



## On The Improvement of the System of Board of Directors in China

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### **ABSTRACT:**

Currently, shareholder democracy in many countries are gaining much more attention because many factors have damaged shareholder's rights and interest, in which is the problem of the system of board of directors when it operated, including the formalization of the board of directors, the autocracy of managers and staggered boards. To safeguard the legitimate interests of the company and minority shareholders, the system of board of directors is to be improved in following areas: defining the supervision functions and powers of the board of directors, setting up sub-committees within the board, improving the director appointing mechanism and electoral system, improving the director qualification system, abolishing the system of legal representative of company, and improving the system of duty of care and related liabilities.

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## **1.0 Introduction**

At present, in China it stands out that the democratic rights of shareholders in corporate governance are damaged, which has great impact upon the level of corporate governance. Therefore, securities markets in China cannot play its due role. Because there are many defects in company culture, political democracy and legal system in China, Company Law of China does not satisfy the requirement of economic development. There are many problems in the application of the system of board of directors, including the formalization of the board of directors, which is controlled by majority shareholders and seriously damaged the legitimate interests of medium and small shareholders. This article will analyze outstanding problems in the application of the board of directors, discuss the reasons for the problems, and propose appropriate measures to improve the system of board of directors in order to obtain a higher level of corporate governance and protect shareholders rights and interests.

## **2.0 Defects of the System of Board of Directors**

### **2.1 The Board of Directors is controlled by Majority Shareholders (Majority Shareholder Despotism)**

In the case of concentrated ownership structure, due to the nature of shareholder democracy, the nature of capital democracy determines the company's natural advantages for majority shareholder, and it seems to be logically necessary that majority shareholders or controlling shareholders are able to control the board of directors. In this regard, all are affected by this legal constraint.

In China, the shareholding structure is very concentrated because of the dominance of state-owned shares. Although share reform has already been completed and state-owned shares also have been tradable, a lot of state-owned stocks are not traded in stock market in order to lock the controlling stake. On China's securities market, the proportion of capital stock is still low, and one major reason is that many state-owned shares could not be traded. As Chinese shareholders of listed companies are concerned, the feature of "dominance" of majority shareholder is still very prominent.

This kind of dominance allows for a single shareholder to control a company completely, thus the indirect majority shareholder democracy degenerated into a kind of despotism. On the surface, company business decisions are made by the board of directors. However, in fact, it is the majority shareholder who makes business decision and who actually control the board of directors. The board of directors cannot help but become a legitimate tool of the abuse of majority shareholders' rights. Generally controlling shareholders control the board of directors by four ways: (1) control the nomination of candidates for the board of directors; (2) control the source of board members; (3) control the nomination of chairman candidate of the board of directors; and (4) control the motion of removing the member of the board of directors. In China, the listed companies always have a majority shareholder who dominates the company, especially the

dominance of state-owned shares. In addition, in various markets especially in capital market, there is a serious lack of market mechanisms that control and constraint majority shareholder's behavior, thus majority shareholders could put forth motions including director candidates nomination, nomination of chairman candidate of the board of directors, and motion for removing member of the board of directors and motion for dismissal of directors at their own discretion. In this situation, the board of directors turns to be a puppet controlled by majority shareholder. Behind the veil of the board of directors, majority shareholder take advantage of their economic power to damage the legitimate rights and interests of minority shareholder or small and medium investors.

## **2.2 Internal Control: the Authoritarian of Management**

In widely held public company, minority shareholders are difficult to control the company effectively by virtue of their shares. Moreover, even a certain number of minority shareholders together are also difficult to achieve a shareholder resolution in a general shareholders meeting and thus realize shareholder democracy. In such a public company, various constraint mechanisms pointed to the management are ineffective, and in some sense the board of directors is controlled by the executive director of the board and managers, which is known as "internal control".

According to current research and business practice, company management usually takes control of the board of directors in the following ways: First, top manager has final say on the appointment and removal of top executive and chairman of the board of directors. Second, top manager actually has the power to make decisions, including company's organization reform guidance, mergers and acquisitions, and corporate discipline. Third, top manager actually dominate the standing committee, and his influence is much higher than that of the board of directors and chairman of the board. As a result, although the core position of the board of directors is high in word, in all corporate governance legislation, practically, the board of directors often turns to dust, and thus becoming a kind of furnishings. Unluckily, the board of directors could not take effective control on the management, further the former is subject to the management respectfully and gratefully. No wonder people deem that the board of directors is dead. The formalization of the control of the board of directors over the company has become the most worldwide challenge.

