Phillips, Banks Have A Long Way to Go to Win Confidence, THE AGE (Oct. 21, 2005), http://www.theage.com.au/news/business/banks-have-a-long-way-to-go-to-win-confidence/2005/10/20/1129775901483.html# (“Meanwhile it was recently touted that to fix China’s bad loans fiasco in the country’s state-owned commercial banks alone, the Chinese government would have to fork out the equivalent of 44 per cent of the nation’s gross national product (GNP). This, according to the latest figures released by the World Bank, equates to approximately $US1 trillion.”).
88 Jirak, supra note 67, at 338; see also Brian Brenner & Dexter Roberts, Wanted: A Big Broom For China's Banks, BUS. Wk., May 9, 2005, at 52; Lan Cao, continued . . .
In 1998, the Chinese government “bailed out [the Big Four] with capital infusion of $33 billion” and in 2004 gave over $45 billion to the Bank of China and China Construction Bank, in an effort to rid the banks of bad loans. In 1999, China also removed over $169 billion worth of NPLs from the Big Four and sent them to asset management companies. China hopes that these efforts will stabilize the banks and allow them to better cope with the increased competition that will come with the full opening of the Chinese market. However, only time will tell just how endemic the NPL problem truly is.

F. Banking Day of Reckoning Near?

What about China’s growth risks? “Officially, the large state-owned banks have reduced their nonperforming loans dramatically, to 300 billion yuan ($44 billion) in 2010 from more than one trillion yuan in 2005.” However, “the government spurred the banks to lend 1.4 trillion yuan in 2009, and even the optimists concede that some portion of these loans are starting to go south.” Can investors “trust the balance sheets of banks that are simultaneously arms of the state and listed companies?” Moreover, it has been argued that

the world must pay close attention to Chinese fundamentals, including the stability of its banking system. Beijing will no doubt continue to insist on the principle of noninterference in its internal affairs, but there is a pressing need for greater transparency. As the Journal reports, China is the biggest player in the

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90 Id. at 338 (citing Li Yong Yan, China’s $45 Billion Bank Headache, ASIA TIMES (Jan. 9, 2004), http://www.atimes.com/atimes/China/FA09Ad02.html).

91 Id. (citing Cao, supra note 88, at 565).

92 Id. at 338-39 (citing Yan, supra note 90).

93 Id. at 339; see generally James Kynge, “Bold Action Needed” on China’s Banks’ Bad Loans, FIN. TIMES (LONDON), Oct. 1, 2002, at 14 (discussing speculation by some analysts who believe NPLs are actually increasing).


95 Id.

96 Id.
global steel market, yet nobody has a clear picture of how much it produces and consumes. The financial system is even more opaque, as official data are suspect and information that would be public elsewhere is still considered a state secret.97

One commentator warns that “[t]he liabilities of the [Chinese] shadow banking system are unknown and uncontrolled.”98 Moreover, the secrecy and tactics of the Chinese “add up to a financial system that in some respects is running out of control. The more liabilities build up out of sight of regulators, the more serious the risk that a financial crisis could catch authorities by surprise.”99

That same commentator believes that the “problem is twofold.”100 First, “[i]t is very difficult to capture information about nonbank sources of lending, which comprise everything from corporate balance sheets to unrecognized promises for future profits. Second, the bank regulators control only the banks, but not the whole economy.”101 Essentially, “[t]hey are in a tug of war both with China’s planning board—the National Development and Reform Commission—and local governments, all of whom have a vested interest in spending as much money as possible.”102

However, “the downside is more frightening. There is a rampant growth of credit, uncontrolled or even incalculable by the country’s top leadership. This means the financial system is generating liabilities that could easily turn sour and, come some kind of crisis, prove difficult to clean up.”103 A different group of commentators state that [t]he first wave of problem loans originating from the 2009 economic stimulus is about to hit China’s banking system. If the reports citing anonymous officials are true, Beijing is considering assuming responsibility for some two trillion to three trillion yuan ($300 billion-$450 billion) of loans that were made to local government[s].104

97 Id.
99 Id.
100 Id.
101 Id.
102 Id.
103 Id.
Such a bailout would be bigger than the U.S. Troubled Asset Relief Program and account for about 7% of China’s gross domestic product. How did this happen?

When the global financial crisis affected China’s exports in 2008, Beijing ordered its banks to support a massive credit expansion to create jobs and stimulate growth . . . The machinery to remove bad loans from the banking system is already in place. In 1999 Beijing created four asset management companies (AMCs) to acquire nonperforming loans. These “bad banks” were supposed to exist for only 10 years, during which time the government expected them to complete the sale or disposal of their portfolios.

In China, “national debt narrowly defined is 20% of GDP, but if all obligations of the sovereign were added up it is closer to 80%. This is before this round of local government loan acquisition, and before considering the other 70% of the stimulus loans made to state enterprises.” History has shown that these state enterprises have repeatedly been bad creditors. “With few voices able to question its actions, Beijing will apparently continue along the path of increasing systemic financial leverage. The weight of its inability to halt profligate spending by local governments and state enterprises will be put squarely on the backs of future generations.”

In spite of international praise regarding Chinese economic planning, the truth is that the Chinese government has wasted $400 billion. Had China been more responsible with this money and “added [it] to the National Social Security Fund, China might be several steps further along the path of creating an economy driven by domestic consumption rather than infrastructure investment.”

Perhaps Beijing’s willingness to assume a portion of local government debt shows the political will to act decisively. But it must be remembered that the central government approved these loans in 2008 and 2009 in


105 Id.
106 Id.
107 Id.
108 Id.
109 Id.
110 Id.
111 Id.
the knowledge that many projects were of questionable
goodness. The experience of these two years shows that a
large part of the Chinese economic miracle has been
built on a foundation of ill-considered lending and
accounting sleight-of-hand.\footnote{Id.}

Those engaged in entrepreneurial activities or corporate
governance either in China or other parts of the world (dealing with
Chinese commerce) are well-advised to have a heightened sensitivity
to the risk introduced by a fragile Chinese banking system.

IV. A CONTROLLED ECONOMY IS A BUREAUCRACY
AFTER ALL

A. Business Formation

The number of required administrative approvals can be frustrating
for a Westerner anxious to do business. Business formation may take
legal counsel as little as an afternoon in the United States: to ascertain
availability of a corporate name, draft, and then file a corporate charter
and bylaws with the appropriate state authorities. Not so in the PRC.
During my discussions with practicing Chinese attorneys while in the
PRC during July and August 2007,\footnote{See Zhang Yong, Professor, Nankai University Law School in Tianjin China, Lecture for the 2007 International Conference at Nankai University in Tianjin, China (July, 9-Aug. 4, 2007); See generally DAVID GRANICK, CHINESE STATE ENTERPRISES: A REGIONAL PROPERTY RIGHTS ANALYSIS (1990) (providing detailed summaries of twenty case studies of large and medium-sized state-owned Chinese industrial enterprises, covering the period 1975 through 1984); JOHN HASSARD, JACKIE SHEEHAN, MEIXIANG ZHOU, JANE TERPSTRA-TONG & JONATHAN MORRIS, CHINA’S STATE ENTERPRISE REFORM: FROM MARX TO THE MARKET (2007).} a consensus suggested that it
may take as long as two years to move a foreign joint venture or
wholly-owned enterprise through the necessary approval processes.
However, one U.S.-educated attorney observes,

[i]n my own practice, I believe that in major cities such
as Tianjin it takes about one month to complete all the
paperwork for a joint venture or WFOE (“wholly
foreign-owned enterprise”). Many cities follow
Tianjin’s model of establishing one-stop service centers
to help overseas investors’ registration and pre-
operating needs. The Tianjin Municipal Foreign
Investment Service Center was established in the late
1980s and is the first one-stop service center in
Usually 20 “chops” (the official ‘stamp’ of the particular authority) will be required to navigate the many layers of relevant PRC governmental authorities having possible jurisdiction (often overlapping) over any new enterprise, with the following being most significant:

5. The State Council (the PRC’s major legal governing body). [It] is responsible for the bulk of regulation. If the project involves $100 million (U.S.) or more the State Council must approve. This is the mechanism where an attempt is made to ensure compliance with the state’s five-year economic plan;

6. The Ministry of Commerce (“MOFCOM”). [It is] the central agency located in Beijing that is responsible for approving any project over $30 million (U.S.) [except for Tianjin and Shanghai]; and

7. The Commission of Commerce (“COMCOM,” formerly COFTEC). [It is] the local branch of MOFCOM, may approve projects of $30 million (U.S.) or less.  

V. BRIEF HISTORY OF CHINESE SECURITIES MARKETS

The reemergence of the PRC during the past few decades as a world economic power of substantial proportions is intimately interwoven with its success in providing a pragmatic approach to capital formation. One author’s cogent description of the historical development of Chinese securities markets is included below.

The first stock exchange in Chinese history, the Shanghai Stock Exchange (Shanghai Gupiao Jiaoyisuo), was the largest in Asia before 1941.  

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114 Interview with Gu Ming, Attorney, Oklahoma City, Oklahoma (May 30, 2008). 
116 Chenxia Shi, Competition in China’s Securities Market: Reform of Current Regulatory System, 3 LOY. U. CHI. INT’L L. REV. 213, 216 (Spring/Summer 2006) (footnotes omitted from original) (citing WILLIAM A. THOMAS, WESTERN continued...
was established in 1905 following the formation of the Shanghai Stock and Stockbrokers’ Association in 1898. This exchange boomed in cotton and rubber share trading but also experienced highly speculative share trading, with sharp rises and falls, as a result of the [turbulent] political and social unrest from the 1911 Revolution until 1929. Political uncertainty and military activities in and around the International Settlement in Shanghai in the 1930s shook the “security and economic integrity of China’s premier port and financial center,” and resulted in a long period of share market depression.\footnote{Id. at 216-17 (footnotes omitted from original) (quoting \textsc{William A. Thomas}, \textsc{Western Capitalism in China: A History of the Shanghai Stock Exchange} 211 (2001)).} Although this was momentarily relieved by the surge in price of rubber and other commodities, 1941 saw the closure of the share market and the stock exchange. After the Sino-Japanese War, the Shanghai Securities Exchange (Shanghai zhenquan jiaoyisuo) was opened in 1946, but its membership was limited to Chinese citizens. It was closed when the Communist Party defeated the Nationalist Government in 1949.\footnote{Id. (footnotes omitted from original) (citing \textsc{William A. Thomas}, \textsc{Western Capitalism in China: A History of the Shanghai Stock Exchange} 211 (2001)).}

It can be said that the past twenty years of Chinese securities market evolution has been punctuated by a series of miscues, false starts, occasional scandals (like everywhere else) and chaotic changes in expectations. The Chinese economic reform effort envisioned by Deng Xiaoping as early as 1992 has depended heavily upon incorporation of Chinese companies and their listing of shares.\footnote{See \textsc{Walter & Howie}, \textit{supra} note 11, at 280.} Walter and Howie write that the Chinese securities markets have “adopted all the infrastructure, accounting, legal, regulatory, and industry functions typically found in the West. Now stock markets do exist in China and give the outward appearance of any emerging market in the world . . . however, China’s markets are not the same.”\footnote{Id. at 280.}

Walter and Howie summarize major differences between Chinese
securities markets and those elsewhere to include:

1. **The past 15 years have clearly demonstrated that stock markets in an economy, every aspect of which is controlled by the state and rife with moral hazard, don’t work.** Yes, great sums of money have been raised for SOEs (state-owned enterprises), and yes, international fund managers have generally supported overseas SOE listings, at times with enthusiasm. But support domestically has been largely speculative, while internationally it has been the result of excess liquidity and a firm belief in China’s great future potential. . . . To a large extent, the very existence of Chinese company IPOs and the domestic markets have given the outward impression that China has changed in a fundamental way. It hasn’t. Nor has its markets developed in the same way as, say, the Indian market.

2. **China’s companies and financial institutions, particularly the so-called Blue Chips, are still overwhelmingly state-owned.** There has been no sign at all of the state’s interest in truly privatizing such companies. Even more important, however, is that all senior management is appointed by the still Leninist Communist Party; their careers are party careers and not bound up with the success or failure of the companies they manage. This year they are managers, next year they are vice governors of provinces and so on. To the extent that a non-state sector exists it does so by the party’s leave and its existence and success depends entirely on how well each entrepreneur manages his relationship with the government.

3. **There is no law protecting private property.** The March 2006 People’s Congress, enthralled by the view that foreign capital is taking over China, once again put off passing a law that would at last give some legal recognition to private property.

4. **China’s manufacturing sector actually shows the way forward.** Although ultra-nationalists may argue that foreign companies are taking over the economy, they miss the point. Who can say that Chinese companies have not benefited from the significant foreign presence? China is now filled with what seem to be highly competitive companies operating in every industry from convenience store chains, to Home Depot-like mega-stores to automobiles and auto parts.
5. **The market needs more foreign participation, not less.**

6. **The Chinese securities landscape is rife with moral hazard.** The exchanges are controlled by the state and the Party, as are the securities companies and the banks and corporates that lend and invest in them and the companies that list on them. Although there is a foreign presence in the fund management and insurance sectors, state companies continue to dominate trading and take direction from their various state owners. Together with the national pension fund, they have been blatantly used to ramp the market in support of state policy.

7. **The regulator, deep in the industry’s pocket, is protectionist, and has done everything it can to benefit political favorites.** This has created a culture of dependency on the state for everything, including bailouts. Such a feeling on the part of the retail investor, who has been used egregiously by all sides, can be understood, but the flip side of dependency is lack of accountability. Where are the court cases brought against those who committed the huge market frauds that brought the securities industry down?

8. **[T]he CSRC [China Securities Regulatory Commission], by catering to the industry and consistently ignoring the regulatory violations and outright fraud of major securities firms until too late, has prevented the market from developing the kind of infrastructure—legal, accounting, information transparency, sound corporate governance, and even-handedness—that would have enabled the domestic markets to grow, so that pushing Chinese companies off to Hong Kong would not have been necessary, if it ever was necessary.** Its inaction has also precluded the development of true professional expertise, which would have allowed it not just to regulate more effectively, but also to encourage reform of the non-tradable share problem long before it became the issue that it has.

9. **Listed companies have also paid a huge penalty, both economically and otherwise.** **[T]he average first-day market pop for IPOs caused by the one-size-fits-all pricing formula set by the CSR . . . has ranged from between 50% and 180%. No doubt whoever got hold of shares was happy, but think of the money left on the table for hard-pressed SOEs.**
10. **[O]ver time, investors came to view all companies as commodities—if the CSRC treated them this way, why should anyone else do otherwise?** This included the underwriters, who had no need to learn how companies should be valued. Because shares were commodities the market simply lost sight of the underlying company. For all intents . . . companies were simply shells without identifiable characteristics other than perhaps their particular industry.  

In many ways, securities markets have developed in China despite the government, rather than because of purposeful, enlightened governmental policy. According to Walter and Howie, markets developed in rural China:

> Between 1978 and 1983, far away from the cities, small agricultural enterprises out of necessity began to raise funds and pay interest on things called “shares” but which more closely resembled fixed income securities. On July 3, 1979, the State Council affirmed this spontaneous practice in a notice saying: “It is permitted to take an appropriate amount of funds from the brigade or production group’s common accumulated funds to put in as (start-up) equity (gu).”

**A. Not Really Privatization**

The Chinese experience with capitalism has been an experiment, not an ideological commitment. The resultant “fits and starts” of progress seem entirely understandable, “since the Chinese governmental mindset has been one based upon balancing: the continued desire to maintain control of state-owned enterprises (“SOEs”) with a need to “monetize” state assets to raise hard currency necessary to finance the retirement and medical-care liability represented by China’s gigantic aging population.”

During his 1992 tour of Southern China, Deng Xiaoping set the stage for the Chinese experiment with the following forward thinking and history-changing words:

> Are securities and the stock market good or bad? Do they entail any dangers? Are they peculiar to

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121 Id. at 280-82.
122 Id. at 5.
123 John F. Cooper, Dean, Stetson Univ. Coll. of Law, Lectures at Nankai University, Tianjin, PRC (July 23 – July 26, 2007).
capitalism? Can socialism make use of them? We allow people to reserve their judgment, but we must try these things out. If, after one or two years of experimentation, they prove feasible, we can expand them. Otherwise, we can put a stop to them and be done with it. We can stop them all at once or gradually, totally or partially. What is there to be afraid of? So long as we keep this attitude, everything will be all right, and we shall not make any major mistakes.124

Concerns about private ownership are so strong in the history of Chinese securities market development that regulators devised a schematic of share types focused on ownership characteristics, rather than the “rights” represented by the shares.125 The share designations are as follows: A, B, H, L, and N, where

- “A shares” represent the largest class of Chinese shares; trading in the local currency (RMB) and are available only to Chinese residents and Qualified Foreign Institutional Investor (“QFII”) holders;126
- “B shares” trade on either the Shanghai (in $U.S.) or Shenzhen ($HK) exchanges; where originally only foreign passport holders could own. Issuers here are usually smaller-cap companies;127
- “H shares” are those of Chinese companies trading on the Hong Kong Stock Exchange;128
- “L shares” are those of Chinese companies trading on the London Stock Exchange;129
- “N shares” are those of Chinese companies trading on the New York Stock Exchange; and130
- “Red Chips” are Hong Kong Incorporated companies trading on the Hong Kong Stock Exchange; with at least 30% of the outstanding shares held by provincial Chinese governments or other state-owned organizations.131

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124 Kister, supra note 18, at 317 (quoting DENG XIAOPING, SELECTED WORKS OF DENG XIAOPING 361 (The Bureau for Compilation and Translation of Works of Marx, Engels, Lenin and Stalin Under the Central Committee of the Communist Party of China trans., Foreign Languages Press 1994)).

125 Id. at 317-18.


127 Kister, supra note 18, at 318; Fung, supra note 126, at 255.

128 Kister, supra note 18, at 318; Fung, supra note 126, at 255.

129 Kister, supra note 18, at 318.

130 Id.

131 Fung, supra note 126, at 256.
B. Regulation Evolves

The task of establishing efficiently functioning securities markets during transition from a centralized government-controlled economy into modern capital markets is mammoth. The odds of successfully building a regulatory framework capable of handling this high-growth, almost-overnight transition from socialistic economic stagnation to pragmatic capital formation, seems beyond comprehension. Given no recent cultural experience, expertise, or appreciation of how capital markets function, it is understandable (even highly probable) that many “experimental” false starts and abrupt changes in strategy have been made on the road toward building the world’s fastest growing significant capital markets.

Emergence of the modern Chinese securities markets happened in an environment where regulators were focused on state-owned shares; highly cautious and concerned that they may be criticized for losing economic control of state assets. Kister points out that regulators “feared that the stock market could open up a channel for the misappropriation or depreciation of state assets, a concept captured by the Chinese phrase, ‘guoyou zichan liushi,’ or simply, ‘liushi,’ for which others could also hold them accountable.”

Since Deng Xioping’s “open door” policy was introduced during 1979, in less than thirty years, China has crafted a multilevel legal framework for regulation of its securities markets. Chenxia Shi observes that, “[t]he Company Law and Securities Law are the main legislative components; the State Council, CSRC, and other regulatory bodies supplement the Laws with administrative regulations and rules.” In describing the Chinese “regulatory fabric” for listed companies and stock exchanges, Chenxia Shi observes that the “regulatory framework . . . began a path of development in the early 1990s. Since then, the National People’s Congress (NPC), State Council, CSRC, and other relevant government agencies have promulgated laws and regulations governing securities markets, stock exchanges, and listed companies.” Shi observes the recent major laws and regulations making up this regulatory framework to include the Securities Law of the People’s Republic of China (“Securities Law”) and the Company Law of the People’s Republic of China

132 Kister, supra note 18, at 318.
133 Id. at 318.
135 Shi, supra note 134, at 458.
(“Company Law”), which regulate the issuing of securities and shares. 136 “Specifically, the Securities Law regulates the establishment and operation of stock exchanges and market intermediaries, information disclosure, insider trading, and market manipulation.”137

The regulatory framework of the securities market also includes supplemental State Council and CSRC regulations. Shi observes that:

These supplemental regulations are necessary because the laws lag behind China’s rapid development; new situations arise which are not covered by existing laws or regulations. To remedy this, the Chinese government established a unified regulatory body (the CSRC) for the securities market with rule-making powers that reports to the State Council.138

Included in these supplemental regulations are the Securities Investment Fund Law; Criminal Law; Administrative Measures on the Separation of Equity Ownership and Trading Rights of Listed Companies; The Measures on the Administration of Stock Exchanges; the Shanghai Stock Exchange Guidelines on Internal Control of Listed Companies; the Code of Corporate Governance for Listed Companies; and Guidelines for Introducing Independent Directors to the Boards of Directors of Listed Companies.139

The catalyst for the development of regulation of its securities markets was China’s accession to the WTO in December 2001:

China made several commitments to the WTO: It would allow foreign securities institutions to trade B shares without a Chinese intermediary; allow offices of foreign securities institutions to become special members of Chinese stock exchanges; permit foreign service suppliers to invest up to 33% in joint ventures for managing domestic securities investment funds; and, within three years of accession (December 2004), permit foreign securities institutions to invest up to 33% in joint ventures to underwrite A, B, and H shares, . . . government bonds, and corporate bonds.140

136 Id. at 459.
137 Id. at 460-61.
138 Id. at 461.
139 Id. at 459-60, 485.
140 Id. at 461.
C. The People’s Bank of China (“PBOC”)

It is to be expected that the Chinese will have difficulty understanding the economic functioning and mechanics of the capital formation process and how to establish efficient securities markets from ground zero.141 So too, it is difficult for Westerners to appreciate the internal struggle that has developed within the bureaucratic machinery that is China. Different agencies competing for “turf” is a considerable part of the history of how PRC securities market regulation has evolved.