## **2.3 Chinese State-owned Company: Management Dictatorship or Autocracy of Chairman of Board of Directors**

First, there is a management dictatorship in the board of directors of state-owned companies. Since most state-owned companies are restructured from state-owned enterprises, the formalization of board of directors has its own characteristics. In such state-owned companies, nominally the board of directors exists and functions, but the director list is controlled by government departments. Government agencies could easily manipulate general shareholders meeting, and thus formally control the board of

directors. In other words, the government will cover the rubber stamp of general shareholders meeting; it is the latter that make resolution to manifest the company's will. The biggest problem is that chairman of the board directors or general manager is the only one who has the biggest authority, the other members actually do nothing but are obedient to him. From this perspective, there is no equal relationship between them. Further, except for the main managers, most members of the board of directors are retirees, thus in a sense the board of directors turns to be an office of retirees. Accordingly, the board of directors inevitably has become an empty shell. The boards of directors not only do not enjoy the right to make business decisions, but also cannot take effective supervision and check on the management. Top managers in fact enjoy all important powers and authorities within the enterprise, and take a paternalistic control over the enterprise. Therefore, in the state-owned company a personal dictatorship or so-called "the dictatorship of manager" stands out.

Second, there is a phenomenon that chairman of the board of directors acts with dogmatism. According to Article 48 in Company Law, in the voting process one director shall represent one vote. On the board of directors, all directors are equal legally, and there is no superior-subordinate relationship between them. Chairman of the board of directors should only act as the convener or host of the meeting of the board of directors in accordance with the articles of association or act as representative of company to deal with external issues. The chairman's functions and duties are mostly procedural and in service issues rather than a special leader for the company. However, in practice, the chairman has become head of the board of directors and other directors subject to him. On board of directors, the other directors submit themselves to the chairman's directions. The chairman often makes decision to form a company resolution at his own discretion while other directors are obedient to him, thus almost no controversy about company resolution does occur. After Company Law is amended, the problems still plague company. The board of directors decision-makings is lack of democracy and rationality, which is becoming an outstanding problem in listed company's internal control. Chairman of board of directors unconscionably abuse power, resulting in failure of internal control, followed by a lot of property fraud and insider trading in which the case of Huang Guangyu, the former chairman of Gome Group Board of Directors, and the former president of China Aviation Oil Singapore, Chen Jiulin, are typical cases.

### **3.0 Legal Reasons of the Formalization of Board of Directors**

#### **3.1 Lack of Internal Supervision Functions and Powers within Board of Directors**

The functions and powers of the board of directors include management and internal supervision. The internal supervision functions involves electing and/or removing of managers, building managers talent pool to ensure that there is qualified candidates to replace substandard managers at any time, supervising on the financial disclosure, information disclosure of company, and business operation of management, evaluating the performance of management, and decide on their remuneration. Indeed, all these

mentioned-above functions and powers are so comprehensive that they almost involve every aspect of the functions and powers of the board of directors. From the provisions of functions and powers of the board of directors in Company Law, it follows that the provisions on the supervision function and powers of the board of directors on behalf of shareholders is not comprehensive. The management could bypass the supervision from the board of directors easily by taking advantage of their information in contrast with the board of directors. Moreover, the management may make use of company property to bribe and capture directors, which will inevitably harm the interests of shareholders and company, and even have an impact upon the interests of stakeholders.

### **3.2 The Defects of the Form of Meeting Employed by Board of Directors**

The board of directors runs in the form of holding meeting, and the latter is easily subject to being controlled by the management. The board of directors is difficulty to exercise their supervision functions and powers proscribed for in Company Law.

On the surface, the meeting of the board of directors is much more democratic and adequately represents shareholders' interests. However, because the board of directors could not hold regular meetings with ease, some company decisions are made by management themselves, namely executive director or chairman of the board of directors. This situation will deviate from the main goal of company, i.e. to maximize shareholders' profit. In addition, the non-executive directors in the board of directors do not participate in actual business and are difficult to directly possess the information needed to make decisions by the board of directors. In other words, the information asymmetry between non-executive directors and management is obvious and great. The problem is that it is difficult for the board of directors to supervise managements without sufficient information.