Following twenty-five years of Soviet-style central planning, the People’s Bank of China emerged as the sole administrator and supervisor of the Chinese financial sector which includes both bank and non-bank financial institutions.142 Although termed a “central” bank, Walter and Howie observe that this entity was very decentralized “with principal staffing and functions at the provincial level and a staff of a few hundred in Beijing.”143 Further, the PBOC developed close relationships with local governments. This occurred in part because the local party had the right to nominate senior branch staff.144 Although local branches of the PBOC reported on a direct line to Beijing, they “had strong links to local governments and were active proponents of the corporation wave that swept across China in the 1980s.”145 Walter and Howie observe:

Against this background, it is clear that the PBOC was hardly an appropriate candidate to act as the national regulator of a rapidly evolving market-based experiment. Given the marginal nature of the shareholding experiment at the start, however, the government did not conceive of the need for a more independent regulator until much, much later.146

The close relationship between the PBOC and local governments continued to develop:

In 1988 local governments . . . with the active cooperation of local PBOC branches mov[ed] ahead to establish 34 securities companies and 100 trading

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141 See generally WALTER & HOWIE, supra note 11, 5-43 (providing an excellent historical account of the Chinese experience with capital markets).
142 Id.
143 Id. at 46.
144 Id. at 49-50.
145 Id. at 46.
146 Id.
counters across the country . . . Local governments continued to pursue their own best interests together with the local branches of the PBOC, which began to establish their own brokerages. Eight years later, in 1996, the PBOC was the controlling shareholder in 43 of the nationwide total of 96 brokerages, all of which it had approved itself. It was long since clear that the PBOC was at odds with itself.147

Walter and Howie observe that “it is no surprise that the government’s approach to securities markets regulation in the 1980s was haphazard and driven by local developments.”148 Moreover, the 1989 and 1990 hyper-stock craze culminated with August 1992 civil unrest and riots, resulting in the demise of the People’s Bank as market regulator and giving creation to the China Securities Regulatory Commission (“CSRC”) as securities regulator.149

Many instances of false starts and unintended consequences of regulatory action are a major part of the historical development of Chinese securities markets. As noted earlier, a major goal motivating the PRC has been to raise much needed cash for their National Social Security Fund.150 An example of the unintended consequences of misguided market regulation is found in the State Council’s 2001 requirement that 10% of all IPOs and follow-on offerings monetize state-owned shares by inclusion.151

In the four months following this measure, the market dropped by 24.8%.152 Investors reacted with hostility, claiming “the measure was suicidal because its dilutive effect would send prices plummeting and harm multitudes of individual investors.”153 Kister notes that the most troubling aspect of the measure was probably that it required the sale

147 Id. at 47.
148 Id. at 45.
149 Id.
150 Id. at 15.
151 See Kister, supra note 18, at 326-27 n. 93 (“Guowuyuan guanyu jian chi guoyou gu chouji shehui baozhang zijin zanxing banfa [State Council’s Temporary Measure Regarding Selling Down State-Owned Shares and Raising Social Security Fund] (promulgated by the State Council, Jun. 6, 2001), art. 5, available at http://www.molss.gov.cn/correlate/gf200122.html.5. To avoid conflict with the three-year lock-up on promoter’s shares, the measures stated that those issuers that had been established for less than three years would transfer (huabo) its shares to the National Social Security Fund.”). See also HEHONG CHENG ET AL., GUOYOU GUQUAN YANJIU [RESEARCH ON STATE-OWNED EQUITY] 321 (Ping Jiang ed., 2000).
152 Kister, supra note 18, at 327.
153 Id.
of state assets through the market during every initial and follow-on offering:

For investors, this signified the beginning of a long stream of dilutive releases into the market. For conservative politicians, it meant the weakening of a lever of control over the economy that the government had no power to stop arbitrarily. The political pressure grew so intense that the government abandoned the measure on October 23, 2001.¹⁵⁴

D. China Securities Regulatory Commission (“CSRC”)

The early 1990s proved to be a difficult environment for the CSRC to wrestle away regulatory authority from the PBOC and other political bodies seeking to control regulation. Then again, any governmental body seeking to regulate the securities market, “bore the hefty burden of proving its loyalty to socialism, and that therefore the designers of the regulatory framework were concerned not with creating the most rational structure, but with creating the structure that would most likely be accepted politically.”¹⁵⁵

During this time, the early IPOs of the 1990s in China were seemingly an enormous success based on high issuing prices. “Issuing prices of some companies in 1992, for example, represented price-to-earnings ratios of over 100.”¹⁵⁶ Kister observes that these “ski-high” prices had multiple causes: “For one, there was a surging demand for stocks from investors, many of whom lacked financial know-how. Another reason was poor regulatory oversight, which allowed companies to over-value their assets in the appraisal process. Finally, some argue that the CSRC’s price-setting mechanism artificially bolstered issuing prices.”¹⁵⁷

But these high issuing prices were unsustainable and were followed by precipitous falls.¹⁵⁸ Nonetheless, even after sharp price declines, “shares still traded at price-to-earnings multiples several times higher that [sic] those of foreign counterparts.”¹⁵⁹ This prompted concern by the CSRC of “the dilutive effect that the entry of promoters’ shares into the market would have on the prices of

¹⁵⁴ Id.
¹⁵⁵ Id. at 321.
¹⁵⁶ Id. at 319.
¹⁵⁷ Id. at 319-20.
¹⁵⁸ Id. at 320.
¹⁵⁹ Id.
currently trading shares.”

This “added a new reason, on top of existing political and ideological reasons, for limiting the tradability of state and state-owned legal person shares.”

Starting in 1994, the government began imposing non-tradable restrictions on state-owned shares and legal person shares. The restriction applied to both state and state-owned promoters and private companies. “As a result, . . . in the spring of 2005 approximately 69.7% of the shares of listed companies in China were non-tradable, representing 70.9% of the total market capitalization of China’s stock market.”

While the regulatory schematic for China’s securities markets remains in the early stages of development, the PRC’s entry into the World Trade Organization (“WTO”), rocketing economic growth during recent years, and increasing the pace of economic globalization has served as a catalyst for more effective securities market regulation.

Writing in 2005, Terry E. Chang observes that the Chinese securities markets had “outperform[ed] not only the Dow Jones World Emerging Markets Index but also the Nikkei 225 of Japan, the Hang Seng Index of Hong Kong, and the Dow Jones STOXX 600 for Europe.” Chang notes, however, that “despite these phenomenal statistics, the Chinese stock market suffers from seven negative traits. One such negative trait is the “dualist regime” of China:

China’s unique split in the market between government-subsidized and SOEs and private firms–has spawned a stock market with abnormal traits. Many of the irregularities arise from artificial barriers instituted by the CP [Communist Party] (e.g., low float ratio, quota systems, segregated shares, foreign exchange controls). Overall, the result is a market with an uneven consistency and volatility (e.g., where expansion is dominated by IPOs as opposed to share appreciation, by retail as opposed to institutional investors, by small-cap as opposed to blue chip stocks)

\[160\] Id.
\[161\] Id.
\[162\] Id.
\[163\] Id. at 321.
\[165\] Id. at 279.
that is rarely found in mature markets.\textsuperscript{166}

Other negative traits enumerated by Chang are:

1. Distortion in Incentives Produced by Government Ownership of Shares;

2. Political Favoritism of the Quota System;

3. Segregated Share System;

4. For-Ex Controls Block Flows Between PRC and Global Capital Markets.\textsuperscript{167}

E. Shanghai and Shenzhen Markets Develop

As noted previously, Yuwa Wei credits the decision to open the Shanghai and Shenzhen securities markets: "(1) to utilize domestic savings to facilitate social funds and private companies; and (2) to discipline the listed companies and accelerate the pace of building a modern corporate governance system."\textsuperscript{168} The channeling of domestic savings is particularly important to PRC capital formation, since these funds equate to approximately 40\% of China’s GDP.\textsuperscript{169} Wei notes that channeling domestic savings to securities will increase economic efficiency:

Traditionally, domestic savings could only be deposited at state banks that channeled the money into state-owned enterprises as loans. This method was the least efficient use of the money, because a substantial number of the loans were bad. By channeling them to the securities market instead, the government hopes that domestic savings can be allocated more efficiently. Allowing and encouraging citizens to invest in securities increases the likelihood that the money goes to the best performing or most efficient enterprises. These enterprises will, in turn, further advance their economic efficiency.\textsuperscript{170}

The securities business in China has prospered since June 1990

\textsuperscript{166} Id.

\textsuperscript{167} Id. at 297-99.

\textsuperscript{168} Id. at 297-99.

\textsuperscript{169} Id. at 209.

\textsuperscript{169} Id. at 210.

\textsuperscript{170} Id. at 210.
when “citizens in Shanghai, Shenzen, and other business centers began to show great enthusiasm for share investments.”\(^{171}\) The volatility of the early 1990s was followed by a bull market in 1996 and then two years of market stability.\(^{172}\) A record high followed that lasted until 2001, “when the market once again tumbled and a bearish market surfaced.”\(^{173}\)

As noted previously, the Chinese markets produced impressive returns of 98% for the Shenzhen Composite and 130% for the Shanghai Composite during 2006, and produced 163% (Shenzhen) and 97% (Shanghai) returns during 2007; but losses of (30)% in Shenzhen and (36)% for the Shanghai Stock Exchange Composite Indexes during the first five months of 2008.\(^{174}\) By September 26, 2011, the five-year non-inflation adjusted return for the Shenzhen index was 144% and 44% for Shanghai.\(^{175}\) For perspective, these results contrast with a loss of approximately (5)% on the Dow Jones for the comparable period.\(^{176}\)

**F. Is “Stock” Traded on the Shanghai or Shenzen Exchanges a “Security” as Americans Understand the Term?**

Under U.S. law, the term “security” is defined in Section 2(a)(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934.\(^{177}\) Just because an investment is labeled “stock” does not necessarily mean that it fits the definition of “security” for the purpose of the Act(s). For example, the Supreme Court found that the shares of stock in United Housing Foundation, Inc. v. Forman constituted neither an “investment contract” as defined under SEC v. W.J. Howey Co.\(^{178}\) nor the required attributes of ordinary stock.\(^{179}\) The traditional Howey test for an investment contract (therefore “security” under Section 2(a)(1) of the 1933 Act) is: (1) an investment of money; (2) in a “common enterprise”; (3) with an expectation that profits will be derived “solely” through the efforts of others.\(^{180}\) In 1985, the Court adopted a “plain meaning” approach to

\(^{171}\) Id. at 212.

\(^{172}\) Id.

\(^{173}\) Id.

\(^{174}\) Id. at 214; see also BLOOMBERG, supra note 63.

\(^{175}\) Wei, supra note 17, at 214.

\(^{176}\) Id.


\(^{180}\) Howey, 328 U.S. at 298-99.
the statutory definition of a “security” by holding that “stock” necessarily falls within the Act’s coverage if it possesses the following traditional characteristics:

(i) [T]he right to receive dividends contingent upon an apportionment of profits;
(ii) [N]egotiability;
(iii) [T]he ability to be pledged or hypothecated;
(iv) [T]he conferring of voting rights in proportion to the number of shares owned; and
(v) [T]he capacity to appreciate in value.

In the PRC, where “control” is evidenced in listed companies by concentrated ownership, commonly by a single State shareholder, does a “security” exist under either the common language meaning of the term in the United States or under case law? Is it still a “security” by Western standards in situations where effective control of corporate governance rests in State entities which may have an agenda conflicting with the interests of shareholders desiring profits and dividends? For example, state-controlled corporate governance may be driven by a desire to affect: either job subsidy, or the selling of products below market “cost” to achieve a desired social purpose. Professor Donald C. Clarke has observed:

[A]s long as state policy requires the state to stay as an active investor in firms of which it is not the sole shareholder, meaningful legal protection for minority shareholders is going to mean either constraints on the state’s ability to do precisely those things for which it retained majority ownership, or else a de facto separate legal regime for enterprise in which the state is the dominant shareholder.

Share ownership and market participation is inherently risky in a country still struggling to establish an effective rule of law. Terry E. Chang has observed that “[f]oreign investors are discovering that, on the new Chinese frontier, they will not necessarily enjoy the comforts of the legal protections afforded to them by the securities laws of their home countries (e.g., shareholder rights, corporate governance, and

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182 Id. at 686.
judicial enforcement).”

In a state-controlled scenario having a covert agenda of fostering job maintenance, it may prove unlikely that a shareholder will enjoy an unfettered “right to receive dividends contingent upon an apportionment of profits.” In a state-controlled scenario, can it really be possible for a shareholder to enjoy “the conferring of voting rights in proportion to the number of shares owned?” Further, in a situation where the state controls corporate governance, is it realistic for a shareholder to enjoy capacity for unfettered appreciation in value of the “stock” in question?

VI. DEVELOPMENT OF CHINESE CORPORATE LAW

A. The Chinese Corporate Law

Roots of the modern Chinese Legal System are much different from those of many Western nations. It was the Opium War, launched by the British government in 1840, which resulted in a measurable presence of foreign investment, business operations, and what may today be recognized as a “modern business enterprise” having the indicia and introducing the concepts of separate legal entities and limited liability. Prior to 1904, many Chinese family businesses were considered by many commentators to have been the “economic equivalent” of the modern American corporation, in that “the members of large clans worked together not merely out of affection for their kin, but also to accumulate capital and to pursue profits more effectively.” The first Chinese corporation law, patterned on the British Joint Stock Company Act (1856), the British Company Act (1862), and the Japanese Commercial Code (1899), dates back to 1904 (near the end of the Qing Dynasty, which was overthrown in 1911) and is known as the Da Qing Gong Si Lu.

184 Chang, supra note 164, at 281.
185 Gu, supra note 10, at 6.
186 Id.; see also Teemu Ruskola, Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective, 52 STAN. L. REV. 1599, 1605 (2000) (quoting Max Webber stating, “[I]n the absence of a law governing voluntary associations, most businesses were ‘merely’ family businesses”).
187 Gu, supra note 10, at 7.
188 Id.
189 Id.
190 Id.; see also The Principles of the Chinese Company Law (Zhongguo Gongsyi Fa Yuanli) 7-8, The Social Science Documents Press (Beijing) (1998) (stating that “the contents of Da Qing Gong Si Lu could be found in Wang Baoshu and Cui Qingzhi); Graham Brown & Wei Xin, Introduction to Company Law, in China continued . . .
The beginning of relevant modern Chinese legal development dates back only to the 1970s, following the death of Mao Zedong. The Constitution of the People’s Republic of China (the fourth Chinese Constitution since 1949) was adopted at the Fifth Session of the Fifth National People’s Congress and promulgated for implementation by the Proclamation on the National People’s Congress on December 4, 1982. The most recent revision, Amendment Fourth, was approved on March 14, 2004, by the Tenth National People’s Congress at its Second Session.

Formal modern Chinese national company law dates back to only 1993, when the National People’s Congress (the “NPC”) promulgated the Law of the People’s Republic of China (adopted on December 29, 1993 by the Fifth Session of the Standing Committee of the Eighth NPC). The Company Law of the PRC became effective July 1, 1994. The Thirteenth Session of the Standing Committee of the PRC was responsible for revision and re-promulgation on December 25, 1999, and the Eleventh Session of the Standing Committee of the Tenth PRC amended the laws on August 28, 2004. Its most recent revision took place by adoption on October 27, 2005, effective January 1, 2006.

B. The New Company Law (effective January 1, 2006)

Foreign investors in China will find the changes to The New Company Law particularly important since the statutes which govern direct foreign investment in the PRC require that operations by foreign
investors be conducted through a Chinese Limited Liability Company.\textsuperscript{198}

The genesis of the Chinese \textit{New Company Law} may be found in the need to reform SOEs, resulting in many provisions lacking compatibility with the corporate law of many developed countries or regions.\textsuperscript{199} With almost nothing of the old law surviving the 2006 revisions, \textit{The New Company Law} may be considered essentially a nearly complete revision.\textsuperscript{200}

Gu Minkang observes, “The 1993 Company Law cannot be regarded as a well-drafted law for various reasons, such as its short history, insufficient experience, and changeable circumstances during the transitional period.”\textsuperscript{201} Gu cites the following main problems: Chinese Company Law (1) reflects state administrative interference, (2) provides too many benefits and, therefore, preferences SOEs over other kinds of investors, (3) requires too much capital to establish a company, and (4) has substantial systematic flaws that, for example, limit autonomy of internal management, limit the amount of investments a company can make to 50\% of net assets, and provides weak protection for shareholders.\textsuperscript{202}

Gu Minkang contends the following additional defects need to be corrected in Chinese Company law:

1. \textit{To enhance the check and balance relationship between the shareholders’ general meeting and the board of directors [and to create the right of derivative action for shareholders];}

2. \textit{To improve the check and balance relationship between the board of directors and the board of supervisors (or supervisory committee) [and to give the right of appointing and dismissing directors to the board of supervisors]; and}

3. \textit{To improve the mechanism of protecting minority shareholders.}\textsuperscript{203}

\textsuperscript{198} Id.

\textsuperscript{199} Gu, \textit{supra} note 10, at 2.

\textsuperscript{200} Dickinson, \textit{supra} note 194, at 1.

\textsuperscript{201} Gu, \textit{supra} note 10, at 2-3.

\textsuperscript{202} Id. at 3-4 (citing GUO FENG & WANG JIAN, \textit{VERTICAL AND HORIZONTAL DISCUSSION ON REFORM OF THE COMPANY LAW} (Gongsi Fa Xiugai Zhongheng Tan, The Law Press, Beijing 2000).

\textsuperscript{203} Id. at 4; see also Varun Bhat, \textit{Corporate Governance in India: Past, Present, and Suggestions for the Future}, 92 \textit{IOWA L. REV.} 1429 (2007) (describing growth and suggestions for corporate governance architecture of developing countries).
C. Convention on Contracts for the International Sale of Goods ("CISG")

Designed to create a uniform law for the international sale of goods, the United Nations Convention on Contracts for the International Sale of Goods ("CISG") has been the "Magna Carta" for international trade. China was an early adopter of the CISG, signed during 1980; ratified December 11, 1986; and effective January 1, 1988. Non-Asians, seeking to do business in the PRC may find the choice of law, choice of forum, and arbitration provisions of the CISG particularly helpful in structuring their relationships.

D. Arbitration and Dispute Resolution

As discussed more fully elsewhere in this article, China lacks the Western tradition of following the “rule of law” for dispute resolution. Instead, the Chinese culture has resorted to thousands of years of attempting to foster the goal of “harmony” in relationships, while minimizing conflict between families (often these extended ‘families’ have been comparable to Western corporations). The Chinese tradition of seeking the preservation of “harmony” when attempting to resolve disputes “involves drawing in more people involved with the dispute to resolve the difference. It does not appeal to parties, ‘outsiders,’ or non-Chinese to resolve what is essentially seen as a relationship problem.” As a result, parties to the conflict are also unlikely to be satisfied with a decision handed down in the context of the Chinese legal system.

Attorney William Greenlee offers a practical assessment of arbitration and mediation in the Chinese cultural setting. He notes that “there is a strong preference for the resolution of disputes through conciliation–litigation is not favored, and, at least for most, may not be practical.” Because mediation facilitates understanding between...
the parties to reach a solution, it is preferred to arbitration, which uses a “go-between . . . who has authority to render a decision based on the evidence presented by the parties.” Greenlee recognizes, however, that “arbitration is so ingrained in Western business thinking, China is learning to accommodate it.”

E. Bankruptcy

The Civil Procedure Law of the People’s Republic of China, adopted on April 9, 1991, provides in Chapter XIX a “Procedure for Bankruptcy of Enterprises as Legal Persons.” Over ten years in the making, China has been working on a modern bankruptcy regime, producing an “Eighth Draft” of a new bankruptcy law during June 2004, and a “Ninth Draft” from the Legal Committee of the National People’s Congress during 2005. Eu Jin Chua observes that proof of the effectiveness of the new law will be at the provincial level because the procedural idiosyncrasies in the Ninth Draft may make it difficult to implement and enforce against debt-laden enterprises. Additionally, with regard to state-owned enterprises:

The Ninth Draft provides a carve-out (as is the case in

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212 Greenlee, supra note 24, at 13 (noting that this results in about ten million mediators in China and very few arbitrators).

213 Id.

214 Chua, supra note 211, at 135 n.4.

215 Id.

216 Id. at 160.

217 Id. at 161.

some other jurisdictions) for financial institutions and certain [SOEs]. The Ninth Draft now clarifies the extent to which China’s SOEs will be able to avail themselves of the carve-out by stipulating that the State Council will determine the time period and the types of SOEs that will be exempt from the Ninth Draft . . . Both the Eighth Draft and the Ninth Draft contemplate three different procedures: liquidation, reorganization, and conciliation.219

F. Intellectual Property Issues

The field of intellectual property rights, perhaps better than any other area of commerce, illustrates the vast differences between Chinese and Western cultures. Westerners who have not had an opportunity to study Chinese history and culture may be surprised to learn just how dramatically opposed the concept of Western intellectual property rights is to Chinese traditions thousands of years old. Carl Erik Heiberg notes that Confucianism is a major cause of the lack of development of IP rights because it mandates “that all individuals have access to a shared intellectual past.”220 Under Confucian philosophy, individuals “learned by copying the past,”221 and, therefore, copying was not a moral offense but rather “a ‘time-honored learning process’ through which people manifested respect for their ancestors.”222

Heiberg further notes that the first Chinese copyright law was formerly introduced in 1910, just one year before the Qing Dynasty was overthrown,223 and “when Mao Zedong’s Communist Party assumed control of China in 1949, all existing copyright laws were retracted as part of the national expulsion of foreign nationals and Western concepts.”224 Even as Mao Zedong attempted to replace Confucian values with Communist values, views on IP rights did not change because “owning property [in a Socialist system] is tantamount

219 Chua, supra note 211, at 161.
221 Id.
222 Id. (noting that discouragement of individual ownership of ideas was facilitated by a lack of means to mass produce literary works and a low literacy rate and citing Peter K. Yu, The Copyright Divide, 25 CARDOZO L. REV. 331, 361 (2003)).
223 Id.
224 Id.
Class struggles and revolution resulted in many intellectuals being imprisoned, killed, or sent away, and resulted in rampant copyright infringement. The treatment of intellectual property under Mao Zedong cast a shadow on its international reputation long after his death:

After Mao’s death and the end of the Cultural Revolution in 1976, Deng Xiaoping and other leaders sought to renew China’s commercial ties with the United States, Japan, and other Western developed countries. China’s lack of IP legislation and the historical treatment of IP under both Confucianism and socialism understandably made foreign nationals apprehensive about investing their technology and other IP into China. As China began entering into trade agreements with Western nations, foreign countries began pressuring China to enact more protective IP laws.

China’s focus on complying with Intellectual Property requirements of the WTO is credited with strengthening copyright protection in the PRC. China’s poor record of providing protection for intellectual property rights was a serious obstacle toward admittance to the WTO. Heiberg notes, “while WTO membership may have brought about improvements in legislation to reflect international standards, actual enforcement of those standards has remained inadequate.”

In a 2005 copyrighted story by The Economist Newspaper Limited, KPMG advocates adopted ten key strategies for use by multinational companies operating in China to help protect their intellectual property rights:

1. Seek to secure full ownership and managerial control

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226 Id.