### **3.3 The Defects in Director Appointment Mechanism and the Lack of Positive Qualification Requirements in Legislation**

There are defects in director appointment mechanism, especially in state-owned companies. In state-owned companies, the directors are appointed by organs of state administration in advance. These directors are treated as state officials and are appointed by the organs of state administration. Administrative appointment mechanism sets aside the principles and mechanisms of checks and balances within companies; the appointees are only responsible to the appointees rather than shareholders. To tell the truth, the shareholders in state-owned companies are more virtual rather than realistic, which makes the internal control mechanism lose effective. Accordingly, it is impossible to maximize the interests of shareholders.

There is a lack of positive qualification requirements for directors in legislation, which has an impact on director selection. From an international perspective, director qualifications

include both positive requirements and negative requirements. Only a few countries and regions did not make provision for director's qualification in their company law. As for as the positive qualifications is concerned, the provisions in those countries and regions generally include nationality, qualification shares held by directors, age and whether a legal person could be a director. Negative requirements mainly involves person without full capacity for civil conduct, with a criminal record, with a bankrupt, and other inappropriate causes as a director. Company law in most countries and regions have made provisions on the identity and qualifications for natural person director, and made by restrictive or prohibitive provisions on director qualifications by law or articles of association. Company law of China also stipulates some negative provisions on director qualifications. Unluckily, Company Law of China does not stipulate the positive requirements for director candidate, which could be regarded as a loophole. If directors do not have the expertise and skills of managing company, it is unimaginable that the board of directors will manage the company very well and will supervise the managements effectively. In practice, that the legislation does not specify the positive qualifications of directors has resulted in a bad outcome, namely the directors with low quality and lay man supervising the experts. The board of directors could not really play their due role, thus the interests of company and shareholders could not be guaranteed properly.

### **3.4 The Defects of the Uniqueness of Legal Representative in Company**

The sole legal representative easily leads to the concentration of powers and the abuse of powers, which is not beneficial to company business. The legal representative of company is a fixed statutory agency in the company which expresses the manifestation of intention of company when the latter contacts with external parties and conducts company business. Company Law of 1998 stipulated that the legal representative is a person, and this position should be held by chairman of the board of directors or general manager, who was granted wide and important functions and duties. In practice, these provisions brought about many problems, such as when the legal representative does not convene the board of directors to perform his duties, and the company is difficult to operate normally, and even some companies will fall into deadlock. Although Company Law was later amended to allow the company to select one as a legal representative from chairman, executive director or general manager. However, if anyone of the above three kinds of people act as the legal representative, it will be inevitably lead to concentration of power and abuse of power, which will have an impact upon the interests of shareholders and company.

The excessive concentration of company powers and authorities is contrary to the idea of company democracy, and it will be detrimental to shareholder democracy. In fact, except for the Legislative bodies in Chinese mainland and Taiwan area, there are no provisions on the legal representative in both legal systems. Further, even chairman of the board of directors is regarded as the legal representative. Even in civil law system, "according to the legal provisions in civil laws in Germany, Japan and Taiwan area, it is a director



who represents the company. If there are many directors, then each director could represent the company except prescribed otherwise by articles of association.”

### 3.5 The Impact of Staggered Board or Classified Board

Staggered or classified board of directors will offset, buff or weaken the effectiveness of the system of cumulative voting rights of shareholders, which is detrimental to the protection of minority shareholders' interests. Staggered or classified board usually turns to be a tool for management to be self-perpetuating.

Staggered board is also known as classified board or board of rotation system. The rules of staggered board are usually specified in the articles of association, so it is also called staggered board clause. This clause often defines different terms of service for directors. The typical practice is that the members of board of directors are divided into several groups, and each group has a different term of service. Therefore, every year only the service term of one group of directors expired, and only the expiring directors were reelected, other directors stay unchanged.

Under cumulative voting system, when more than two director candidates are to be elected in general shareholders meeting, each share is granted with the same votes as the total number of directors to be selected. Shareholders with voting rights may vote for either one candidate or several candidates with all his votes. Under this election regime, the elected directors at last are dependent upon the number of votes that those candidates obtained in the election process. Cumulative voting system aims to prevent large shareholders taking advantage of their economic power to manipulate director election, and this voting system could correct the drawbacks of the principle of one share one vote. Under such a voting system, each share represents not one but with the same number of directors to be elected. The total number of voting rights in director election is equal to the total number of shares multiplied the number of directors to be elected. The voting rights enjoyed by shareholders can be concentrated to one or several candidates to vote for directors. By this kind of local concentration in poll, it can enable minority shareholders to elect directors that represent their own interests, and avoid one outcome that major shareholders elect out all directors.