227 Id.

228 Id. at 119, 229.

2. Assign budget and responsibilities in internal IPR housekeeping

3. Use direct sales and design outsourcing models

4. Conduct contractual audits on distribution and manufacturing partners; stay in touch

5. Keep tracking, tracing and labeling in control systems

6. Explore the feasibility of uniform pricing and product customization

7. Police inventory and manage the inventory cycle

8. Educate and stay in touch with consumers; send a strong corporate governance message

9. Find allies within the system: domestic enterprises and local officials

10. Avoid lawsuits, but draw on innovative measures when necessary.\(^{230}\)

In 2009, China issued its largest number of patents ever;\(^{231}\) however, “concerns are growing that new patent regulations and other initiatives may damp that growth.”\(^{232}\) In addition, Mark Cohen, an attorney at Jones Day in Beijing, has highlighted concerns that the implementation guidelines issued in January 2010 create “uncertainties that could result in extra expense and delay,” which could be used to disadvantage foreigners.\(^{233}\)

By 2011, China “is expected to spend $153.7 billion on R&D . . . , up from the $141.4 billion [spent in 2010], according to Battelle Memorial Institute . . . By comparison, Japan is expected to spend $144.1 billion [during 2011], up from $142 billion in 2010.”\(^{234}\)

\(^{230}\) Anil

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\(^{232}\) Id.

\(^{233}\) Id.

\(^{234}\) Gautam Naik, China Surpasses Japan in R&D as Powers Shift, WALL ST. J., continued . . .
Gupta and Haiyan Wang report that “China today hosts about 1,000 foreign-owned R&D labs. Yet, with rare exceptions, these labs focus primarily on local adaptations of innovations developed elsewhere, rather than the development of leading-edge technologies and products for global markets.” Gupta and Wang contend that “[i]f it wants to become a global technology leader, China needs open doors, strong intellectual property protection, and no stacking of the deck in favor of Chinese companies – a policy mix exactly opposite to some of its current indigenous innovation measures.”

Of concern, The Wall Street Journal reported an alleged “intellectual-property theft scheme that stretched around the globe, [in which] the U.S. company, American Superconductor Corp. of Devens, Mass., said . . . that it had filed suit in Beijing against China’s biggest wind-turbine maker, Sinovel Wind Group Co.” Accordingly, American accused Sinovel of agreeing to pay more than $1 million to one of American’s employees in Austria, who allegedly stole software that was expected to account for 70% of American’s revenue in 2011, and is now facing criminal charges.

G. U.S. Court Judgments in China: Enforceable?

As economic commerce continues to grow between the United States and China, a question that will increasingly be asked is whether judgments obtained in courts of the United States are enforceable in China. According to Professor Donald Clarke the answer is straightforward; U.S. judgments will not be enforced in China. “Chinese law requires the existence of a treaty or de facto reciprocity in order to enforce a foreign judgment; neither exists between the United States and China.”

Professor Clarke notes that he has found only three cases from China’s modern legal era in which a foreign judgment was


236 Id.


238 Id.


240 Id. (noting that “[t]he basic rule of Chinese law on the enforcement of foreign judgments is set forth in Articles 267 and 268 of the Civil Procedure Law.”).
recognized.\textsuperscript{241} The cases involved uncontested divorce proceedings between Chinese citizens, at least one of whom lived abroad.\textsuperscript{242} The parties in the cases asked merely that the Chinese courts confirm the validity of the foreign divorce decree.\textsuperscript{243} Their requests did not even rise to the level of having the court enforce the judgment.\textsuperscript{244} Thus, it is extremely rare that courts in China would recognize and enforce a judgment from any foreign court, and perhaps even less likely that Chinese courts would enforce a U.S. judgment.\textsuperscript{245}

In short, there is to date no evidence suggesting that a Chinese court would enforce the judgment of a United States court, and considerable evidence suggesting it would not. Parties seeking the assistance of Chinese courts in their disputes should either seek arbitration – arbitration awards from New York Convention member countries are enforceable in China – or litigate in China.\textsuperscript{246}

H. Judicial System and the Practice of Corporate Law in the PRC

Modern Chinese corporate law is very much in its infancy. Writing in 2006, Beijing-based attorney Eu Jin Chua observed an increased reliance upon Chinese law and Chinese dispute resolution organizations because foreign investors often realized, after the close of a deal, that “the relative certainty of law and judicial processes prevailing in the investor’s home states may not exactly be replicated in [the PRC].”\textsuperscript{247} As recently as 1999, before implementation of the Five-Year Peoples’ Court Reform Plan (“First Reform Plan”), it was common to find judges who lacked legal qualifications or any experience with commercial transactions.\textsuperscript{248} Amendments to the Judges Law during 2001 provided for stringent requirements for judges, including a university degree, continuing education, and passing a rigorous national judicial examination (for those judges

\textsuperscript{241} Id. at 3.
\textsuperscript{242} Id.
\textsuperscript{243} Id.
\textsuperscript{244} Id.
\textsuperscript{245} Id.
\textsuperscript{247} Chua, supra note 211, at 133.
\textsuperscript{248} Id. at 137.
appointed after January 1, 2002).\textsuperscript{249} The First Reform Plan (1999) also included anti-corruption regulations, with guidelines regulating the interaction between lawyers and judges and providing for disciplinary sanctions and even criminal liability.\textsuperscript{250}

The lack of legal analysis and reasoning in traditionally written judgments has been a frequent criticism of the Chinese judicial process.\textsuperscript{251} The judgments are often brief and may come as a surprise to sophisticated investors who are more accustomed to the longer opinions provided in most developed judicial systems.\textsuperscript{252} However, according to Chua, the practice is slowly changing. More recent judgments issued by higher-level PRC courts have provided more legal analysis and reasoning behind the decision.\textsuperscript{253} “Although there is no system of binding case precedent in China, such written decisions can at least provide guidance to the public and legal practitioners.”\textsuperscript{254}

The Supreme People’s Court issued the Second Five-Year People’s Court Reform Plan (2004-2008) (“Second Reform Plan”) late in 2005. “The Second Reform Plan attempts to guarantee the financial independence of the courts, adopt a system of using significant cases as guidelines for legal interpretation, and coordinate a consistent understanding of the law across China.”\textsuperscript{255}

What about the conflict between Chinese traditional culture and the transaction structure and corporate law as it is practiced in the West? William Greenlee has offered that “guanxi” may explain the relatively low profile of lawyers in commerce.\textsuperscript{256}

Chinese businesses rely on relationships rather than legal bonds. The increased interaction with the West is bringing with it the greater use of legal instruments. The People’s Republic of China now recognizes that it needs a system of legal enforcement of contracts and that the traditional system (including guanxi) is no longer enough.\textsuperscript{257}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{249} Id.
\item \textsuperscript{250} Id.
\item \textsuperscript{251} Id. at 136.
\item \textsuperscript{252} Id.
\item \textsuperscript{253} Id. at 168, n.10 (stating “For example, the judgments published on the website of Chinese Commercial and Maritime Trial Involving Foreign Elements, available at http://ccmt.org.cn/english/case/index.php (visited May 7, 2006), which are for foreign related cases, all include detailed reasoning”).
\item \textsuperscript{254} Id. at 136.
\item \textsuperscript{255} Id. at 138.
\item \textsuperscript{256} Greenlee, supra note 24, at 12.
\item \textsuperscript{257} Id. at 12-13.
\end{enumerate}
\end{footnotesize}
From a practical standpoint, when entering into a commercial transaction with a Chinese entity, contracts should be drafted in both Chinese and English. It may even be prudent to have such important documents translated twice by independent translators and, then, in order to ensure that the contract language is unambiguous, to compare the two versions.\textsuperscript{258}

If a contract must be approved by Chinese government authorities, it does not become legally binding until an approval certificate is issued.\textsuperscript{259} Such approval by the government generally is not required, but it is important to note that the contracts do not become legally binding upon signature.\textsuperscript{260}

Sida Liu reports that “[e]ven in China, where the legal profession is still in its formative stage, a small sector of elite corporate lawyers has already emerged and controls much of the most profitable and prestigious legal work.”\textsuperscript{261} The nature of legal practice in China appears unusually diversified given the unique client mix of private enterprises, SOEs, and foreign corporations.\textsuperscript{262}

In the past thirty years, corporate law practice in China has changed drastically. It was as recent as only 1992-93 when the privatization process of law firms from state direct control took place.\textsuperscript{263} However, the corporate law market began developing in the late 1970s, when economic reform and revival of the legal system in China began to bring in foreign investment. Transnational law firms then began to enter China’s burgeoning market.\textsuperscript{264} Although foreign lawyers were not allowed to acquire a PRC lawyer’s license or to establish branch offices in mainland China, foreign lawyers conducted most high end corporate law practice in the Chinese legal system. Most local lawyers at the time did not have the expertise to handle complex international transactions because they were state employees working in legal divisions of government agencies.\textsuperscript{265}

The monopoly of foreign firms in corporate law practice in the early 1980s gave way to an emergence of local law firms specializing in transnational legal work in the 1990s.\textsuperscript{266} The government continued

\begin{itemize}
  \item\textsuperscript{258} Id. at 13.
  \item\textsuperscript{259} Id.
  \item\textsuperscript{260} Id.
  \item\textsuperscript{262} Id. at 752.
  \item\textsuperscript{263} Id. at 758.
  \item\textsuperscript{264} Id.
  \item\textsuperscript{265} Id. at 758-59.
  \item\textsuperscript{266} Id. at 759.
\end{itemize}
to restrict licenses for foreign lawyers, and foreign lawyers were not allowed to interpret Chinese law. Thus, local law firms were, and remain today, the only firms permitted to provide formal legal opinions on legal projects involving questions of Chinese law. Consequently, “national barriers to transnational law practice gave birth to these elite local law firms in China.” Commenting on the emergence of local law firms in the corporate law arena, Sida Liu notes:

> With the burgeoning of China’s market economy and the persistent government protection, by 2004, . . . a small number of elite local law firms had grown into crucial players in China’s corporate law market . . . and their practice areas all concentrate on high-end corporate legal work, including foreign direct investment (FDI), banking and finance, securities, mergers and acquisitions (M&A), real estate, corporate litigation and arbitration, and intellectual property . . . Although their collaborations with foreign law firms on big projects (especially FDIs and IPOs) are still frequent, with an increasingly large number of lawyers with foreign law degrees and experience with transnational law practice, these elite local law firms have already acquired great expertise in most areas of corporate law. Most of their lawyers graduated from prominent law schools in China, and the majority of them also obtained law degrees from Britain, the United States, Germany, or Japan.

In 1992, the Ministry of Justice granted twelve foreign law firms the right to establish administrative offices in the mainland. Eight of those firms were from Hong Kong. By 2004, there were 114 foreign law offices and thirty-five Hong Kong law offices in mainland China. Despite a strong foreign presence, local law firms continue to grow stronger and more profitable. “Not surprisingly, local corporate law firms have a wider client base than their foreign counterparts. Foreign companies seeking to make investments in

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267 Id.
268 Id.
269 Id. at 759-60.
270 Id. at 759.
271 Id.
272 Id.
273 Id. at 760.
China, large and wealthy SOEs, and some newly established but successful private enterprises constitute the three major client types for these elite local law firms.²⁷⁴

For both foreigners and seasoned senior managers of Chinese state-owned enterprises, the economic boom in the PRC creates the need to navigate a new “rule of law” minefield. Liu uses the metaphor of “feeding babies” to describe the unique expertise of local Chinese lawyers:

[Even the most experienced and sophisticated foreign companies are sometimes reduced to babies who need to be spoon-fed with culturally contingent legal analyses; likewise, the newness of China’s rule of law and market economy reduces SOE managers and private entrepreneurs to neophytes who must be taught how to behave well.]²⁷⁵

VII. DUTIES AND RESPONSIBILITIES OF DIRECTORS IN A CHINESE SETTING

A. Comparison of U.S. Corporate Governance with that of the PRC

About 190 years ago, Chief Justice Marshall in the Dartmouth College Case, noted that “a corporation is an artificial being, invisible, intangible, and existing only in contemplation of law.”²⁷⁶ U.S. corporate governance has been evolving since that time with particularly formative periods resulting from the “great depression” (the ’33 and ’34 Acts)²⁷⁷ and as an outgrowth of corporate abuses such as Enron, WorldCom, and Adelphia Communications around 2001 (Sarbanes-Oxley legislation).²⁷⁸

China experienced its own securities and corporate governance scandals “involving false statements, misleading disclosure, insider trading, and market manipulation, such as the Qiong Min Yuan case,

²⁷⁴ Id. at 760-61.
²⁷⁵ Id. at 778.
²⁷⁸ Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002); GREGORY V. VARALLO & DANIEL A. DREISBACH, FUNDAMENTALS OF CORPORATE GOVERNANCE (Section of Business Law, American Bar Assn. 1996); see also Leo E. Strine, Jr., The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face, 30 DEL. J. CORP. L. 673 (2005).
the Chengdu Hongguang case, and the Zheng Bai Wen case.\footnote{Wei, supra note 17, at 214; see also Donald C. Clarke, Three Concepts of the Independent Director, 32 DEL. J. CORP. L. 73 (2007).} The “bottom line” is that the U.S. experiment with corporate governance in a free economic system benefits from experience gained over approximately two centuries. The Chinese system, on the other hand, has evolved only within the last decade or so from a tradition of a socialist-controlled economy, suffering from: no business schools, no established accounting profession, untested and illiquid securities markets; no vision or experience as to how securities markets might facilitate capital formation if encouraged to function efficiently, an immature judicial system, and thousands of years of cultural conditioning that has provided no “vision” of corporate governance as practiced in the West.\footnote{Trautman, supra note 3, at 49.}

In terms of economic theory, a pragmatic Chinese government may optimize job creation and enterprise efficiencies by encouraging a policy of delegating the economic function of enterprise growth and efficiency to the “invisible hand” of enlightened corporate governance. Of course, the practical problem then remains of a lack of seasoned corporate management and directors.\footnote{Gu, supra note 10, at 131-39.}

Gu Minkang observes that, similar to the situation in Hong Kong or the U.S., “Chinese Company law does not define the term ‘director.’”\footnote{Id. at 131.} Further,

...some books describe a director as a member of the BOD [Board of Directors] and the legal standing organ of a company for carrying out business. In fact, Taiwanese scholars originated this kind of definition when they interpreted Japanese company law. In line with the continental legal system that Taiwan belongs to, the term ‘director’ means two things. Firstly, a ‘directorship’ is one of the organs of a company, and a director’s act is deemed to be the act of the company. Secondly, a ‘director’ is a person who has a mandate relationship (‘Wei Ren Guan Xi’) with the company, i.e. a director carries out businesses under the authorization of his or her company.\footnote{Id.}
1. Number of Directors

Article 45 of the Chinese Company Law provides that there must be at least three directors in LLCs, and Article 112 provides that there must be at least five directors in JSCs. Neither Hong Kong nor the United States has the same number requirement. As Minkang points out, “[t]he Chinese Company Law fails to address the situation where the number of directors does not satisfy the statutory requirement or how the BOD shall work out a resolution to solve this problem . . . One contributing reason may be the short life of the Chinese Company Law.”\(^\text{284}\)

2. Term of Office for Directors

“Article 47 of the Chinese Company Law requires that the articles of association shall state the term of office of directors.”\(^\text{285}\) However, the term of office shall not exceed three years.\(^\text{286}\)

3. Qualifications

Gu Minkang describes qualification requirements in both positive (where these conditions are required) and negative (if met, dismissal is immediate) terms. These qualifications include:

(a) (i) Nationality: The Chinese Company Law does not provide this kind of limitation and it is particularly easy for foreign investors to take the position of director.\(^\text{287}\)

(b) Requirements of Shareholding Status: As is the case in Japan and Germany, the Chinese Company Law does not require directors to hold qualifying shares.\(^\text{288}\)

(b) “Despite the silence of the Chinese Company Law on the matter of share qualification, companies in China can require directors to be shareholders through their articles of association . . . in line with Chinese legal tradition, if a general law does not specifically prohibit one particular conduct, people may act without suffering legal consequence. Secondly, both Article 22(11) and Article 79(13) authorize companies to provide in

\(^{284}\) Id. at 134.  
\(^{285}\) Id. at 137.  
\(^{286}\) Id.  
\(^{287}\) Id.  
\(^{288}\) Id. at 139.
the articles of association any lawful items that shareholders think necessary. These two provisions indicate a possibility that the articles of association may require directors to have qualifying shares.”

(c) **Legal Person Directors:** Gu Minkang reports that “The Chinese Company Law does not expressly state that a legal person director is not allowed.” Moreover, the remaining issue is whether it is possible to interpret the Chinese Company Law in a positive way. In order to do so, we have to carefully examine relevant theories and practice. The idea of legal person directors is subject to heavy criticism. The Review of the Hong Kong Company Ordinance (Consultant Report) 1997 offered a recommendation that “permitting corporations to be directors cuts directly across current preoccupations of proper exercise of directors’ discretion and board accountability. It should not be permitted.” In China, the Mandatory Provisions for the Articles of Association of Companies Seeking to be Listed outside the PRC which governs Chinese companies listed outside China, clearly excludes a non-natural person from being a director of a company listed outside the PRC. This legal document has clearly indicated that Chinese relevant authorities have considered this issue and hold a negative position. One could argue, however, this legal document only applies to companies listed outside China, especially in Hong Kong. It has no direct connection to the Chinese Company Law, which is silent on the issue. On the other hand, we have seen that in practice, nominee directors (which are equivalent to legal person directors) commonly exist in China. For example, in Sino-foreign joint venture companies, directors are nominated by each party who invests in the companies. Obviously, further research is required before taking a proper position on this matter, but legal person directors should be permitted at least for domestic companies.

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289 Id.
290 Id.
291 Id.
292 Id.
293 Id.
294 Id.
295 Id. at 140.
296 Id.
(d) **Age of Directors**: No specific age limitation is provided by The Chinese Company Law, although most countries provide that for natural persons to have civil capacity, they must be of a specified age.\(^{297}\)

(e) **Dismissal Provisions**: Gu Minkang lists the following situations of business ability, capacity, criminal record or credibility which should result in the automatic disqualification of a director:

1. He or she has no capacity or has restricted capacity for civil acts;
2. He or she was sentenced to criminal punishment for the crime of embezzlement, bribery, seizure of property or misappropriation of property or for undermining the socioeconomic order, and not more than five years have elapsed since the expiration of the enforcement period; or he or she was deprived of his or her political rights for committing a crime, and not more than five years have elapsed since the expiration of the enforcement period;
3. A director, or factory head or manager who was personally responsible for the bankruptcy or liquidation of a company or enterprise due to mismanagement, where not more than three years have elapsed since the date of completion of the bankruptcy or liquidation;
4. A legal representative of a company or enterprise that had its business license revoked for violating the law, where such representative bore individual liability therefore and not more than three years have elapsed since the date of revocation of the business license; and
5. A person with a relatively large amount of personal debts that have fallen due but have not been settled.\(^{298}\)

(f) **Disqualification**: Directors should be automatically disqualified upon the development of any situations specified under Article 57 or 58 of The Chinese Company Law.\(^ {299}\) However, Gu Minkang reports that “without proper procedures stipulated by the Chinese Company Law, directors cannot be
easily disqualified because there is no legal proceeding to protest against any such action.”

What then is a reasonable expectation for the Chinese corporate governance experiment that is now just a few years old? The PRC’s turbo-charged economic growth during recent years seems to have been achieved through a pragmatic borrowing of Western strategies such as the most basic of corporate governance concepts, rather than the earlier version of production-by-state-mandate. Examining basic corporate governance concepts through the prism of Chinese needs, reminds me of a speech I gave many years ago before the Harvard Business School Club of Greater New York on the topic of “What Exactly is Expected of a Director: A Few Thoughts About What They Must Do and What They May Do.” At that time, Roswell B. Perkins of the New York law firm of Debevoise & Plimpton provided a review of the history and issues involved in the decade-plus undertaking by the American Law Institute in their “Corporate Governance Project.” Perkins observed, “[C]orporations must be capable of succeeding in a competitive world environment. This requires entities that can move rapidly and that can take big risks.”

This fundamental foundation calling for strong and effective corporate governance seems just as timely today.

Yuwa Wei makes the case that since “the key task for the Chinese government in establishing a modern enterprise system is introducing modern management mechanisms into China’s state-owned enterprises. Corporatization represents the only effective method to modernize China’s enterprise system.” Yuwa contends this theory follows because the conversion to wholly state-owned companies created problems with insider control, leading to a lack of transparency and oversight over management in those companies. Abuse of power and impropriety by the directors and boards of private companies are also a concern, because of the lack of a statutory framework and clearly defined corporate roles.

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300 Id. at 142.
303 Id. at 1197.
304 Id. at 1197, at 210.
305 Id. supra note 17, at 210.
306 Id.
What then has been the historical view as to what corporate directors must do? Professor Harvey Goldschmid (before Sarbanes-Oxley) narrowed the focus of a board of director’s required functions to the following:

1. The election, evaluation and dismissal, where appropriate, of a corporation’s principal senior executives (perhaps the top six individuals);

2. To review and approve matters that the board or the principal senior executives consider to be major; and

3. Oversee the conduct of the corporation’s business (all major corporate commitments).  

Professor Goldschmid states that a board must set acceptable goals, make sure that management is effectively pursuing those goals, and ensure that the firm is not endangered through exposure to unacceptable risks. Among other things, it is important that directors and the board:

1. Select and elect the Chief Executive Officer and delegate to the CEO all the duties to manage the Company not specifically reserved to the board;

2. Monitor the activities of the management to assure that:
   a. The management is competent, properly structured and staffed; that provisions exist for succession to top management positions; and that programs exist to develop future managers;
   b. The management plans effectively the future activities of the Company;
   c. The management designs adequate targets in performance areas such as the following:
       • Return on investment
       • Capital allocation
       • Personnel management


308 Id. at 55 (citing Trautman, supra note 301).
• Future planning

3. Evaluate the performance of the Chief Executive Officer and other top management executives;

4. Monitor the management of pension funds;

5. Deal with matters that management brings to the Board or that concern the Board;

6. Respond to material issues which stockbrokers, government officials, or other groups may bring to the attention of the Board, either directly or through members of the top management; and

7. Ensure that the board gets all the information it needs to perform its duties (including an acceptable internal audit function with the company). 309

In addition to the above, any foundation for skill-sets germane to the practice of U.S. corporate governance will include an understanding of: the duty of care and business judgment rule, duty of inquiry (duty to be informed), right of reliance, delegation issues, concept of rational belief, issues surrounding burden of proof, and the duty of loyalty. 310

B. Duty of Loyalty

Gu Minkang observes that “even though the Chinese Company Law does not expressly mention the ‘duty of loyalty,’ it can be inferred from several relevant provisions.” 311 Moreover, Article 59 states that directors shall faithfully perform their duties, maintain the interests of the company and not take any advantage of their position, functions and powers to seek personal gain. 312 Article 61 states that directors shall not operate on their own, or operate for others, the same category of business as the company they are serving, or engage in activities which damage the interests of the company. 313 Article 61 targets conflicts of interest, which are commonly seen around the world. 314

309 Id.
310 Id.
311 Gu, supra note 10, at 147.
312 Id.
313 Id.
314 Id.
While the Chinese Company Law does not specifically mention the “duty to exercise powers for proper purposes,” Gu Minkang reports that “this duty could certainly be inferred from Article 59, which says that directors shall not use their position and powers of office to seek personal gains.”