From the perspective of shareholder democracy, staggered board reduced the effectiveness of shareholder voting rights, thus weakening shareholder rights. In a company with a staggered board, there are only some directors who are re-elected, usually only one third directors, in annual general shareholder meeting. Therefore, shareholders who are not satisfied with the board and try to replace all the incumbent directors should have to go through a three-year period, which seriously damages shareholder's ability to elect out the majority of board of directors and thus take control of the company. In addition, it is difficult to for shareholders to change the direction of company business. We believe that if shareholder voting right can not play its due role in major company issues such as proxy fight or acquisition, we will have sufficient reason to doubt

the real value of shareholder voting right and even it is hard to say the important status of shareholder voting right in Company Law. In fact, some scholars argued that the true value of shareholder voting right can be achieved only in a change of control transaction such as an acquisition, and only in this circumstance shareholder could possess the capacity to change company's business direction. The threat of control transaction shall ensure that managers pay much attention to what shareholder will be concerned about in order to avoid being ousted/expelled from board of directors, which surely will increase managers accountability to shareholders. However, in these situations, staggered board hinder shareholders' ability to change the control of company, thus making shareholders voting rights lose effectiveness. Thus, it could follow from shareholder democracy perspective that staggered board is contrary to the nature of company, corporate governance objectives and shareholders rights, so it has no theoretical rational.

### **3.6 The Vagueness of Director Duty of Care and the Lack of Relevant Liabilities**

Director duty of care means that a director should be careful and try his best in performing his duties and functions as a director, sufficiently exerting his management capabilities in business decision-making, implementation and business supervision. Under duty of care system, if directors violates the duty of care and bring about damages to the company, he should assume related responsibility to compensate the company. From this perspective, duty of care could really play a positive role for directors to exert their business capacities. Theoretically, there are two standards to decide on the duty of care, namely subjective test and objective test. Generally, it should be take an integrated objective test. Specifically, the judgment of duty of care should be in accordance with following way: it should be based upon the similar attention, knowledge and experience of an ordinary prudent director similar position, similar companies and in similar circumstance. However, if the experience, knowledge and qualifications are obviously higher than such test, the test turns to be whether the directors do exert his actual capacities in company business.

Throughout the legislation of duty of care in China, there are some defects needed amending. First, the provisions of duty of care in current Company Law are rather general and abstract, lack of specific criteria and with little practicality. Second, the discrete stipulations of duty of care are in Guidance for Articles of Association of Listed Companies issued by Chinese Securities Supervision and Management Committee. This guidance is a kind of administrative regulations; its ranking in law system is rather low and less rigid (which will has impact on its enforce ability). Moreover, its application scope is narrow and confined to listed companies. Third, there are no related provisions on director's liabilities for breach of duty and exemption for this liability, which is not conducive to compel and encourage directors to perform their functions and powers, and do their best. The vagueness of duty of care makes it difficult to identify the mistakes that directors make, while the lack of legal liability related to duty of care will make it impractical for directors to assume their responsibilities. As a result, directors just muddle along on the board of directors.



## 4. The Path of Improvement and Reform of the Board

### 4.1 Specifically Defining the Supervision Functions of Board of Directors and the Path of Performing Those Functions of Board of Directors

It is a legislation trend to strengthen the functions of board of directors and the internal control in company law, and it is also a response to a global problem that insider control and ineffectiveness of supervision of general shareholder meeting and the board of supervisors. In order to protect the interests of shareholders and company and strengthen the supervision functions of board of directors to keep with the world legislation trend, our legislation should make appropriate provisions:

First, it should be clearly stipulated that the board of directors has a right to control the candidate of managements and to stipulate the managements. The board of directors has authority to establish a pool of manager candidates, and it can propose and/or implement various incentive programs for managements, even could determines the terms of these programs. Second, the powers of board of directors to supervise and control the managers business and financial conduct. Third, the functions of board of directors to supervise and control a variety of risks company business should be stipulated. Theoretically, the board of directors appoints the management and the managers enjoy the authorities granted by the former. The legal relationship between them is a relation of delegation and employment, namely a contract of trust and retaining; the parties rights and duties or obligations should be specified by employment contract. However, given the seriousness of internal control in practice, it may be more conducive to proscribe for these mentioned-above functions of board of directors in legislation in a given period in order that the board of directors could exert their functions and authorities of internal supervision.