C. Duty of Care

Gu Minkang reports that Chinese Company Law does not expressly provide for a duty of care. Article 63 holds directors liable to pay compensation if they violate the law or articles of association, in a way that damages the company. Though this provision seems to imply that the duty of care is related to a breach of the law and the articles of association, many cases demonstrate that the imposition of personal liability upon directors is rare in practice. However, actions considered to be a breach of the duty of care traditionally give rise to administrative or criminal liability in China. Article 63 of the Law of Wholly State-Owned Enterprises provides for administrative or criminal penalties for parties who cause heavy losses to the enterprise and the State due to errors in his or her work.

D. Disclosure

Professor Nicholas C. Howson states that “the touchstone of U.S. securities regulation is disclosure — the theory being that insofar as participants have adequate knowledge about the value or potential value represented by the abstract instrument that is a share of stock, they should be permitted to make their own purchase or sale transaction decision.” Howson observes that legal mechanisms which provide transparency and protect minority shareholders against oppression and manipulation could lead to a more active market and faster economic growth. Writing in 2005, Howson finds that simply imitating concepts foreign to China would be ineffective because its markets, companies, societal factors, and legal institutions all contain

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315 Id. at 148.
316 Id. at 151.
317 Id.
318 Id.
319 Id.
320 Id.
322 Id. at 241.
unique elements. Some of the considerations that set China apart are the “dominance of state-tied controlling shareholders, the civil law tradition that many Chinese scholars and lawyers feel defines the Chinese legislative and judicial system, and the still-developing court system.”

Even before Sarbanes-Oxley, the role and value of the audit committee had been firmly established as an integral component of corporate governance in the United States. However, as observed earlier, required systems for effective financial audit and control appear to suffer from cultural considerations different from Western concepts of good business practice. Yuwa Wei observes that Chinese law “does not clarify the status of internal auditors. Total subjection to a general manager’s will substantially weakens an auditor’s monitoring power.”

E. Chinese Directors Report to the PRC Government

The state has a dominant role in most Chinese listed-companies. Minority shareholders do not have the influence to change management or select new corporate boards. The dominant shareholder is the state, which has to exercise its shareholder rights through agents. These agents appoint directors, who are likely to remain primarily loyal to the agent that appointed them rather than to the company. Additionally, directors can personally benefit from their appointments by entrenching themselves as de facto owners of their respective companies, thus using the company to pursue private goals rather than protecting the shareholder’s interests. Without any non-insider supervision, directors are free to take advantage of their

323 Id. at 241–42.
326 See discussion supra Part III-C.
327 Wei, supra Part III-C.
328 Id. at 217.
329 Id.
330 Id.
331 Id.
position by taking action such as increasing their compensation and private benefits.\textsuperscript{332}

Because Chinese directors ultimately report to the PRC Government, it may be argued that there is no stand-alone independent corporate governance practiced among Chinese corporations; rather, Chinese corporations remain a political sub-set of the state and shares are the functional equivalent of baseball trading cards at this time. Donald C. Clarke notes that because directors are supposed to be elected by shareholders, it is exactly the intended outcome of the voting system in China’s Company Law for the majority shareholder to out-vote minority shareholders.\textsuperscript{333} Therefore, it is unlikely that directors representing minority shareholders could be elected to a board at all unless there is a fundamental change in the way directors are selected.

F. Two-Tier Board System

Professors Donald C. Clarke and Yuwa Wei provide a helpful description of the relationship between the Chinese company board of supervisors and the independent director.\textsuperscript{334} Chinese company law creates a two-tier board structure with a board of supervisors and a board of directors.\textsuperscript{335} Shareholders elect the board of supervisors, which play an oversight role in the company.\textsuperscript{336} The board of directors plays a relatively active managerial role.\textsuperscript{337}

While Chinese commentators compare China’s model to Germany’s, there are several important differences.\textsuperscript{338} Under the two-tier model in Germany, the shareholders elect the supervisory board, which then elects the company’s board of directors.\textsuperscript{339} Thus, in Germany the board of supervisors has a significant oversight role because it has the power to appoint and dismiss members of the management board.\textsuperscript{340} In contrast to Germany’s model, the board of supervisors in China lacks the ability to effectively monitor management because it does not have the power to elect the

\textsuperscript{332} Id.
\textsuperscript{333} Clarke, \textit{supra} note 183, at 170 & n. 159.
\textsuperscript{334} See id. at 173-75; Wei, supra note 17, at 218; see also Chao Xi, \textit{In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China}, 22 CONN. J. INT’L L. 1 (2006).
\textsuperscript{335} Clarke, \textit{supra} note 183, at 173.
\textsuperscript{336} Id. at 174.
\textsuperscript{337} Id. at 173–74.
\textsuperscript{338} Id. at 174.
\textsuperscript{339} Wei, \textit{supra} note 17, at 218.
\textsuperscript{340} Clarke, \textit{supra} note 183, at 174.
Company shareholders elect both the board of supervisors and the board of directors. In essence, China’s company law “expects the board of supervisors will perform a supervisory role by simply saying that it will, without actually giving the board any significant powers or providing structurally for its independence from those it supervises.”

Since the board of supervisors has no real power, its role in Chinese corporate governance is severely diminished. Clarke further explains that:

In enterprises dominated by state ownership—a significant number—[of] the supervisors are enterprise employees and are subordinate to the head of the enterprise. Indeed, a recent study showing that over half the companies surveyed maintained supervisory boards with only the legal minimum number of members suggests that this institution plays no real role in corporate governance.

Independent directors, however, may be able to step in and fill the necessary monitoring role that the board of supervisors seems unable to perform.

G. Impact of Sarbanes-Oxley

As a reaction to corporate scandals such as Enron, WorldCom, and Adelphia Communications, the Sarbanes-Oxley Act of 2002 contains provisions that require disclosure of governance practices and policies. The “independent director” concept runs heavily through

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341 Wei, supra note 17, at 218.
342 Id.
343 Clarke, supra note 183, at 174.
344 Id.
345 Id. at 174–75.
346 Id. at 175.
347 Sarbanes-Oxley Act, supra note 278.
the corporate governance literature in the West embracing the thought that “the need for non-management directors on the board to serve as a check on management is in the interests of shareholders.”349 According to Gu Minkang, Sarbanes-Oxley has had a significant impact on the development of Chinese securities and company law.350 Moreover, the Deputy Secretary General of the China Securities Regulatory Commission has said that Sarbanes-Oxley is important to Chinese “accounting practice[s], to the regulation of the capital market and to Chinese companies listed in the U.S.”351 While it is worth noting that the act will build healthy corporate governance and set the example for the rest of the world, it is exposing deficiencies in China’s corporate system:

Dr. Wang correctly pointed out that the problem in China is more than a corporate governance issue. ‘The difficulty lies with China’s failure to cope with the market economy, as [SOEs] still dominate the economy. And if the State does not make fundamental changes to become a more market-oriented system, no matter whether the enterprises are State-owned or privately-owned, corporate governance alone cannot solve the problem.’352

H. Director and Officer Liability

Chenxia Shi states that before the recently passed new securities law,

[prev]ious company and securities laws did not provide investors with effective civil remedies, such as the right of class actions. Because of the inadequacy of the laws in this area, investors in the Chinese securities market, particularly minority investors, were susceptible to market manipulation and fraud and were often left without redress.353

However, investors now have more protection after a recent Supreme Court ruling that a company or its directors could be sued upon a
The new law increases the liability of top corporate officials and requires senior management to take a more active role in combating fraud. The new law also reflects the correlation between disclosure and investor protection—“investors rely on publicly disclosed information to make their investment decisions.”

Gu Minkang reports an example of how the new law has been implemented:

[A] director may be free from any personal liability for the loss to his or her company caused by his or her negligence, as long as he or she does not breach the duties imposed by Articles 59 and 62 or if his or her actions are not in violation of the Chinese Company Law, administrative law and the articles of association.

The case of the Jin Hua Department Store Joint Stock Company (hereinafter referred to as the “Jin Hua”) is a typical example. In that case, the chairman of the BOD, Dan Hua, was sentenced to three years’ imprisonment for causing damage in the sum of Y1,041,000 to Jin Hua. The sentence was due to his responsibility for arbitrarily offering Y1,416,000 as the guarantee in Jin Hua’s name for the debts of other companies or other persons. In that case, the other 11 directors didn’t take any responsibility for the loss suffered by Jin Hua and were not asked to pay any compensation for the loss.

I. Role of the Chinese Communist Party in Corporate Governance

The Chinese Communist Party (“CCP”) has traditionally enjoyed a dominant influence in the making of laws, although such an arrangement would not be apparent from a reading of its Constitution. The Communist Party and Government may appear separate in relevant documents, but seem inextricably linked in practice. Sheehy argues that “the law has been a tool of the CCP. While the CCP has

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354 Id. at 228.
355 Id. at 229 (noting that the new law has a number of new requirements that affect senior management and directors: more continuous disclosure, strengthened regulation, and they must “include their opinions in the periodic reports of the company”).
356 Id.
357 Gu, supra note 10, at 151.
been seeking to change this status, change is still at an inchoate stage, and as a result for foreign commercial interests, access to predictable legal outcomes and enforcement has been very limited.\textsuperscript{358}

Westerners may encounter a special problem with their assumption of a “rule of law solution” to disputes within a PRC context under likely future bilateral trade agreements. Accordingly, Benedict Sheehy points out the peculiar results created by bilateral trade agreements, which “usually grant rights to private parties” and thus requires states to answer to citizens of foreign countries for their policies.\textsuperscript{359} This is particularly relevant to, and difficult for, China because the state has neither been forced to answer to its citizens nor has it faced scrutiny in its economic dealings.\textsuperscript{360}

State dominance over corporate governance is vividly illustrated by Donald C. Clarke, as he quotes the Dean of the Changjiang School of Business (who serves as an independent director) as saying, “I have never thought that the independent director is the protector of medium and small shareholders; never think that. My job is first and foremost to protect the interests of the large shareholder, because the large shareholder is the state.”\textsuperscript{361} Sheehy observes that, unlike the Anglo structure of separation of powers, the official view of Chinese governmental structure is based on a unity of powers, where “the CCP, the government, and the people’s will are one . . .”\textsuperscript{362} While the CCP continues to consolidate functions of government in this fashion, the 2002 revision to the CCP constitution reflected the development of social strata in society and the shift from “politics in command” to “economics in demand.”\textsuperscript{363} Even as China ascends to economic power, the CCP makes strong efforts to maintain a “socialist market economy with Chinese characteristics.”\textsuperscript{364} To complicate things further, China’s dictator takes a different view of the government structure:

\begin{quote}
China’s dictatorship has viewed itself as a representative of the people and a democratic dictatorship born out of the coalition of four classes of people mentioned above. This view comes not only
\end{quote}

\begin{itemize}
\item \textsuperscript{358} Sheehy, \textit{supra} note 208, at 226–27.
\item \textsuperscript{359} \textit{Id.} at 261.
\item \textsuperscript{360} \textit{Id.} at 261–62.
\item \textsuperscript{361} Clarke, \textit{supra} note 183, at 171-72.
\item \textsuperscript{362} Sheehy, \textit{supra} note 208, at 234 & n.32.
\item \textsuperscript{363} \textit{Id.} at 235 (noting that the revision recognized “workers, peasants, members of the armed forces, intellectuals and ‘advanced elements’ of other social strata,” each of which being eligible for membership to the Party).
\item \textsuperscript{364} \textit{Id.}
\end{itemize}
from the founding principles of the CCP, which have been subjected to various revisions and reforms, but also from the complex structure of China’s government. With 23 provinces, 5 autonomous regions, 2 special administrative regions and 4 municipalities, all with different amounts of power, China’s government is necessarily complex . . . China also has 56 ethnic minorities and a multitude of CCP organs and civil associations.365

J. Foreign Corrupt Practices Act (“FCPA”)

It is likely that many entrepreneurs have had no occasion to be familiar with the Foreign Corrupt Practices Act (FCPA),366 nor believe it to be applicable to them. More and more, “[f]oreign operations constitute a major source of revenues and earnings for companies as diverse as ExxonMobil, McDonalds, Pfizer, Proctor & Gamble, or Walmart.”367 Trautman and Altenbaumer-Price (2011) observe, “[e]ven if a company is not currently doing business outside the borders of the United States, every director needs to be aware of the risk posed by the provisions of the Foreign Corrupt Practices Act (FCPA) to both the companies they serve and to themselves.”368 Moreover, increased enforcement by the Securities & Exchange Commission (SEC) and Department of Justice (DOJ) should incentivize company directors to be well versed in FCPA because the cost of failure to comply could result in “corporate catastrophe.”369 China and other fast-growing economies are an important illustration of the importance of company directors understanding the FCPA. As U.S. companies increase international commerce with China, they increase their exposure to potential corruption and running afoul of the FCPA.370

While the goal of most businesses may be to operate effectively within foreign markets as an attractive business partner, to the extent that robust business results, the 1977 passage of the United States’ FCPA as amended:371

365 Id. at 235-36.
368 Id. at 147-48.
369 Id. at 148.
370 Id.
. . . prohibits bribery of foreign officials. This prohibition applies to three categories of actors: (1) “issuers”; (2) “domestic concerns”; and (3) other persons who take any act in furtherance of the corrupt payment while within the territory of the United States. “Issuers” are companies whose securities are registered in the United States or that are required to file periodic reports with the SEC. “Domestic concerns” are defined as any U.S. citizen or company incorporated in a U.S. state or territory. Issuers and domestic concerns are both subject to the FCPA’s anti-bribery provisions anywhere in the world where they act.  

Additionally, it is a crime for a U.S. company, or anyone affiliated with the company, to pay or offer to pay a foreign official to do anything that official would not have otherwise been obligated to do absent the payment. Under the FCPA, the official need not actually carry out the act he or she was paid to complete for the U.S. company to face liability. The FCPA also contains “books and records” requirements and internal control provisions dictating that all company transactions be accurately reflected. 

Corruption Threatens China's Future

Trautman and Altenbaumer-Price contend “[b]ecause of the sheer size of China’s economy and the growth in the business and economic relationship between the U.S. and China, the country provides an illustration for the impact of corruption in a given country in light of the rise in FCPA enforcement.” With particular focus on the PRC, Anbound, a consulting company, notes that “of the 500,000 bribery cases investigated in China over the last 10 years, 64 percent involved [non-Chinese] companies.” Failure to contain endemic corruption

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373 *Id.* at 237-38.

374 *Id.* at 238.

375 *Id.*


377 Trautman, *supra* note 367, at 177 (citing Liu Jie, *Slipping Stature, CHINA contin...
among Chinese officials poses one of the most serious threats to the nation's future economic and political stability, reports the Carnegie Endowment for International Peace in its October 2007 study by Minxin Pei. \(^{378}\) Pei, an expert on economic reform and governance in China, argues that corruption "fuels social unrest [and] contributes directly to the rise in socioeconomic inequality," but holds major implications beyond its borders for foreign investment, international law, and environmental protection and roughly 10 percent of government spending, contracts, and transactions is estimated to be used as kickbacks and bribes, or simply stolen. \(^{379}\) Moreover, corruption could endanger economic development in China because, among other things, it undermines the governing institutions, makes inequality worse, and exacerbates public resentment. \(^{380}\) While measuring corruption in China is incredibly difficult because of a more general lack of transparency, official audits, press reports, and official anticorruption data demonstrate the high cost of corruption in China. \(^{381}\) Pei highlights five key findings with regard to corruption in China:

1. Though the Chinese government has more than 1,200 laws, rules and directives against corruption, implementation is spotty and ineffective. The odds of a corrupt official going to jail are less than three percent, making corruption a high-return, low-risk activity. Even low-level officials have the opportunity to amass an illicit fortune of tens of millions of yuan;

2. The amount of money stolen through corruption scandals has risen exponentially since the 1980s. Corruption in China is concentrated in sectors with extensive state involvement, such as infrastructure projects, real estate, government procurement, and financial services. The absence of competitive political process and free press make these high-risk sectors susceptible to fraud, theft, kickbacks, and bribery. The direct costs of corruption could be as much as $86 billion each year;


\(^{379}\) Id.

\(^{380}\) Id.

\(^{381}\) Id.
3. The indirect costs of corruption (efficiency losses; waste; and damage to the environment, public health, education, credibility and morale) are incalculable. Corruption both undermines social stability (sparking tens of thousands of protests each year), and contributes to China's environmental degradation, deterioration of social services, and the rising cost of health care, housing and education;

4. China's corruption also harms Western economic interests, particularly foreign investors who risk environmental, human rights, and financial liabilities, and must compete against rivals who engage in illegal practices to win business in China; and

5. The U.S. government should devote resources to tracking reported cases of corruption in China, increase legal cooperation with China (to prevent illegal immigration by corrupt officials and money laundering), and insist on reforms to China's law-enforcement practices and legal procedures before tracking Chinese fugitives in the United States and recovering assets they have looted.382

"[C]orruption has not yet derailed China's economic rise, sparked a social revolution, or deterred Western investors. But it would be foolish to conclude that the Chinese system has an infinite capacity to absorb the mounting costs of corruption . . . Eventually, growth will falter," writes Minxin Pei.383

Writing in the New York Times, journalist David Barboza reports "prominent corruption cases in China are often the outgrowth of power struggles within the Communist Party, with competing factions using the 'war on corruption' as a tool to eliminate or weaken rivals and their corporate supporters."384 Barboza continues, "[t]his may help explain one of the enduring contradictions of China's political and economic system: the government regularly publicizes an astonishing number of corruption cases, yet little progress seems to be made in uprooting corruption."385

For those desiring more on this topic, James Heffernan explores some of the obligations, both legal and ethical, facing U.S.  

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382 Id.
383 Id.
385 Id.
Corporations and the American attorneys representing them, when faced by authoritarian regimes such as China.  

K. Hong Kong Is Different

Over a decade has now past since Hong Kong returned to Chinese sovereignty on July 1, 1997. Largely because of their different legal and philosophical backgrounds, the development of company law in Hong Kong is heavily influenced from its history as a colony of the United Kingdom. Gu Minkang observes that the Companies Ordinance, along with supplemental legislation, is a large, complex statute that regulates companies in Hong Kong. Hong Kong’s company law, however, will not merge with the rest of China’s law for some time, even though it became part of China in 1997:

Under the policy of “One Country, Two Systems”, it will be quite difficult to have a unified economic system shared by both Hong Kong and the mainland; this will not happen for at least 50 years. In this situation, the governments on both sides will have to operate with a limitation on administrative authority. For example, companies of mainland China can be listed on the Hong Kong Stock Exchanges. According to Hong Kong’s securities law, those companies should be supervised by the Hong Kong authorities. However, authorities in mainland China also have the power to supervise them because they are registered in mainland China.

That being said, efforts have been made to achieve more integration of Hong Kong and mainland China, even though changes to Hong Kong law have been difficult to make due to its diverse population and history. The 2003 “closer economic partnership arrangement” effort and “mutual recognition of judgments in commercial matters” will likely result in more similar laws across all of China.

387 Gu, supra note 10, at 9.
388 Id. at 9-10.
389 Id. at 10.
390 Id. at 10.
391 Id. at 11.
VIII. CONCLUSION

The economic expansion of the PRC seems without historical precedent. It is truly remarkable that such growth has been achieved within a legal framework that is less than thirty years old. Domestic securities markets have been crafted and capital formation infrastructure has been achieved within a scant seventeen-year period. The financial well-being of the global economy seems to depend on continued growth and manufacturing capacity of the PRC. China lacks the Western tradition of using law (or outsiders) to resolve conflicts. Evolving from Confucianism, the traditional Chinese culture places much more emphasis on the nurturing and maintenance of relationships, the vehicle in which Chinese business is conducted.

Shares of common stock in China do not represent the same “ownership interest” or have the same designated rights as in the United States. There is no history of protecting private property as we know it, and the functions of true “free economic markets” (securities or goods and services) have neither been understood nor embraced by officials having a natural cultural instinct for governmental control of economic enterprises. The four major objectives of the PRC government appear to consist of: increasing industrial productivity; seeking foreign exchange; import substitution; and job creation (perhaps the primary goal). Development of capital markets and an efficient framework for capital formation should allow China to tap its internal assets and the resources needed from the rest of the world to finance and fuel the PRC’s impressive economic growth.

However, non-performing loans may continue to comprise a large percent of all banking assets in the PRC. Those engaged in corporate governance either in China or other parts of the world (dealing with Chinese commerce) are well advised to have a heightened sensitivity to the risk introduced by a fragile Chinese banking system. Systems for financial audit and control appear to suffer from cultural considerations different from Western concepts of good business practice.

Because Chinese directors ultimately report to the PRC Government, it may be argued that there is no stand-alone independent corporate governance practiced among Chinese corporations; rather, Chinese corporations remain a political sub-set of the state and shares are the functional equivalent of baseball trading cards at this time.

The economic health and well-being of the PRC and its Western trading partners seem to be co-dependent. All involved have a significant vested interest in making the necessary transaction machinery work. With every passing year, increased commerce should foster a greater awareness of the extent to which the future of
individual members of the global economic community are linked. The economic engine of increased trade brings the promise for increased personal understanding and more probable peace among nations.

However, with less than a decade’s experience attempting to deal with complex questions of corporate law, as would be expected, the PRC is highly challenged by the stresses associated with providing adequate legal-system capacity, implementation of the New Company Law, the hiring and training of adequate numbers of legal professionals for implementation, and an adequate court system for enforcement. Entrepreneurs and corporate directors from Western countries are well advised to conduct their affairs with sensitivity to the cultural and institutional stress resulting from hyper-economic growth in the PRC.