### 4.2 Setting up Sub-committees to Overcome the Defects of Meeting Operation of the Board of Directors

To ensure that the board of directors can effectively perform its supervision functions, we should learn from foreign experience and set up specialty division within the board of directors, namely nomination committee, audit committee and remuneration Committee, etc., thus making the Board tends to specialize in order to better fulfill supervision functions. To keep with this trend, China Securities Regulatory Commission issued Corporate Governance Guidelines, in which Section VI makes provisions on six sub-committees. However, the Corporate Governance Guidelines still has two defects. First, the terms of setting up sub-committee is optional and whether setting up these internal organs depends on the resolution of general shareholder meeting, so it is full of uncertainty. Second, the Corporate Governance Guidelines belongs to administrative regulations and with a low legislative level, which will lead these provisions to be lack of rigidity. The relevant reform should focus on enhancing its legislative level and should be proscribed for in the Company Law so as to enhance the rigidity of legal norms. Based

upon the specific provisions in legislation, the company should be encouraged to make innovative institution arrangements within company in accordance with its own conditions and surroundings and Company Law so as to achieve diversification and multiple system of corporate governance, which is undoubtedly a scientific and reasonable choice.

### **4.3 Improving Director Appointing Mechanism and Electoral System**

The mechanism of director appointment in state-owned companies is administrative appointments mechanism, while in other companies with a concentrated holding the problem is that the candidates of director are controlled by majority shareholder or the management. To deal with the mentioned-above problem, the countermeasures to be taken should include prohibiting the administrative appointment of director in state-owned companies, and adopting mandatory cumulative voting system in other companies.

Given that the staggered board has an effect of offsetting or reducing the functions of voting rights and is not conducive to protecting the interests of minority shareholders, the future legislation should explicitly prohibit staggered board and the existing staggered board should be repealed in order to catch up with the trend of corporate governance and shareholder democracy. Accordingly, the director election should take a form in which all directors are to be re-elected annually.

### **4.4 Improving the Director Qualification System**

The requirements for director positive qualifications in Company Law are not clearly defined. As a result, the board of directors is questioned in their business qualities and is claimed to have a poor performance of supervision duties and functions. The establish of the board of director aims to manage the company and make profit on half of shareholders. The legislation should proscribe for positive qualifications of directors, mainly put forward some requirements in director's ability, knowledge and business level and so on. Thus, the elected directors could possess relevant abilities to manage business and make business decisions. The future Company Law should make provisions on positive qualifications, in which the director in a joint-stock company should have professional knowledge, skills and abilities such as law, accounting, economy management, finance or that required for performing their functions and duties. This qualification requirement is reasonable, and it is also conducive to curb the phenomenon of laymen directing experts to some extent.

### **4.5 Abolishing the System of Legal Representative**

The legal representative system, originating from Taiwan Area, has been a feature of Company Law of China. Given the defects of existing legal representative system, many scholars proposed various solutions to deal with its defects. Professor Tang Xin advocated the system of "independent director representation", while Professor Ning Jincheng advocated "abolition of the uniqueness of legal representative and who and how many

people can represent the company should be stipulated in the articles of association.”We deem that the academics have reached an agreement that the system of legal representative should be abolished. In the future amendment of Company Law, the system of legal representative should be abolished. As company external affairs is concerned, Company Law should insist on the idea of company autonomy, and who and how many people can represent the company should be stipulated in the articles of association of the company.

#### 4.6 Improving the System of Duty of Care and Related Liabilities

Duty of care and related liabilities should be improved in the following aspects. First, based upon the principle provision, i.e. abstract stipulation of duty of care for directors, those typical situations of duty of care should be stipulated specifically in Company Law. Second, the test for duty of care should be clearly defined in Company Law, and an integrated objective test for duty of care should be taken. In other words, when a director’s performance of duty of care is determined, it should be determined against a common prudent director with similar attention, knowledge, experience, and in a similar position in similar companies in similar circumstance. It should be based upon whether the director has indeed exerted his capacities honestly. Third, the liabilities and exemptions of liabilities should be proscribed for in legislation when the directors breach the duty of care. Professor Zhu Ciyun etc put out a relatively fair and reasonable proposal, namely directors, supervisors and executives should be liable for the damages incurred to company if they violate duty of care when they perform their duties and functions; they may be exempted from this liability if they could prove their innocence. This kind of legislation will be helpful for both the company and the innocent.

#### 5.0 Conclusion

Improvement of the Board of Directors shall plural and innovate in the main aspects above. However, it needs to be clear that the running of the legal system should also have a good operating environment. Thus, to achieve the real purpose of corporate governance we need economic, political, ideological and cultural and other aspects of construction and provide protection.

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